LOTS OF LIQUIDITY OUT THERE, BUT CLOUDS ARE GATHERING

MARKET COMMENTARY — APRIL 8, 2022

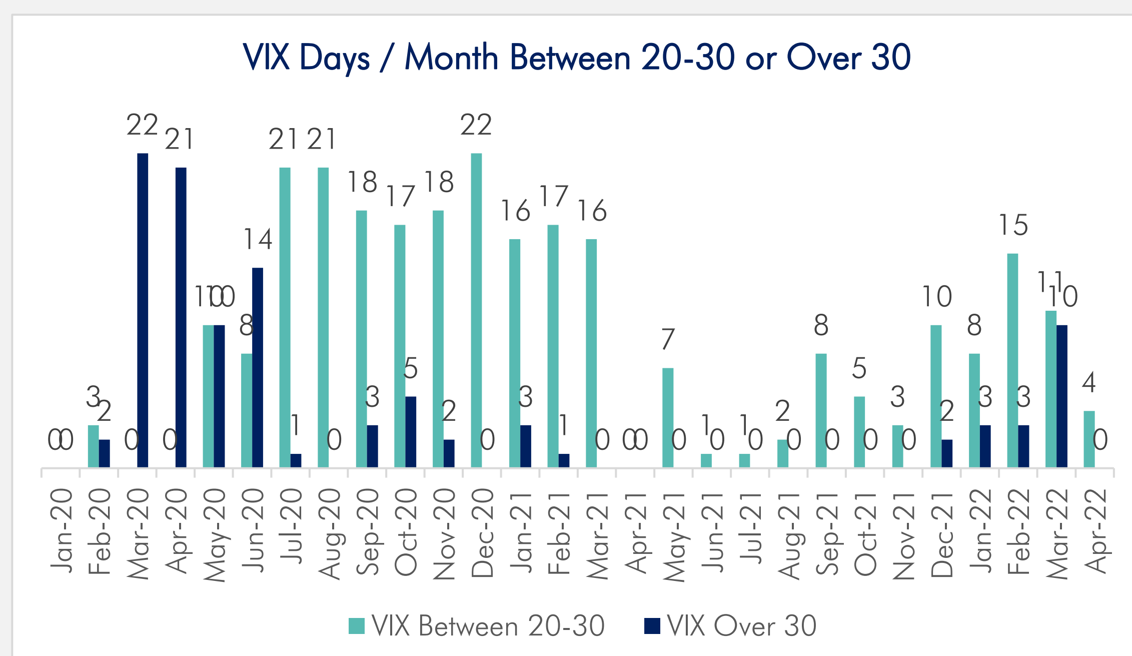
LBX is Positioning Investments to Weather a Potential Slowdown

Fundamentals Remain Strong But Downside Protection is as Important as Ever

For the first time since COVID-19 emerged in 2020, commercial real estate is facing a somewhat uncertain investment climate. Widespread macroeconomic factors – e.g., war, inflation, supply chain issues, Fed tightening and the rising cost of capital – have led to recent market volatility. In turn, this is pushing investors to ask uncomfortable questions about the future trajectories of asset valuations and NOI growth across all sectors. Over the past several weeks, we've fielded questions around leverage, interest rates, and exit cap rates to such an extent that we believe investor risk tolerance may be moderating.

