2023 OUTLOOK: THE FROTH IS GONE, BUT OPPORTUNITIES WILL EMERGE

LBX investments

MARKET COMMENTARY JANUARY 30th, 2023

Lenders Have Pulled Back, Cap Rates Have Expanded And Market Conditions Are Tougher

Open Air Retail Remains Well-Positioned, And We See Plays In Strips And Gap Financing

The last half of 2022 was a roller coaster ride in the real estate capital markets. Liquidity for real estate transactions was almost nonexistent, with most lenders on the sidelines and the securitization markets in disarray. As an example, in late December, we closed on a ~$40 million shopping center acquisition in Suburban Philadelphia. From the time when we first won the bid (3Q) through when we closed at year-end, market conditions changed dramatically. Interest rates rose considerably, and available leverage went down. As a result, we had to go back to the seller and negotiate a sharp purchase price reduction in order to provide us and our investors the returns commensurate with the level of risk being taken. We were able to use the dislocation in the capital markets to our advantage and ended up buying a great piece of real estate at an even better basis than initially anticipated. But it was not smooth sailing to get there – we had to rework the entire capital stack and navigate through very choppy waters for a few months in order to execute the transaction.

This sort of volatility was not confined to the retail sector. Formerly hot sectors (e.g. multifamily) went cold. Money center and regional banks, life companies and securitization platforms all pulled back from the commercial real estate lending market, slowing transaction volume sharply[1] and significantly reducing access to debt capital. Muted rent growth expectations impacted underwriting assumptions. Cap rates began to widen after years of compression. We had suggested early last year in our Storm Clouds Are Gathering research piece that ongoing, widespread macroeconomic issues – e.g., war in the Ukraine, inflation, supply chain issues, Fed tightening – were pushing investors to ask uncomfortable questions about the future trajectories of asset valuations and NOI growth across all sectors, and that's exactly how the back half of 2022 ended up playing out.

REMEMBER JANUARY 2022? HOW THINGS CHANGED

MARKET RATES	JANUARY 2022	JUNE 2022	JANUARY 2023
Federal Funds Rate	0% - 0.25%	1.5% - 1.75%	4.25% - 4.50%
10-Year Treasury Rate	1.63%	2.94%	3.80%
SOFR	0.05%	0.80%	4.30%

Source: Eisner Amper

As we kick off 2023, we expect market conditions to remain volatile. In our view, this will create a favorable climate for opportunistic investors over the next 12-24 months. Here are three themes we expect to see this year:

(1) Changes To The Lending Environment Will Present Investment Opportunities Across Sectors

With a recession likely looming, and the real estate capital markets still in a holding pattern, we expect transaction volume to remain muted as we head into 2023. Bid/ask spreads should remain wide as sellers only sell if/when they have to, and buyers become very picky from an asset quality and risk/return perspective. The Mortgage Bankers Association (MBA) is projecting real estate lending volume to drop significantly this year,[2] across both commercial and multifamily.

In talks with brokers and lenders and private equity providers, we are hearing consistent themes emerge, and they all point to more challenging financing conditions for borrowers:

- Most lenders are back in the market but remain tentative – and not all lenders are behaving uniformly. For example:
    - Large money center banks generally remain on the sidelines or have significantly reduced their lending volumes and have become very selective.
    - The securitization markets are still very choppy and have much less liquidity than in more stable times, creating a meaningful hole in the financing markets.
    - Smaller banks (local/regional) are highly selective, as their balance sheets are somewhat full, and they can take a more conservative approach since they are one of only a few active lenders.
    - Life Insurance Companies should have their 2023 allocations and so we expect them to be more active, although they can also be very conservative and selective given the market dynamics.
    - Debt funds – which rely heavily on the larger banks to finance their loan portfolios – are generally on the sidelines.

(1) In the Americas, deal volume dropped by 21% in the third quarter, per Real Capital Analytics.

(2) Total commercial and multifamily mortgage borrowing and lending is expected to fall to $700 billion this year, off 5% from 2022's expected total of $740 billion, and multifamily lending alone is expected to drop to $393 billion, an 11% decline.

