December 2023

HMC CAPITAL

Asset Allocation Report – Real Assets

Context

In 2022, global central banks took action to address inflation, successfully reducing price increases in 2023 by raising interest rates. As a result, inflation slowed to mid-to-low single digits.

While the economic conditions vary globally, it is noteworthy that the major economy has demonstrated resilience, largely propelled by robust consumer spending. The labor market's strength has played a pivotal role in maintaining high consumer confidence. Consequently, the recent decline in inflation across developed markets and indications of moderated economic growth in the U.S. have sparked optimism for a soft landing.

Market experts project stable interest rates across major central banks in the coming months. However, analysts speculate that the U.S. and European central banks may consider rate cuts around mid-2024 if inflation decreases.

As U.S. inflation gets back to normal, it's like a domino effect, setting the stage for a series of expected rate cuts across Latin America. This phenomenon is already evident in certain countries where interest rates have rapidly decreased, prompting investors to seek opportunities that promise higher returns actively.

As ultra-low interest rates are being phased out, real assets prices are recalibrating to align with a standard financial market scenario. This adjustment is reinstating the conventional function of this asset class in investment portfolios. This includes producing steady income, securing consistent cash flow, promoting portfolio diversification, and safeguarding against inflation.

In particular, the adaptability of real assets to perform across various economic environments is compelling. However, during periods of higher inflation, this asset class truly distinguishes itself, as its role as an inflation hedge positions it to outperform other asset classes.

Real Assets Implications

Real assets linked to physical structures are gaining attention as inflation hedges in the current inflationary climate. They provide inherent inflation protection and often have contractual safeguards, ensuring stable cash flows and resistance to market volatility. Despite a slowdown, inflation risks above the Fed target persist, influenced by demographic shifts, supply chain issues, housing scarcity, fiscal deficits, and the energy transition.

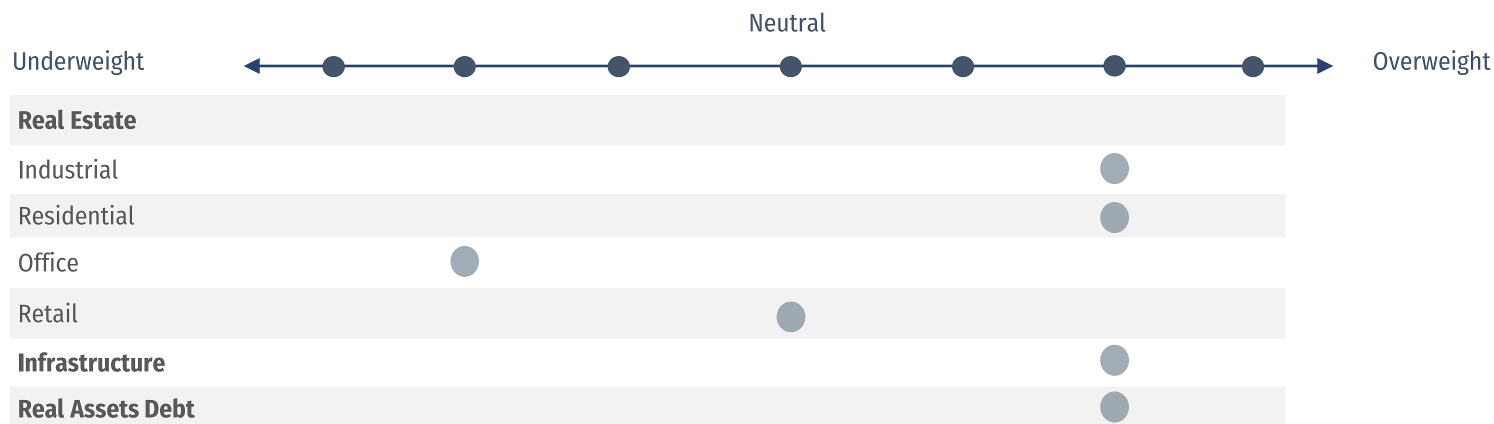
Infrastructure assets with strong market positions are showing resilience in the current economy, maintaining value and stability. Their appeal is enhanced by long-term, inflation-protected contracts and unique characteristics like being hard to replicate and producing predictable cash flows. Assets providing essential services face high entry barriers and play a vital role in a functioning economy. Stability is reinforced by extended contracts in assets like data centers and renewable energy installations, featuring index-based toll adjustments.