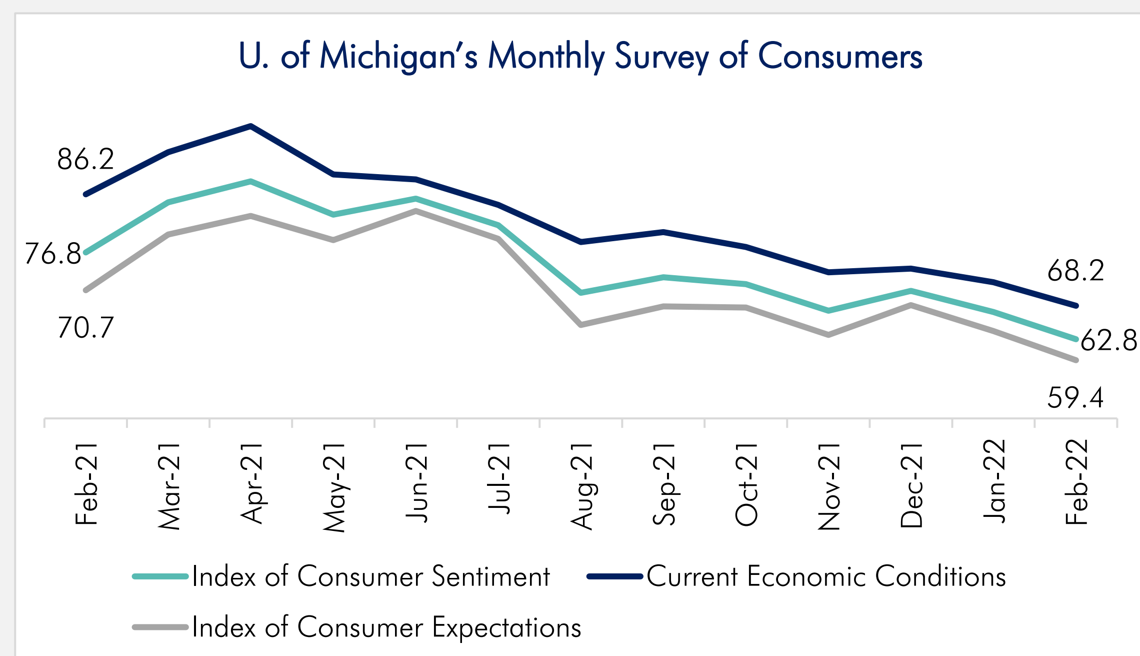
MARKET VOLATILITY IS UP WHILE INVESTOR SENTIMENT IS DOWN

Volatility Has Begun To Approach 2020 Levels Again, Two Years Post-Stimulus



Source: LBX Investments and Yahoo! Finance

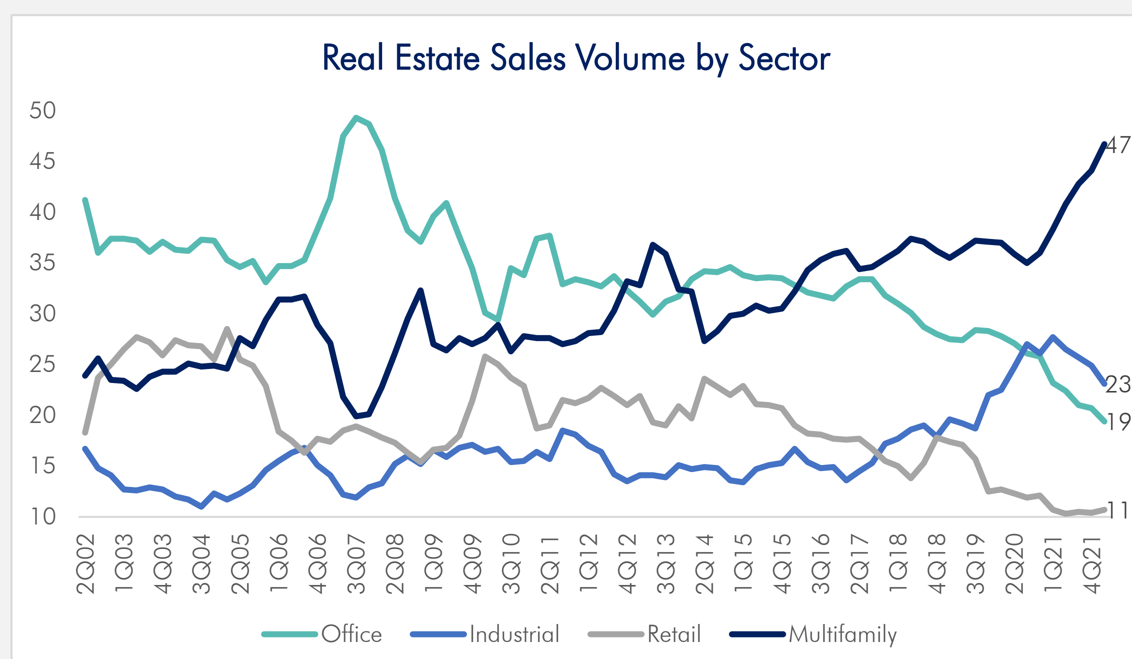
Consumer Perceptions Have Declined Over The Past 12 Months Due To Various Headwinds