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  - In multifamily, agency debt is available for stabilized assets, albeit at lower leverage levels and higher costs of debt, though it has become harder for operators to get to stabilization due to the macroeconomic conditions impacting most markets.
- General lending conditions have deteriorated over the past several months:
  - Proceeds and therefore LTVs are lower, and underwriting is more stringent. It has become more difficult to meet coverage and leverage requirements. Rates and spreads are all up significantly, leading to challenging underwriting metrics. Future funding for prospective leasing / capital improvements is hard to find.
  - Interest-only periods are typically either not available or much shorter than what was available six months ago.

In our view, although this challenging lending climate will make it tougher to get deals done, and harder for acquisitions to underwrite to appropriate returns, **it should simultaneously create attractive investment opportunities for those with access to equity capital and the capabilities to manage through a fraught financing environment.**

First, market sellers who need to shed assets understand cap rates are at wider levels than they saw in the past several years, creating opportunities for bargain-rate acquisitions. We are seeing cap rates widen, for instance, in unanchored strip centers – a traditionally non-institutional retail subsector that continues to perform well and is now offering an attractive risk-return profile. Second, we believe there will be a need for gap financing across many real estate sectors, as many sponsors will encounter financing/leverage challenges as they look to refinance their existing portfolio and will therefore need short- and medium-term financing capital solutions utilizing varying structures including senior debt, preferred equity, mezzanine debt, or even fresh joint venture equity. For example, we are currently evaluating a Class A multifamily opportunity where the borrower requires fresh debt in order to bridge his position until his property underwrites for a more permanent agency takeout. This sort of opportunity could yield a mid-teens return to investors, in a position senior to common equity where, should we have to take the asset back, we would own it at a significant discount to the sponsor's cost basis and to comparable product in the market. **The opportunity for groups like LBX is clear: we can generate attractive risk-adjusted returns, often with high current yields, by providing this type of liquidity to capable operators secured by quality pieces of real estate.**

(2) Open-Air Retail Should Continue To Perform Well, Despite Concerns Around The Economy

While the year has started off with some negative news for a couple higher profile retailers (Bed Bath & Beyond and Party City), the stronger names in the sector – which anchor or shadow-anchor many of our centers – continue to perform well with rock solid balance sheets. In many cases, companies like Ross, Walmart, Target, etc. have seen mild performance declines year-over-year (from the peak of post-Covid sales spikes), but their margins and financial positioning remain very strong.

Leasing across our portfolio has remained strong despite these economic headwinds. We are currently finalizing large leases with national retailers across several sectors (grocery, discounter, food & beverage). **What is predominantly driving retail is that tenant demand for high quality space has remained strong despite economic concerns and market volatility.** While retail sales historically shrink as people have less money to spend, there are several dynamics in place that favor our centers. These include:

- Off-Price Benefits From Consumers Seeking Value: In downturns, consumers tend to adopt more conscious spending approaches, which benefits off-price and discount retailers that comprise a significant portion of our portfolio.
- Hardly Any New Additions to Supply: There have been record low additions to retail supply. Since the Great Recession, additions to the national retail supply have averaged less than 1% of total supply annually. This compares favorably to multifamily (which is on course to add 5% to its total supply this year) and does not take into consideration poorly located or inferior retail that has been permanently taken offline for alternative uses such as multifamily and self-storage.
- Retailer Growth Occurs Both in Downturns and Expansions: Many of the leading retailers – which are publicly traded companies with financial

