NAREIM dialogues

SPRING 2022

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NAREIM *dialogues*

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2
From the CEO

ROUNDTABLE

4

Data for a greater good
NAREIM speaks with *Berkshire Residential Investments*, *Blue Vista Capital*, *National Real Estate Advisors*, *PGIM Real Estate* and *USAA Real Estate* about DEI data collection and where data has the most impact on outcomes, not least employee engagement and inclusivity.

14

DEI
Creating equity for underrepresented groups
Jerome Nichols of *Standard Real Estate Investments* and TJ Edwards of *Walker & Dunlop* speak with NAREIM about CREUnited's efforts to move the needle forward for minority- and women-owned businesses, and how to create lasting change in the industry.

18
Reporting standards
DEI and ESG metrics you should prioritize
The Reporting Standards is introducing real estate KPIs for reporting on ESG and DEI.

20
Defined contribution
The organizational glidepath for GPs in DC real estate
DCREC and NAREIM members *JPMorgan Asset Management*, *National Real Estate Advisors* and *Manulife Investment Management* discuss the challenges and opportunities facing managers as they consider, enter and expand in the DC real estate space — and what it takes to become best-in-class post-Covid.

ACQUISITIONS

24

Q&A: Outposts become in demand
NAREIM speaks with Ryan Swehla of *Graceada Partners*.

32
Alts on the rise
Zach Mallow and Terrell Gates, *Virtus Real Estate Capital*

46
After the resilience assessments
Justin M. Lia, *Partner Engineering and Science*

ASSET MANAGEMENT

28

A holistic approach drives ESG results
Nicholas Stein, *Sentinel Real Estate Corporation*

SUSTAINABILITY

38
Taking inspiration from biophilic design
Lauren Winkler, *The Green Cities Company*

CAPITAL RAISING AND IR

42

Securing the future
Deborah Smith, *The CenterCap Group*

Securing *the* FUTURE

Real estate investment managers, both mid-sized and increasingly large, have been looking to insurance companies as a new source of permanent capital for business longevity and value creation.

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By Deborah Smith, The CenterCap Group

A conversation about permanent capital is also one about creating enterprise value; it is not just about making money. But aren't value creation and making money the same thing? Not necessarily. The challenge many investment managers have is what we affectionately call the 'treadmill' problem. It is very difficult to create sustainable value for a company if the manager is simply raising capital for one fund, deploying it, selling assets and then starting all over again. You can make a lot of money and amass a lot of wealth with such a strategy, but it doesn't necessarily translate to long-term platform value creation, or, put another way, long-term business growth.

A discussion about permanent capital isn't just about the middle-market managers. In fact, for those paying attention, it has been the bigger firms that have led the recent wave of securing it.

What is permanent capital?

Permanent capital is the holy grail of the investment manager business. Securing it can be a godsend to the one-fund manager, or it can be the catalyst to take a manager's business to the next level, or both.

Historically, permanent capital was thought of in terms of accessing the public markets. REITs — listed or non-traded, internally or externally managed — have access to the public markets, which, in theory, provide a permanent source of capital.

The internal vs. external managed REIT is interesting in the context of permanent capital. The internally managed REIT is straightforward, but the manager of the externally managed REIT effectively secures the benefits of

“ Permanent capital is the holy grail of the investment manager business. Securing it can be a godsend to the one-fund manager, or it can be the catalyst to take a manager's business to the next level, or both. ”

permanent capital (as the REIT PropCo is public) while the manager itself (OpCo) can be private, and arguably gets to keep the value creation associated with the REIT growth and performance.

The Global Financial Crisis (GFC) opened the door to create public REITs that were managed by private companies, allowing the manager to reap the rewards of access to permanent capital without having to become public themselves. Externally managed REITs are not new; the mortgage REIT industry has had rebirths and progression too, moreso since 2009. Investment managers such as Starwood, Apollo, Blackstone and TPG, were able to create value for their own organizations by generating fee streams associated with permanent capital courtesy of the public markets while remaining private themselves. In addition, many of the largest managers have created permanent capital vehicles geared toward the retail investor courtesy of non-traded REITs.

While the non-traded REIT space has been around for decades, the adoption and capital raising by institutional firms has been meaningful. These vehicles are permanent and many have annual promote calculations. Given the retirement needs of the aging population and the current paucity of current income investment options, we believe non-traded REITs raised a staggering $35 billion in 2021, led by Blackstone Real Estate Income Trust. These vehicles have created the pathway to long-term platform value creation.