In real estate, disparities are especially in qualities, sectors, and markets. Higher-quality assets are expected to demonstrate superior performance in both fundamentals and capital markets. Limited financing options and high construction costs have led to low construction levels. Various sectors, including residential, data centers, logistics, senior living, student housing, and medical offices, benefit from these structural tailwinds. Solid demand across regions and property types supports the resilience of real estate.

Recognizing these market shifts, key themes and opportunities for compelling investments across global markets and sectors in 2024 have been identified. This approach focuses on utilizing long-term structural trends to navigate the evolving economic landscape skillfully.

Real Assets Views

The following summarizes the view in private markets based on a 12-month Outlook for each strategy. It is crucial to note that specific considerations will be addressed within these strategies in each of the following commentaries. This view cannot be generalized to all managers as each one is unique.



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Asset Allocation Report – Real Assets

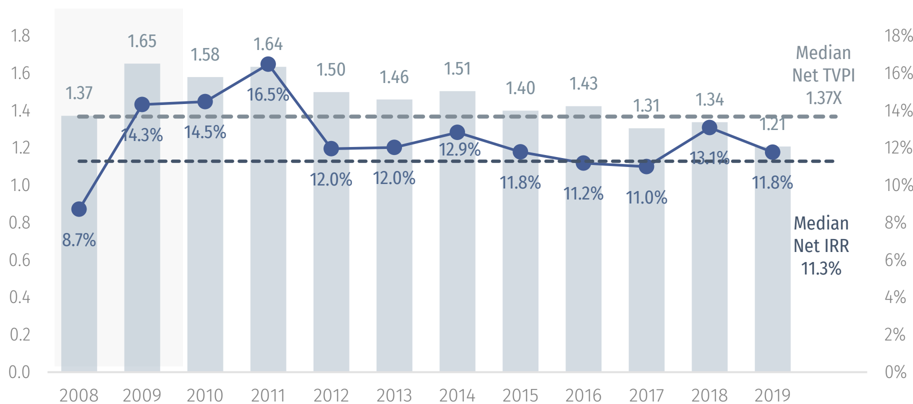
Real Estate

Global commercial real estate investment volumes have faced a decline influenced by the confluence of rising interest rates, banking turmoil, limited debt availability, and pricing uncertainty. Labor shortages and escalating construction costs add to the complexity. These factors, along with a reduction in anticipated future supply, pose hurdles for developers and industry professionals.

Despite challenges, constrained supply presents potential advantages, including reduced competition, improved negotiation terms, and the possibility of more favorable returns for investors. This market dislocation also offers an opportunity for a thematic investment approach, focusing on segments with high occupational demand and limited supply.

Complementing this perspective, private real estate has historically shown its resilience and stability, consistently performing well even during economic downturns. Notably, its track record highlights that the most prosperous periods for real estate investment often coincide with economic tightening cycles and recessions, further underscoring its potential in the current market context.

Real Estate Performance by Vintage Year (2008-2019)



Source: Preqin Pro, HMC, as of most-up-to-date. Left axis corresponds to Net TVPI, and right axis to Net IRR

The steady performance of real estate throughout the years has proven its resilience and dependability, firmly establishing it as a wise and reliable choice for investment within a diverse portfolio.

An additional way to assess the performance of Private Real Estate is through its comparison with Public Markets. When looking at most time frames, Private Real Estate has consistently outperformed Public Markets.

