

Navigating Private Real Estate



Contents

1

Roadmap to private
real estate investing

2

Three key
considerations

4

Case studies

5

Summary



Roadmap to private real estate investing

Insurance investors' jobs have perhaps never been more challenging than they are in today's market environment – the COVID pandemic is entering its second year, interest rates remain near historic lows, and credit spreads in public fixed income provide very little compensation for bearing credit risk. This has led a great many insurers to look to alternative assets for more attractive return opportunities. One such alternative is private real estate, which insurers may find attractive for a variety of reasons:

- Meaningful income generation
- Total return upside potential
- Diversification relative to existing portfolio exposures
- Opportunities across the debt and equity spectrum that enable insurers to invest in a capital-efficient way

Undoubtedly many insurers already invest in real estate – at the end of 2019 (most recent year-end available)*, the average allocation to real estate debt was 13% (Life) and 1.3% (P&C) while real estate equity was 0.5% (Life) and 0.8% (P&C) - but there remains significant potential for this to increase as insurers add to existing allocations or enter the space for first time. This piece highlights the key considerations when investing in private real estate and provides a roadmap for insurers considering entering, or adjusting current exposures within, this space.

When investing in private real estate here's a roadmap for insurers you may want to consider. It may involve considering entering, or adjusting current exposures within, this space. Here are three areas private real estate investors should be aware of:



Know your objectives



Understand your constraints



Consider implementation



Know your objective

The first step in navigating a private real estate allocation, as with any investment strategy, is to clearly articulate one's objectives. Is the primary goal generating steady income? Is it achieving total returns similar to those found in other alternatives like private equity or distressed debt? Is minimization of required capital a necessity?

Answering these questions will bring into focus the subset of strategies that are most appropriate – namely, debt vs. equity broadly, and within those broad categories, the sub-strategies of greatest interest (for example, senior vs. mezzanine debt, core vs. value-added vs. opportunistic equity). It is important to think of these sub-strategies along a spectrum rather than as distinct silos with bright lines separating them; for example, core equity can provide attractive income while also providing potential for upside performance as well.

Primary objectives across a spectrum

INCOME ORIENTED



Book Yield

Generate a high level of stable reported income while protecting regulatory risk-based capital

Modified Total Return

Outperform stated portfolio benchmark while considering income and accounting objectives

RETURN-ORIENTED



Total Return

Outperform market-based benchmark with limited portfolio constraints

Source: Invesco Real Estate as of March 2021.



Understand your constraints

The next step is to consider constraints — capital requirements, internal risk limits like geographical exposure, operational details, internal expertise, and so on. One of the most frequently cited constraints is risk-based capital (RBC) requirements, and while there are pending proposals to reduce charges for life companies (from 15% to 10% for Schedule A assets, and from 23% to 10% for Schedule BA assets), even at current RBC levels private real estate can be capital-efficient.

Commercial real estate debt can be particularly capital-efficient, especially for life insurers seeking mezzanine exposure – depending on loan-to-value and debt service coverage metrics, equity-like returns are possible with RBC charges similar to that of BBB-BB rated corporate bonds. And while P&C and health insurers face somewhat higher RBC charges, they are still considerably lower than charges for other higher-return strategies like traditional equity (30% and 20% for Life and P&C/Health, respectively). For insurers considering real estate equity investments, RBC requirements increase relative to debt as one would expect – but it's important to note these requirements are similar to, and often lower than, traditional equity requirements depending on the type of insurer and real estate equity exposure. Additionally, for insurers with low initial allocations to equity and other non-fixed-income assets, the effective capital requirements – after considering covariance benefits – are lower than these headline numbers.

Objective returns and RBC

	Return	RBC		
		Life	P&C/Health	
Debt	Senior	4-6%	~1-2%	5%
	Mezzanine	7-10%	~2-8%	5%
Equity	Core	6-8%	15-23%	10-20%
	Value-Add	10-14%	15-23%	10-20%
	Opportunistic	14-18%	15-23%	10-20%

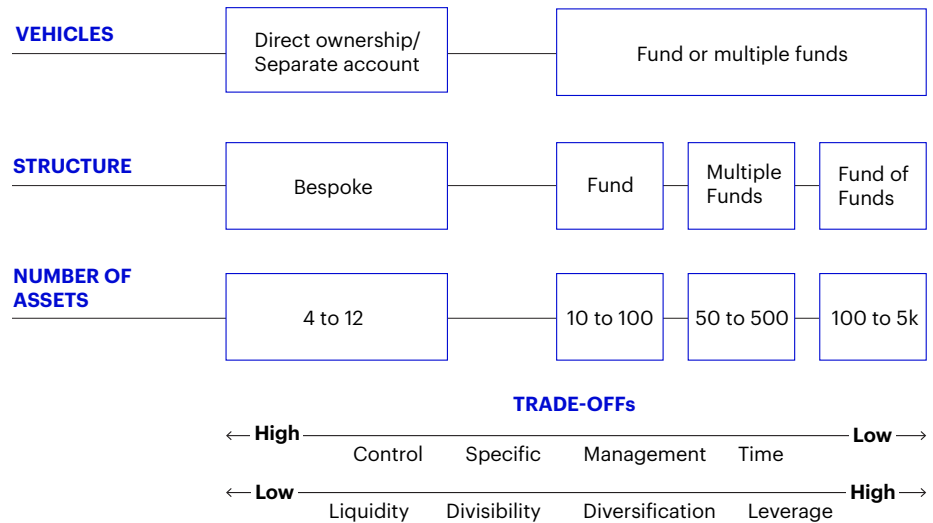
Source: Invesco Real Estate as of March 31, 2021. For illustrative purposes only. Performance results will vary depending on the client's investment objectives and constraints. There can be no assurance that the same or similar results to those presented above can or will be achieved.