Source: University of Michigan

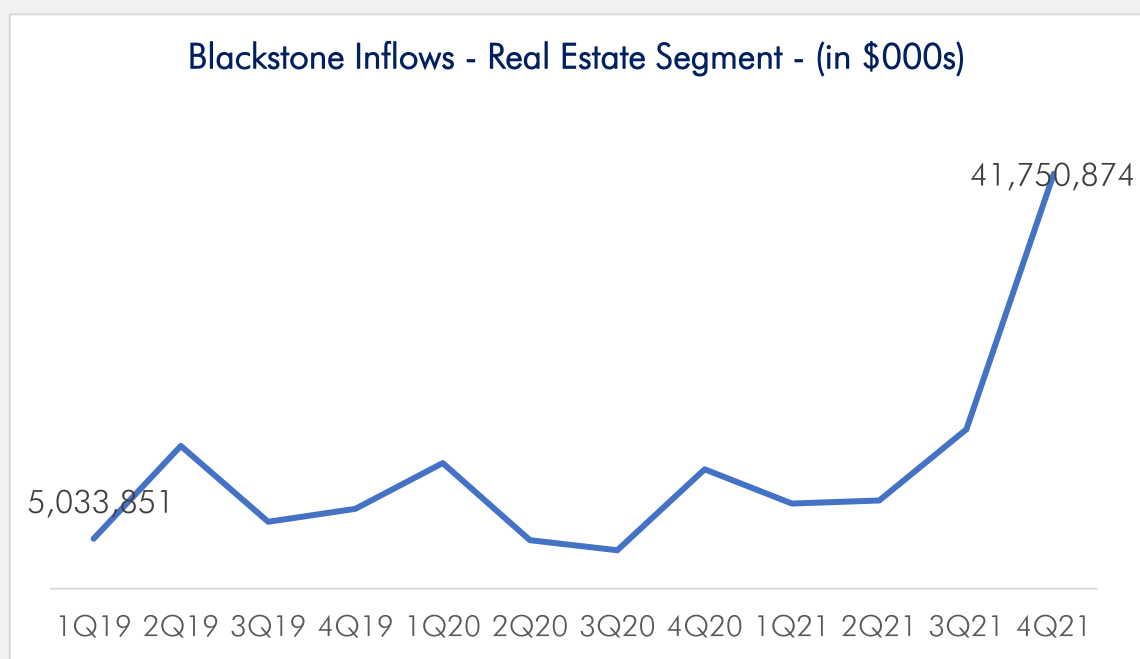
At the same time, unprecedented liquidity continues to drive record transaction volumes and cap rate compression. Blackstone is still raising billions of dollars each month in their non-traded REIT and it is now commonplace for multi-family sales to command cap rates in the very low single digits in many markets. Additionally, record corporate profits, housing shortages, and warehouse demand continue to prop underlying real estate performance. Fundamentals have showed no signs of slowing down.

Apartment Trades Have Spiked While Transaction Volume As A Whole Is Way Up From 2020



Source: CBRE

Blackstone's Real Estate Segment Has Been Seeing Record Quarterly Inflows



Source: Blackstone Public Filings

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What's an investor to do? Sit on your cash and lose to inflation, or invest in deals promising growth that may never materialize? If you're struggling to make sense of today's investment environment, you're not alone. There is a clear tug-of-war between headwinds and tailwinds that was far less prominent a year ago. We can't speak to other sponsors' deals but we can tell you how we are navigating the current climate.

First, at LBX we believe we are very well-positioned to take advantage of market conditions, as retail is arguably the only commercial real estate segment that can offer attractive going-in yields with significant positive leverage right now. We (as always) remain hesitant to overreach for deals, but our team has managed through multiple investment/credit cycles and we are comfortable underwriting and managing retail risk. **We remain bullish on the sector's fundamentals and believe we are well-positioned for the following reasons:**

IN RESPONSE TO COMPRESSED GOING-IN CAP RATES, WE CAN ENTER NEW MARKETS

In 2019, we were acquiring shopping centers at 8-9% cap rates. Many of those centers would trade at significantly lower cap rates today. This holds especially true for shopping centers with grocery anchors, which are in high demand. We were investing primarily in the southeast US, before investing in markets such as Atlanta and Nashville became the hot trend. Now we are finding value in other secondary markets that are not the focus of every publicly traded and institutional retail investor. Our goal is to stay one step ahead of the flock – buy when those large investors are selling, and sell to them when they are buying – and thereby achieve above average risk-adjusted returns.

As we noted in our 2022 Outlook, we have begun to look for attractive yield in new markets, where we can take less risk to achieve it. We look for assets that have strong tenants that operate with consistent, high levels of profitability, and we apply low levels of leverage to those transactions. For example, we are buying a high-quality Target shadow-anchored center in Fort Wayne, Indiana because it's a strong piece of real estate that is almost fully occupied with national credit tenants. While this type of center might trade at a sub-6% cap rate in Atlanta, we can acquire it at close to a 7.3% cap rate, financing the purchase at 65% LTV with debt service coverage of ~2.5x on day one. We can then sell off outparcels to reduce our basis and boost our yield to a 9.0-9.5% cap rate in a relatively quick timeframe. At that point we would have more than 500 bps of positive leverage between our stabilized yield and our cost of debt, and would expect to generate sustained high cash flow for our investors.

