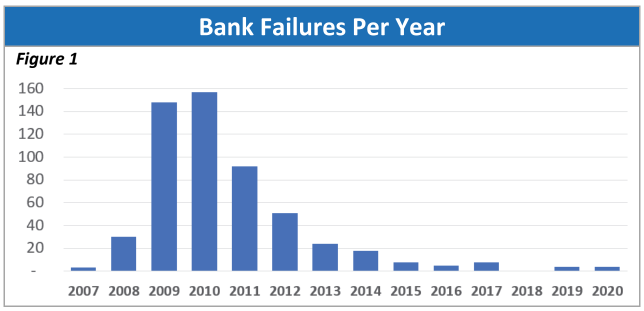
PCCP MARKET COMMENTARY

Second Quarter 2021

Distress Investing Throughout the Market Cycle

In the context of the COVID-19 pandemic, investment opportunities resulting from potential distress in the financial system, or in particular market sectors, like hospitality and retail, have become hot-button topics. Our investors often ask what new approaches we are taking to capitalize on the changing conditions and potential distress. We classify distress into three categories that we call the 3 S's – systemic, secular, and situational. Each of these categories can provide tremendous opportunities for real estate investing, and in order to take advantage of these situations, we as a firm need to be flexible in responding to all three. Our approach has always been to use our broad debt and equity platform and network of relationships to unlock unique investment opportunities in all three distress categories. We continually monitor systemic distress and distress within particular sectors for potential investment opportunities, but have consistently found strong opportunities throughout the ups and downs of the broader macro-economic cycle through investments arising from situational distress. We believe this approach continues to be effective during the uncertainty and distress caused by the COVID-19 pandemic.

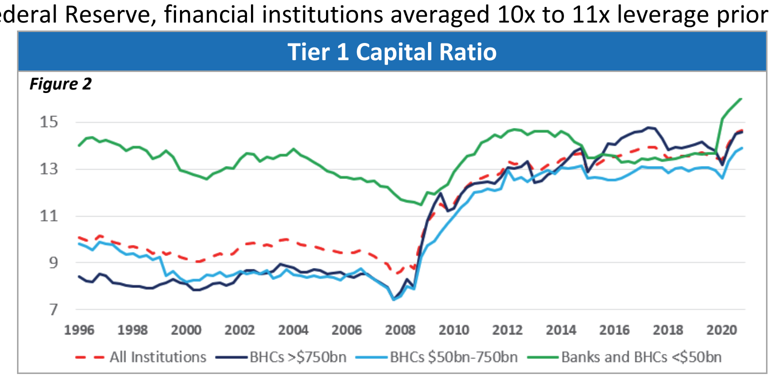


Source: Federal Deposit Insurance Corporation *As of 21Q2*

During the first and second quarters of 2020, concerns about systemic distress were amplified, as uncertainty about the impact of the impeding pandemic loomed over the economy. Such worries were justifiable – systemic distress poses the biggest threat to markets across all sectors, as it signals a shock to the comprehensive financial system. The most salient example of this is the Global Financial Crisis ("GFC"), when we frequently awoke to midnight alerts informing us of yet another household-name financial institution bankruptcy or bail out. During the peak of the GFC, shortage of liquidity within even the largest of institutions sent out massive shockwaves affecting not only banks, but all businesses which relied on credit support. This, of course, included real estate, a capital-intensive sector that relies on support of the credit markets.

Bank failures occurred throughout the GFC (see Fig. 1). Notably, these failures were not confined to a single year but were spread out over the course of 3 to 4 years, creating a plethora of investment opportunities[1]. Distress within the broader financial system permeated all sectors of real estate, and institutions with liquidity were presented with compelling opportunities to invest.

Are we seeing similar systemic distress during the COVID-19 pandemic? Concerns certainly mounted at the onset of the pandemic as public equity markets took a beating last February and March, with the Dow plummeting 34.5% in a little over a month. However, as we pass the 1-year mark of the pandemic's arrival, credit distress has not approached levels attained during the GFC, as illustrated in Fig. 1. In the decade following that crash, banks have built up unparalleled cushions in liquidity (see Fig. 2). Observing Tier 1 Capital and Common Equity ratios tracked by the Federal Reserve, financial institutions averaged 10x to 11x leverage prior to the GFC, and with the write-downs required in their assets during the crisis itself, leverage skyrocketed in 2008 to an excess of 12x[2]. With reforms in the banking system and more responsive injections of liquidity by the Federal Reserve, we believe the banking industry today is as healthy as it has ever been. Financial institutions were just 7.5x levered heading into the pandemic, and that has decreased as the Fed has continued to liberally inject liquidity into the economy through the banking system.