Consider implementation

Once objectives and constraints have been considered, you can address implementation questions. Will management of the real estate portfolio be handled in-house, or via outside managers? Will investments be made directly or via a fund vehicle? How much diversification is desired within the portfolio? The answers to these and other implementation questions largely depend on the internal resources available and the insurer's desire to control decision-making vs. giving outside specialists management discretion.

Private real estate



Source: Invesco Real Estate as of March 31, 2021.

The following case studies highlight how the framework described above has recently been put into practice with two of Invesco's insurance clients.

Case study

1

Real estate debt – Life insurer



Profile: One key motivation was to complement the portfolio of senior loans managed by their in-house team; thus, their focus was in the mezzanine debt space.



Objective: In addition to seeking a higher-return strategy, working with an external manager meant they could access resources complementary to their own with different perspectives, sourcing capabilities, research teams, and so forth.



Outcome: While their senior debt portfolio emphasizes direct lending, we encouraged them to access the mezzanine space via a commingled fund for several reasons.

- Easier for administrative and reporting purposes to handle a single line-item on their balance sheet, particularly since modest leverage is often used in the mezzanine space.
- The strategy's adherence to certain loan-to-value and debt service coverage parameters at the underlying loan level meant that it was expected to qualify for CM3 treatment which carries a 3% capital charge.
- Although investing via a commingled fund means the investor gives up some control, this client was willing to accept that cost in favor of the benefits.

Real estate equity

Case study



Profile: This insurer's focus was on optimizing both allocation and implementation – as a mega-cap insurer with more than \$1 billion to invest in the asset class, they have the scale to access real estate equity in a variety of ways



Objective: Initially their plan was to access the market via direct investments, with an eye toward direct control over the investments being made and fee savings relative to fund investments. After analyzing the tradeoffs between Core, Value-Add, and Opportunistic real estate- building efficient frontiers, examining how each real estate segment would complement the existing portfolio, assessing RBC impacts – it became clear that an emphasis on Value-Add and Opportunistic real estate was warranted.



Outcome: Investing directly, as opposed to via funds, would modestly reduce capital charges (from 23% to 15%). However, we found that after considering covariance benefits, the advantage of investing directly was reduced. While the client has the scale and expertise to invest directly, it became clear that doing so would consume too much of their time and attention. As a result, our client turned their attention to choosing real estate funds that would complement one another, and their broader general account portfolio, with the added benefit of streamlining their operational needs and oversight.

2



Summary

The benefits of real estate investing have been well-documented:



Real estate can be a strong portfolio diversifier



Can act as an inflation hedge



Generation of meaningful income



Can drive meaningful returns in a low interest rate world



Be a complex asset class, with wide variation across property types and geographical exposures.

This makes the selection of a real estate manager critically important. As one of the world's largest real estate managers, investing in direct property and publicly traded real asset securities, Invesco offers investors a proven track record of investing across the risk/return spectrum, across the globe, and throughout the capital stack. an insurance company faces and can serve as a trusted partner to address these challenges.

About Invesco

Invesco Ltd. is an independent investment management firm with a single focus dedicated to helping our clients meet their investment objectives. We are privileged to manage more than \$1.14 trillion in assets on behalf of clients worldwide. We have specialized investment teams managing investments across a comprehensive range of asset classes, investment styles, and geographies. We employ over 8,000 individuals focused on client needs across the globe with proximity to our clients with a presence in 25 countries. We have solid financials, an investment grade debt rating, and a strong balance sheet.

Maximizing the expertise behind your investments

At Invesco, we specialize in the core fixed income insurers need most, plus strategies beyond - expertly crafted to complement your portfolio. We manage over \$35 billion in insurance client assets. As part of our specialized investment teams, we have over 200 fixed income specialists. Our insurance team has over 50 years of experience working with insurance clients.

Global Insurance Solutions

We provide bespoke solutions across asset classes: core fixed income, bank loans, equities, convertibles, global real estate, structured credit, cash, commodities, and private equity. These solutions are delivered in various ways including active, passive and factor investing. And in various vehicles including institutional separate accounts, mutual funds, private placements and ETFs.

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All data as of March 31, 2021

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