Firm/Strategy Update: Nuveen Global Cities REIT

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Son Le, Pat Burkett, Kevin Buskirk, Will Volkman, had a Zoom meeting with Richard Kimble (PM), Gracie Coburn (Assistant PM), Trey Eno, Zarchary Savage on 5.8.2023

Key Takeaways:

- **Fund**: Despite recent negative returns and significant redemptions in Q1 2023, the Fund is optimistic about its position due to the assets acquired in H2 2022 and its ability to meet all redemption requests, resulting in net positive cash flows in Q1 2023.

- **General Market:** The fundamentals of real estate remain strong, and the Fund views 2023 as a strategic entry point for actively seeking deals, given the current capital market conditions and belief that market valuations have bottomed out.
- **Office Building**: The office sector of commercial real estate is undergoing significant transition post-COVID-19, but the overall debt issues of this sector are smaller than perceived and are mitigated by more disciplined and healthier lending practices.
- **Industrial**: Despite slower growth, strong demand for industrial real estate coupled with insufficient supply and low vacancy rates underscore robust market fundamentals, making it a lucrative area for investment.
- **Health care:** The Fund sees significant value in healthcare properties like medical offices and life science buildings, fueled by strong demand drivers such as the aging population and ongoing research efforts, despite pockets of oversupply in major life science clusters.
- **Apartment:** Though there may be temporary softness in the luxury apartment market, the Fund anticipates potential acquisition opportunities due to an overall housing shortage in the US and expects the rental housing market's issues to be short-lived.
- **Single Family:** The Fund’s active participation in the single-family home rental market, coupled with a unique acquisition strategy and rising interest rates, could present opportunities to buy more properties at better prices.
- **Retail**: The retail sector, particularly grocery-anchored properties, is seeing strength due to a stop in overbuilding and the repurposing of outdated centers, resulting in the lowest vacancy rates in a decade.
- **Storage:** The Manager aims to add value by identifying and enhancing small, often locally-run storage operations, with a strategy to build a portfolio that can be sold to larger institutions at a premium.
- **Real Estate Debt:** The Fund strategically invests in real estate debt, yielding significant returns by selling the senior portion of loans to banks with lower capital costs, with the aim to increase this allocation due to promising returns.
- **Outside US:** The Fund has identified potential long-term outperformance in international markets like Europe, and made its first direct asset purchase—a residential rental property in Copenhagen, indicating a possible shift towards a more global strategy.

A. Fund Update:

- Performance Metrics (as of 3/31/23) - Class I (Inception: May 1, 2018)
  - ITD Annualized Return: 10.11%
  - 1 Year Return: 1.6%
  - Distribution rate: 5.41%
  - NAV per share (May 1, 2023): $12.41
- The assets the Fund purchased in the second half of 2022 (which constitute about 25% of the Fund) are expected to be the main drivers of their returns over the medium term. Despite some negative returns in the recent quarter and external market noise, they believe the Fund is well positioned.
- They intend to keep their distribution rate consistent in the short term and predict the Fund's returns will be driven by income for the rest of the year, with a potential uptick later.
- The Fund has brought leverage down to 16% in anticipation of a potential negative return environment. They believe that low leverage offers three advantages: decreased volatility, lower downside risk, and the flexibility (or "dry powder") to take advantage of opportunities when others may be on the sidelines.
- The Fund has been able to meet all redemption requests and has seen net positive cash flows, until Feb and Mar of 2023. A significant contributor to the recent negative cash flow was a client who had leveraged their position and subsequently faced a margin call, necessitating the redemption of their $40 million investment.
  - The exact figures for redemptions in the first quarter are: $17 million in January, just under $10 million in February, and $37 million in March. However, despite these redemptions, inflows have remained positive, with $76 million flowing in, resulting in a net gain of $11 million.
  - In an extreme scenario where the Fund didn't raise another dollar, It could fund over four quarters worth of redemptions without having to sell any real estate property. This is due to their cash, real estate securities bucket, and capacity on their credit facility.
  - Even if they leveraged to meet redemptions, it would only bring their leverage up to about 25%.

- The Fund has strong fundamentals and a defensive position, with 98% of its properties leased and no near-term maturities. Their goal for the coming year is to maintain this defensive position while also being ready to seize new opportunities as they arise.

B. Sector Update & Outlook

- **General Market**
  - The fundamentals of real estate remain strong, except for the office sector. However, they note there is a capital markets issue due to the risk-free rate more than doubling, leading to a need for wider discount rates.
  - The Manager expresses optimism for the future, suggesting that the valuation hits have been absorbed and, barring another black swan event or banking issue, they believe they're close to the bottom.
  - While some investors might be on the sidelines currently, the Fund will be more actively looking for deals, as they consider 2023 a strategic entry point given the strong Fundamentals of real estate and the current capital markets issue. They suggest that once valuations have been adjusted, it could be an opportune time to invest.