STRONGER RETAILERS HAVE SEEN PERFORMANCE SLIP VS. 2021, BUT STILL REMAIN VERY STRONG

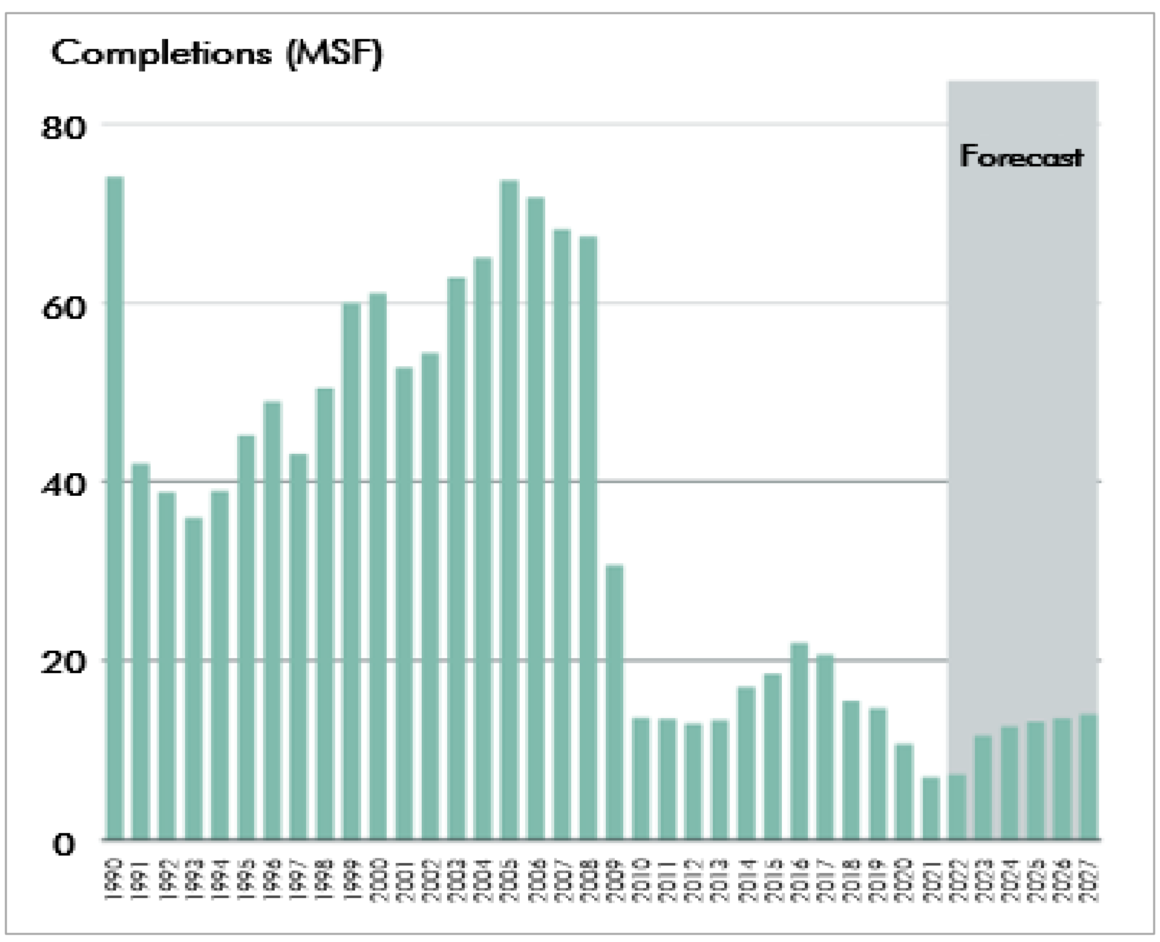
RETAILER	CREDITNTELL RATING	EBITDA MARGIN 2021	EBITDA MARGIN 2022	CHANGE
ROSS DRESS FOR LESS	B1	14.3% (3Q)	13.2% (3Q)	-110 bps
TJX	B1	11.4% (3Q)	11.4% (3Q)	No Change
Walmart	A1	6.4% (3Q)	5.3% (3Q)	-110 bps
ULTA	A2	17.3% (2Q)	19.1% (2Q)	+180 bps
Target	B1	11.1% (3Q)	7.4% (3Q)	-370 bps
HIBBETT SPORTS	B2	16.3% (3Q)	11.6% (3Q)	-470 bps
Burlington	C1	10.9% (3Q)	7.6% (3Q)	330 bps
Foot Locker	B2	13.7% (3Q)	12.1% (3Q)	-160 bps
BEST BUY	B2	8.3% (3Q)	6.5% (3Q)	180 bps

Source: Creditntell

transparency and significant access to capital – have historically opened stores through both economic expansions and recessions, and their balance sheets are generally in great shape. We would expect in a downturn that tenant late payments and/or defaults could rise, but better-positioned centers in strong submarkets would be expected to weather a storm, as they attract the strongest retailers.