WE CAN ACHIEVE NOI GROWTH THANKS TO A COMBINATION OF RETAIL LEASE STRUCTURES AND STRONG LEASING ACTIVITY

Cap rates are unlikely to compress dramatically from this point, which places more emphasis on NOI growth and cash flow as a means of value creation. We have been able to successfully increase our portfolio NOI because we buy well-located centers that – during good times and bad – attract quality tenants. While we do not bank heavily on rent growth (we typically underwrite market rent growth at 1% annually), we have seen leasing spreads in our portfolio of +23% vs. average base rents at acquisition – a huge increase. We continue to underwrite low-to-moderate rent growth on new acquisitions to be conservative but, **should inflation persist at high levels, we would expect to see increased rental rates as leases extend or rollover because the underlying quality of our real estate gives us a degree of pricing power with our tenants.**

On the expense side of the equation, shopping centers are well-insulated from inflation. Retail typically operates with triple net ("NNN") leases, which are a big advantage when compared to other sectors such as multifamily, where landlords need to shoulder more of the expense burden. As landlords, if we own a well-occupied center, we will typically pass through almost all of our expenses to the tenants, who absorb the inflation. We hear many investors talk about the potential rental increases coming as a result of inflation. Our view is that inflation will have an outsized negative impact on costs which is likely to outweigh the benefit of rental growth. **Open-air shopping centers are more protected from expense inflation than any real estate sector.**

Over the past couple years, in turn, stronger retailers have broadly been able to pass through their costs to their customers, as evidenced by their improving profit margins. We do look closely at total occupancy cost for our retailers, but if a store is performing well at a strong shopping center, it will likely remain there.

EXIT CAPS MAY RISE, BUT A LARGE PART OF OUR TARGET RETURNS COME FROM CASH FLOW, NOT GROWTH PROJECTIONS

Retail offers attractive going-in yields when compared to other real estate sectors. While rising interest rates can have an adverse impact on exit cap rates down the road, retail should be less sensitive to this condition than other sectors because a higher percentage of retail's targeted returns (IRRs) come from stable cash flow from operations. A multi-family deal that relies primarily on rent growth and exit cap rate assumptions to hit targeted returns is higher risk, in our view.

DESPITE RISING INTEREST RATES, WE PRIORITIZE FINANCIAL FLEXIBILITY

Investors are focused on financing costs, which have risen recently, and are widely expected to continue to do so. For example, we have seen rates on our deals increase by ~50-75 bps since the beginning of the year, and SOFR (the floating rate index) is beginning to rise as well.

We are still able to maintain attractive debt service coverage ratios, however, because we employ moderate leverage. Typical LTVs in our sector rarely top 70%. As financing environments become more challenging, we believe that working with relationship lenders gives us a big advantage. We structure our deals to protect our equity, and during a slowdown, rigid debt can become a real problem. LBX typically works with relationship lenders for this reason; banks and life insurance companies are often more flexible lenders and their loans can be customized to the needs of the investment.

STRONGER RETAILERS HAVE BEEN PASSING THROUGH SUPPLY CHAIN COSTS AND INCREASING THEIR MARGINS

	Walmart 4Q22: EBITDA and EBITDA margin rose 3.5% and 10 bps, respectively, despite $400 million in increased supply chain costs. The Company appears to be navigating supply chain issues and managed an almost 26% increase in inventory going into FY23.
	Ross 4Q21: Increased sales and gross margin expansion lifted quarterly EBITDA 18% to $598.7 million. EBITDA margin remained flat at 11.7%
	Target 4Q21: EBITDA gained 17% and EBITDA margin expanded 60 bps.
	TJX 4Q22: 4Q22 EBITDA and EBITDA margin increased 38% and 80 bps, respectively, compared to 4Q21, due to higher sales and leveraging operating costs, despite lower gross margin.
	Ulta: Sales growth, along with the leveraging of fixed costs, improved merchandise margins and favorable channel mix shifts, drove gross margin up 730 bps in FY21. This, combined with an 80 bps improvement in SG&A margin drove FY21 EBITDA up nearly 150% to $1.61 billion, with EBITDA margin expanding 820 bps to 18.7%.

Source: Creditntell