- **Office building**
  - The issue of commercial real estate appears to be largely contained within the office sector, which is undergoing a significant transition as companies reassess their needs for physical space, particularly in the wake of the COVID-19 pandemic.
  - The division within the office sector itself, with modern, amenity-rich buildings faring much better than older, "commodity" buildings from the 70s, 80s, and early 90s. These older buildings are struggling to attract tenants and are likely to face difficulties if a loan comes due, often resorting to negotiations with existing lenders or even key handovers.
    - E.g: San Francisco as an example, has shifted from a highly desirable office market to one of the worst globally. New York's Hudson Yards has a high occupancy rate and high rents vs. Sixth Avenue with low occupancy rate despite haft of rent.
  - The office sector's debt issues, while significant, are a relatively small portion of the whole. Commercial real estate debt is about 18.5% of overall commercial debt, and the office sector makes up about 20% of that.

  Moreover, the upcoming maturities are only a portion of the office sector debt, suggesting that the scale of the problem is smaller than it may seem from the headlines.
  - Commercial mortgages are typically well-laddered over many years, which contrasts with the situation during the Global Financial Crisis (GFC), where residential mortgages were a significant issue. This difference provides some context and offers a bit of reassurance about the current situation.
  - The market has seen more discipline in recent years, with loan-to-value ratios decreasing significantly since pre-GFC times (from 70-80% LTV to 40-60% LTM). This indicates a healthier lending market and is another factor that distinguishes the current situation from the GFC.

- **Industrial**
  - Industrial real estate is experiencing strong demand and low vacancy rates:
    - There's been no oversupply of industrial properties. Despite growth being slower, demand for industrial spaces is strong and the existing supply is not sufficient to meet this demand.
    - This situation has been exacerbated by slow municipal approvals for new developments, a labor shortage in the U.S., and ongoing supply chain disruptions that have increased material costs and delayed construction.
  - Vacancy rates in the largest industrial markets in the U.S. are below their long-term averages. Even if all planned industrial projects were completed and delivered vacant, the vacancy rate would remain below this average. This shows strong fundamentals in the industrial market, with about 40% of these projects currently under construction.
  - The last acquisition cap rate was around 5.25%. Due to strong earnings growth, many leases are below market, and cap rates are difficult to quote. The current market cap rates are likely around the low 5% range vs. 2-3% last year. The Fund anticipated the increase and bought a portfolio in Minneapolis at 73% leased, eventually leasing it at 20% higher rents than expected. Industrial properties in their portfolio are 99.5% leased with only one small vacancy.

- **Health care**

    - Healthcare properties, such as medical office buildings, life science properties, and R&D facilities, are of particular interest to Fund. They are not yet bullish on senior living in the US, as they believe the demand is still 5-10 years away. The aging baby boomer population and the need to lower healthcare costs drive the appeal of outpatient and ambulatory care facilities, as well as medical offices and life science buildings.
    - The life science and R&D spaces have been attractive even before the pandemic, with the focus on drug research, cancer cures, and vaccine development. Lab work cannot be done at home, and once a tenant is established in a facility, they tend not to leave often, making these spaces a valuable investment. Healthcare properties are a differentiator for the Fund, accounting for about 23-24% of the portfolio. The Fund has three life science properties in their portfolio, located in San Diego, Boulder, and Sacramento, which represent 4.9% of its direct property portfolio.
    - While there have been concerns about oversupply in these markets, the Manager believes that the demand is still robust. They note that while there has been an increase in supply due to office space conversions, the Fundamental demand drivers for these sectors are strong, not only from the pandemic but also from the aging baby boomer population.
    - There are pockets of oversupply in major life science clusters such as Boston, San Francisco, and San Diego due to factors such as high levels of Funding and the presence of talent pools from major universities. Despite this, the sector's Fundamentals remain healthy. For instance, vacancy rates in these markets are still relatively low at 5.4%, below the national average.

- **Apartment**
    - Housing is still needed in the US, but there may be a pocket of softness in the luxury apartment market, particularly in the Sunbelt region. The Fund tends to focus on middle-income Class A- and B+ properties where renters are driven by necessity rather than choice. They anticipate potential opportunities in the first half of next year due to possible market softness in the luxury sector.
    - The Fund didn't buy any apartment buildings last year. They anticipate that there might be some near-term issues in the rental housing market, particularly in areas like Phoenix, which is currently experiencing some weakness. They believe that the apartment market's potential problems are

short-term rather than long-term, as there is still a lack of housing in the US. They think that there might be some pain in the second half of the year, which could lead to opportunities for them to acquire properties at better prices.
    - They recognize that there are currently a significant number of apartment buildings being built, and some appear to be relatively empty. However, they don't believe that the apartment market will face the same issues as the office market in the next five years.
    - That occupancy rates in apartment buildings are projected to decrease slightly from around 98% or 97.5% to the mid-90s. However, these are still healthy occupancy projections.
    - The pent-up demand for housing in the years leading up to the present has outpaced supply, and the current situation is more of a demand contraction than a massive overbuilding. The supply and demand in the rental housing market are relatively balanced over the long-term projections.