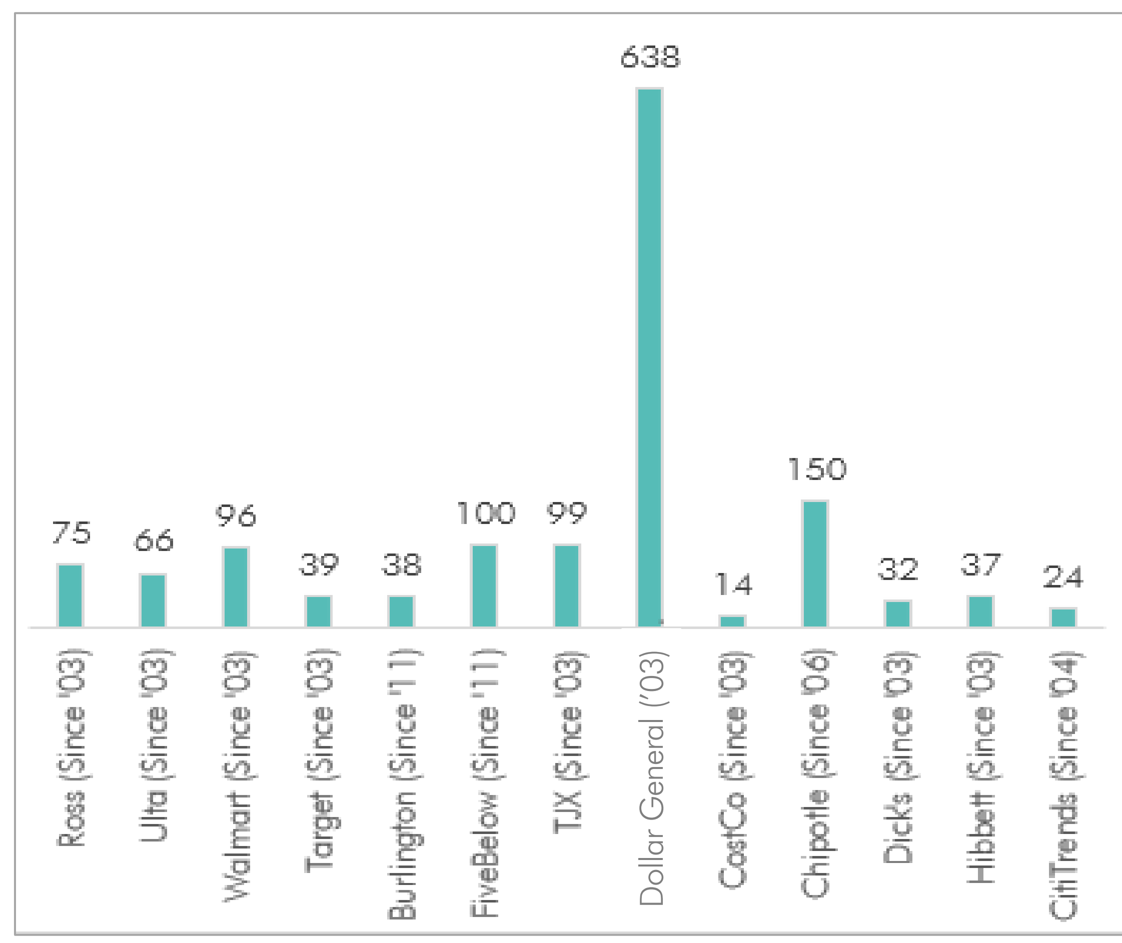
- Positive Leverage: The spread between going-in cap rates and the cost of debt has remained solid. We typically start open-air shopping center deals with at least 200 bps of positive leverage and, through outparcel development/sales and shop-space lease-up, often improve that by 200-400 bps. This creates outsized cash flow and downside protection for our investors day one and compares favorably to sectors where operators need to generate significant rent growth in order to surpass rising interest rates.