Then there is the business development companies (BDCs), another public vehicle catapulted to notoriety after the GFC. BDCs provide a way for retail investors to participate in private operating companies that they otherwise wouldn't have access to. Within the real estate space, there are some familiar names such as Prospect Capital, Golub and Solar to name a few, but Ares, Apollo, KKR, Blackstone and Oaktree all sponsor BDCs too. BDCs don't need to be publicly traded either.

In the fund construct, permanent capital is often liberally thought of in the context of evergreen or open-end funds, which balance the desire for liquidity with the ability to hold assets much longer than the normal 10-year closed-end fund vehicle. With an open-ended structure, there is no termination date where capital can be raised, repaid or transferred on an ongoing basis.

A new source of permanent capital

Insurance companies have become a newer source of permanent capital. Since the end of 2019, there have been at least six large strategic partnerships between insurance companies and investment managers announced or closed.

Apollo Global Management was the first public alternative investment firm to

> “It is more efficient for managers if they can find and solidify a stable, long-term relationship that has the capacity to orchestrate capital inflows in scale.”

invest in an insurance business as a permanent source of capital by backing Athene in 2009. It completed the buy-in of Athene in 2020 in a deal valued at $11 billion. In 2021, three big deals were announced: Adams Street Partners announced it was forming a $2 billion strategic partnership with American Equity Investment Life Insurance, Blackstone Group announced it was acquiring Allstate's life insurance business for $2.8 billion, and AFLAC announced it was committing $1.5 billion to a new real estate credit partnership with Sound Point Capital Management. This was on the heels of three other megadeals — Sun Life Financial acquired a majority stake in Crescent Capital, KKR announced its $4.7 billion acquisition of a 60% stake in Global Atlantic Financial Group, and Carlyle led a group that acquired 97% of AIG's reinsurance business, Fortitude Group Holdings LLC, for $1.8 billion. Permanent capital is going to drive massive AUM growth going forward.

What's an interesting outcome as the industry continues to evolve and permanent capital occupies a growing proportion of a manager's capital sources, is that arguably institutional investors will ultimately have less clout with the investment managers to negotiate terms.

Why insurance company dollars are so attractive

It is easy to simply focus on the megafirms and their deals involving insurance companies; but, given we traffic in the investment management space every day, we can assure you these conversations aren't just happening among the bigger managers. Middle-market managers are waking up to the value creation story too. Whether creating a new insurer, or acquiring a shell or a smaller player in the insurance space, the logic is very much the same — access to permanent capital. The marriage between asset managers, real estate and insurance companies is not new; the likes of Prudential and Metropolitan Life have been big players in the real estate sectors for decades, but today it's the asset managers that are aggressively pursuing insurance capital.

Insurance companies have to hold a lot of capital over long periods because their liabilities are long dated, so they have a lot of capital to put to work. Asset managers can offer attractive yield-based investment options and return on equity. For the asset manager, permanent capital vehicles provide a boost in key metrics — consistent management fees, earning stability and AUM growth — while reducing managers' fundraising costs and reliance on realized performance fees. The fundraising cycle and negotiations with investors around due diligence, terms and economics take time and resources. It is more efficient for managers if they can find and solidify a stable, long-term relationship that has the capacity to orchestrate capital inflows in scale. It also means asset managers aren't under the same types of pressures to exit investments prematurely based on a duration limitation.

However, management fees may be calculated off a percentage of assets (as opposed to a percentage of equity as in traditional funds), and incentive fees may provide greater upside off a lower threshold, depending on the source of investments. For example, Apollo at an investor day presentation in 2020 reported that it collects 40bps of Athene's invested assets plus 100% of return above a 2.5% hurdle (for a relative comparison, Blackstone's non-traded BDC economics are 1.25% on NAV plus 12.5% on the upside). While the megafirms duke it out over the pros and cons of which are the more value-enhancing sources of permanent capital, one thing that's been reported about Apollo's retirement services is, about 10% of Apollo's workforce show up every day to work in retirement services supporting organic capital inflows from Athene of $35 billion annually. How's that for value creation?

The industry is continuing to evolve and an increasing volume of AUM is dedicated to perpetual or permanent capital in nontraditional ways. And it will continue to grow. Insurance companies join the group of vehicles — along with REITs and BDCs — that offer the opportunity for investment managers to move away from the treadmill of returning capital to limited partners and to focus on reinvesting funds, business longevity and value creation. It can be a growth business. It will be a growth business. One casualty may be traditional institutional investors, which arguably will have less clout sometime between now and the future. While no one has a crystal ball to see how that plays out, more change is on the horizon. ◆

Deborah Smith is Co-founder and CEO of The CenterCap Group.