- **Single Family**
    - The Fund has been active in the single-family home rental market, having acquired about 360 homes in 10 Sunbelt markets, including Charlotte, Raleigh Durham, Atlanta, Tampa, Orlando, Nashville, Dallas, San Antonio, and Phoenix. The homes they have acquired are scattered within specific submarkets, and they have maintained tight investment parameters, such as having at least three bedrooms, two bathrooms, no pools, and being part of an HOA community.
    - The Fund differentiated its strategy from other competitors by partnering with a group called Sparrow and purchasing individual homes one at a time, achieving an average yield of 4.8%. This strategy allows them to build up a portfolio and potentially exit with a premium by selling to a single-family rental REIT or another investor.
    - They believe that rising interest rates may create opportunities for them to acquire more properties at better prices in the coming year. The speakers have been buying properties all-cash, which helps support their credit facility.
    - The acquisition process involves having offices in each of the target locations, working with exclusive brokers or realtors for Sparrow, and underwriting deals on a case-by-case basis, with a human touch rather than

relying solely on algorithms. This approach allows them to better estimate costs and potential renovation expenses.

- **Retail**
  - Retail grocery-anchored properties continue to see strength, particularly those with one of the two dominant grocers in the area, like Publix in Florida or HEB in Texas. The retail sector has been performing well due to a stop in overbuilding, weeding out of poor performers, and repurposing of outdated centers. Consequently, vacancy rates for retail are at a 10-year low, and more stores opened than closed in the U.S. last year for the first time in five years. The Fund owns six grocery-anchored centers with one vacancy across 130+ tenants.
  - Grocers typically have long-term leases with rent bumps every five years and multiple options to extend. Percentage rent is generally not applicable to sophisticated grocers but can be negotiated with new tenants like restaurants. Inline tenants have five-year leases with annual rent bumps, typically around 3%.
  - The mall space has not been a significant area of investment for the Fund. While Class A malls are performing well, there is still a struggle for other malls. Lending appetite for malls is limited due to their size and required investment. The focus has been on smaller deals under $100 million, which have more liquidity in the market.

- **Storage**
  - The Manager works with a partner who identifies smaller transactions typically run by mom-and-pop operations, with the aim of instituting more institutional management and building up a portfolio to be sold at a premium. They employ a similar strategy in the medical office building sector, purchasing properties between $9 million to $30 million in value and aiming to exit at higher cap rates.
  - The manager emphasizes the importance of exit optionality, aiming to build portfolios that can be sold to larger institutions that might not have the resources to buy smaller properties. This allows them to obtain a portfolio premium and distinguishes their Fund from others.

- **Real Estate Debt**

    - Real estate debt currently makes up about 6% of the Fund. They have been selective in their lending, only providing loans for new acquisitions and only to known, reputable borrowers. These are floating rate loans, which mean as interest rates rise, the Fund earns more income.
    - The strategy is selling the senior portion of the loan (up to 49%) to banks with lower costs of capital. This has allowed them to increase their spread significantly, with the 6% of their Fund invested in this manner currently yielding a 9.9% coupon. They aim to increase this allocation to 10%.

- **Outside US**
    - The Fund has traditionally involved investing in affiliated Funds in Europe and the Asia Pacific. The primary reasons for this approach are the lack of substantial Funds for significant direct investments and the diversification benefits offered by these regional Funds. If they bought a single property in Europe and Asia, it would expose them to the risks of a single asset rather than providing broad regional exposure.
    - The Fund’s international exposure is about 7%, which is lower than their initial expectation of a 15-20% allocation. The team decided to focus primarily on the US after the pandemic due to what they perceived as better value and better Fundamentals in the US market.
    - However, with property valuations now taking a hit in Europe and the dollar appreciating, they see potential for outperformance in the long term. They have recently made their first direct asset purchase in Europe, a residential rental property outside of Copenhagen.
    - The choice of a rental property in Copenhagen was driven by several factors. Firstly, Denmark's high credit rating (AAA), the relatively youthful population of Copenhagen compared to other European cities, and the high prevalence of renting in the city, with over 50% of the adult population renting their homes.
    - Looking ahead, the team anticipates starting their European and Asian investments in the rental sector, including apartments and alternative sectors like they have done in the US. They are also interested in the industrial sector if they can secure better pricing.