NEW CONSTRUCTION, NEIGHBORHOOD & STRIPS



Source: CBRE

AVG. ANNUAL CHANGE IN STORE COUNTS

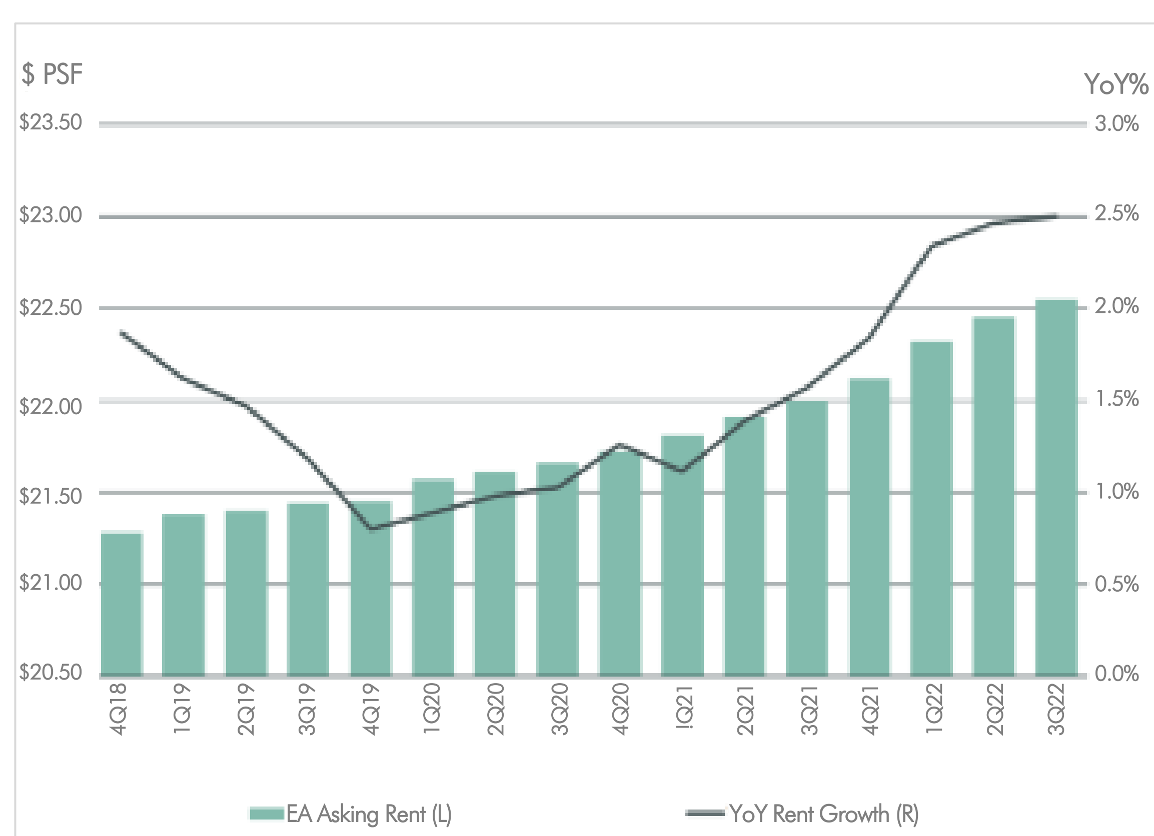


Source: LBX Investments and Company Reports

- Open-Air Occupancy Costs Are Cheaper: Retailers in open air shopping centers tend to maintain low occupancy costs relative to retailers in enclosed shopping malls. Open-air operating expenses (CAM, tax and insurance) that are passed through to tenants tend to be at least $10/SF lower than enclosed malls, making it more attractive for the best retailers to leave malls and relocate to centers like ours.

- E-Commerce Growth Has Slowed: For all the handwringing about Amazon from retail naysayers, e-commerce's growth and penetration of total overall retail sales has slowed over the past couple years. It remains a relatively small (~15%) part of retail sales and brick-and-mortar has enjoyed a revival, as it has demonstrated impressive resiliency since COVID-19 first emerged in 2020. Investors should note two important trends here: first, there is no profitable pure-play e-commerce retailer (i.e., they need a bricks and mortar presence to drive sales and profitability). Second, outside of Amazon, most of the best e-commerce retailers are brick-and-mortar stalwarts like Walmart, Target, Home Depot and Best Buy.

RENT GROWTH HAS BEEN STEADY IN US RETAIL



Source: Aspen Funds

Risks still remain to the sector, particularly in the form of some weaker corporate credits and construction and operating cost inflation. In response, we are being particularly careful underwriting tenant renewal probabilities, capital expenditures and buildout costs. We remain well-protected from rising operating expenses from inflation due to the NNN structure of most of our leases.