Source: New York Federal Reserve *As of 21Q2*

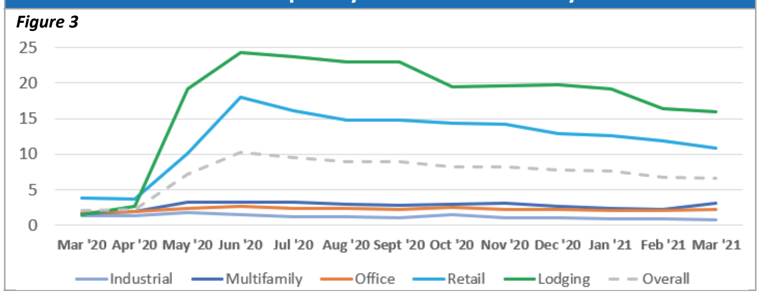
However, even in the absence of distress across the broader financial system, distress may be found within particular asset classes. During the GFC, all real estate asset classes were placed under distress as access to credit dried up. Today, using CMBS delinquencies as a proxy of the pandemic's effects, while the real estate market has taken a hit, distress is concentrated in the retail and hospitality sectors. Like systemic distress, distress within a broad asset class, or secular distress, can create compelling investment opportunities. To carefully approach investing in, and managing, assets within distressed classes, investors

[1] SOURCE: FEDERAL DEPOSIT INSURANCE CORPORATION
[2] SOURCE: NEW YORK FEDERAL RESERVE

need to be cautious, and attempt to understand the underlying economic conditions that can cause an entire asset class to be distressed.

Assets in the hospitality and lodging sector have been severely impacted by the pandemic as stay-at-home orders and travel restrictions have decimated hotel industry demand. 12-month occupancy as of April 2021 is at 41.4% nationally compared to a historical average of 66.2%.[3] International tourism and business travel ground to a halt in 2020, and high-end hotels are suffering from a lack of corporate travel, with luxury and upper upscale hotels experiencing 28.5% 12-month occupancy rates. We believe there is a light at the end of the tunnel for hospitality as the ongoing vaccine rollout provides optimism for a post-pandemic resurgence in travel. Occupancy climbed above 54% in March 2021, the highest national rate since February 2020. We anticipate occupancy and revenue numbers for hospitality assets to continue recovering as pandemic recovery moves forward, but there remain questions on the return of corporate travel and on the negative pressure of labor cost. We believe that the current dislocation of the hospitality market is positioned to provide compelling debt opportunities to take advantage of.

CMBS Delinquency Rates - % of 30 Days +



Source: Trepp *As of 21Q2*

Distress within the retail asset class, unlike the pandemic-induced distress within hospitality, has been characterized by the continued displacement of an aging, overbuilt retail business by eCommerce. In March of 2020, before overall CMBS delinquency rates skyrocketed, 3.89% of retail CMBS loans were delinquent past 30 days compared to 2.07% of all CMBS loans (see Fig. 3). Rising vacancy and mounting negative net absorption continue to plague the sector, reaching -17.6 million SF of net absorption over the past 12 months.[4] Caution must be taken in retail by prudent investors across all product types, and careful screening is required.

Office assets are not broadly experiencing distress even in the age of work-from-home, but we are watching carefully as office tenants return to their spaces. As the corporate world begins addressing its structure post-vaccine rollout, it is uncertain what will ultimately be the new "normal." At this time, the office asset class is a tremendous unknown, and it is not yet clear if opportunities exist in distressed office assets.

Systemic and secular distress provide investment opportunities during specific periods or within specific classes, but we have found that the third category of distress, situational distress, is available in all market cycles and during all times. Situational distress is unique to a particular asset due to the specific circumstances surrounding it – it can be created by over-leveraged property, a distressed seller, or some other localized impact that results in an opportunity to create value at acquisition.

Throughout the years, and particularly against the backdrop of the COVID-19 pandemic, we have found opportunities from corporate sellers disposing of corporate real estate, and owners who are paring their portfolios of specific product types. Asset-specific over-leverage within the capital stack can also create ample opportunities. In all these cases, it is not the underlying property that is distressed, but the situation itself.

We believe PCCP is positioned to tackle distress, whether systemic, secular or situational, however we have traditionally found the most opportunity through situational distress, which we believe can exist at any time through any market cycle. The relationships that PCCP creates with experienced operators, and our product type expertise across all major metro areas in the U.S., provides us with expertise in sourcing these types of situational distress opportunities, and this drives our investment philosophy.

Our thanks to PCCP's Brian Yeo in drafting the quarterly newsletter.

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[3] SOURCE: COSTAR U.S. HOSPITALITY MARKET REPORT
[4] SOURCE: COSTAR U.S. RETAIL MARKET REPORT