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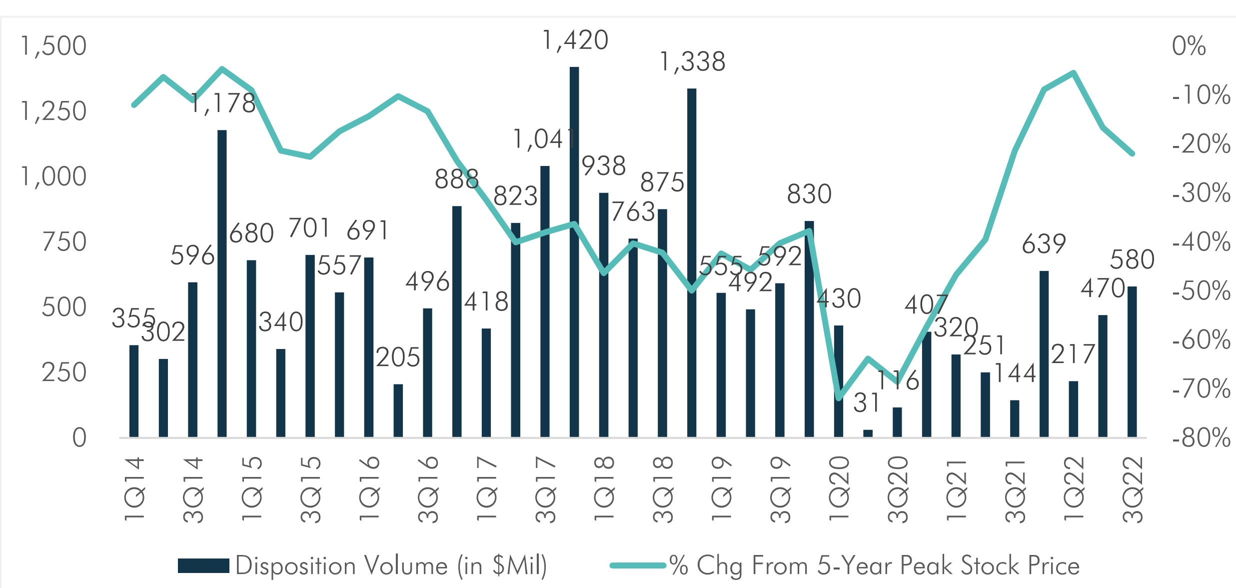
(3) Liquidity Needs Should Trigger Institutional Sales at Attractive Pricing

We expect that institutions will be net sellers of retail in 2023, and therefore anticipate an increase in deal flow from both publicly traded and non-traded REITs, for different reasons.

- Publicly Traded REITs: Market conditions are putting shopping center REITs under pressure to generate cash flow and reduce their leverage. The weaker ones, in particular, have to fund either significant redevelopment pipelines, capital expenditures, stock buybacks or asset purchases in their primary markets. Capital constraints tied to weak public market demand and stock prices have historically led to forced asset sales in order to raise money. We have often bought from the public companies when they are active sellers. In our view, they tend to own high quality real estate, in good markets, and capitalize those assets very effectively. But they do not do all the small things that we do to drive value, which is the opportunity for us when they are selling.

WHEN SHOPPING CENTER REIT STOCK PRICES DROP, THEY HAVE HISTORICALLY TURNED TO ASSET SALES



Source: LBX Investments and Company Reports

- Non-Traded REITs: There was significant press coverage of the public, non-traded REIT market recently because Blackstone's BREIT and Starwood's SREIT – the nation's two largest public non-traded REITs ("NTRs"), opted to limit and prorate investors' redemption requests. Whereas publicly traded REITs are marked to market daily, and provide immediate liquidity for those who want to sell, non-traded REITs are not marked and do not guarantee instant liquidity. The chart below shows the gap between BREIT and public REITs asset valuations from 2018 through November 2022.

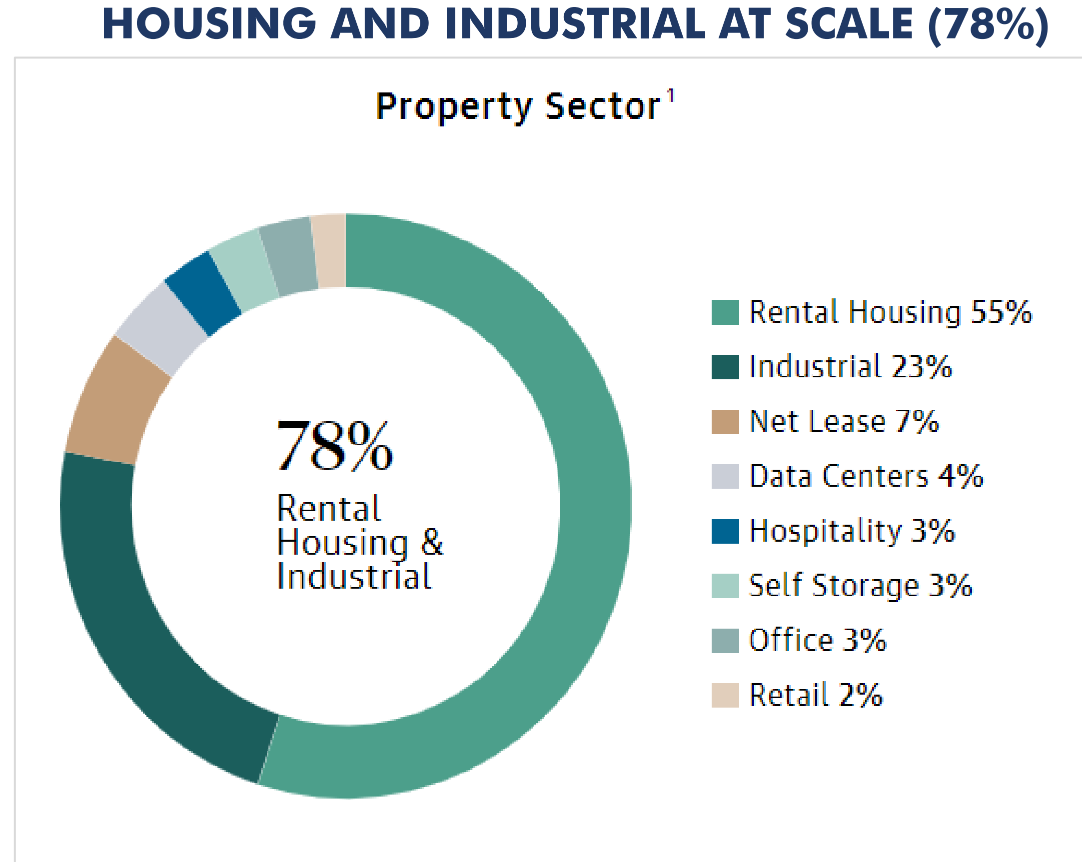
  In our view, the separation in public and private values can only go on for so long. At some point, we expect that NTRs will have to mark their books to market, which could create even more selling pressure, unless they are saved by an overall increase in real estate valuations (which feels unlikely).

What has been overlooked in widespread coverage of the redemptions is that NTRs run a business that is heavily dependent on fees as a percentage of total assets under management. During the low-interest rate boom years, they raised billions of dollars and were significant acquirers of property, helping push asset prices up and cap rates down globally. By some estimates, as much as 50% of the commercial real estate transaction volume was acquired by BREIT and SREIT in the past few years. As prices went up, fees followed (they charge fees on Net Asset Value ("NAV")). This is overly simplistic, but if they were to start selling assets – at scale – into a declining market in order to meet all of their redemption requests, they would need to mark their portfolio to market at lower valuations and their fees would decline dramatically. As a result, the NTRs have started quietly bringing assets that comprise a small portion of their portfolios to market and retail comprises a miniscule portion of their portfolios relative to multifamily and industrial. We expect them to look to shed non-core assets, such as shopping centers, as the year progresses should elevated redemption requests persist. BREIT has already, for example, sold its 49.9% stake in two Las Vegas Hotels to its partner, recouping ~$1.27 billion.

PRIVATE REITS AND PUBLIC APARTMENT REITS' PRICES VS. APPRAISED VALUES – THEY DON'T BEHAVE THE SAME

Source: Real Capital Analytics

BREIT WILL BE MORE LIKELY TO SHED RETAIL ASSETS (2% OF PORTFOLIO) THAN RENTAL HOUSING AND INDUSTRIAL AT SCALE (78%)



Source: Blackstone Public Filings