Performance Private and Public Real Estate Indexes

Index	3-year	5-year	10-year	15-year
Private Real Estate	6.04%	5.26%	7.39%	6.03%
Public Real Estate	4.51%	1.62%	4.65%	4.58%

Source: Private index represented by NCREIF Property Index. Public Real Estate is represented by MSCI US REIT TR, both as of September 2023.

The illiquidity premium of private real estate often results in higher returns, as investors are compensated for the inability to sell these assets quickly. On top of this, Private Real Estate benefits from active, hands-on management, allowing for strategic improvements and adaptations to market conditions. This contrasts with Public Real Estate, which is more susceptible to market volatility and often lacks the same level of direct control over assets.

Moreover, a detailed examination of the track records in this asset class reveals a strong equilibrium between risk and reward. Notably, value-added and opportunistic strategies lead in returns, with core and core-plus strategies also showing solid performance.

Private Real Estate Performance by Strategy (Vintage 2000-2019)

	Net IRR				Net TVPI			
	Core	Core-Plus	Value Added	Opportunistic	Core	Core-Plus	Value Added	Opportunistic
Top quartile	17.3%	18.9%	20.5%	18.8%	1.90X	1.70X	1.73X	1.69X
Median IRR	9.7%	13.0%	13.0%	11.1%	1.43X	1.42X	1.44X	1.37X
Bottom quartile	6.3%	7.5%	6.9%	5.0%	1.12X	1.22X	1.16X	1.12X

Source: Preqin Pro, HMC, as of most-up-to-date.

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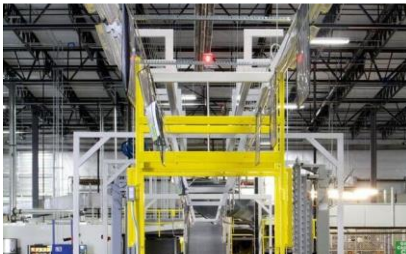
Asset Allocation Report – Real Assets

Exploring the primary segments of real estate investment reveals several important highlights. The next sections will discuss some of these key point:

Multifamily

After interest rate hikes, the surge in home demand during the pandemic reversed, causing price corrections—inflated mortgage costs and restricted capital accessibility restrained buyer activity, maintaining demand for multi-family units. Globally, limited affordable inventory persists due to increased construction costs and financing challenges. The mismatch between home supply and demand continues, making multi-family residential units a vital housing option for those unable to buy.



Industrial

This sector has been reshaped by e-commerce expansion, logistics, and reshoring investments, leading to heightened demand and competition for space. Pandemic-fueled consumer spending has pushed warehousing and manufacturing demand to new highs, revealing major investment opportunities. A record number of industrial constructions are in progress to address the pronounced supply-demand gap.

Offices

Remote work has decreased office space demand, impacting asset values. Economic uncertainty has led to cautious commercial leasing, focusing on cost efficiency in personnel and office spending. The market sees a disparity, with higher-end, modern offices still performing well. Property owners and investors recognize the need to adjust to the ongoing trend of hybrid work and reevaluate lower-performing properties. Strategies may include repurposing, upgrading, or demolishing non-cost-effective properties.

Retail

In 2024, consumers may struggle with limited affordable housing, higher interest rates, and slow economic growth, likely leading to constraining discretionary consumer spending throughout the year, consequently impacting the retail sector. Despite this, select segments within the global retail market are positioned for notable outperformance, given the appealing entry point for new investors. Lower construction activity has helped improve occupancy rates in different markets.

Areas of focus

- Rising demand for **digital infrastructure**, fueled by data and AI, is clear. JLL Research forecasts an 11.3% yearly growth in the data center market through 2026. Data centers attract investors with low vacancy rates and strong rental growth, promising returns, particularly in the U.S.
- The **living** and **logistics** sectors boast favorable supply and demand characteristics and provide the chance to employ short leases. This strategic decision empowers investors to capture rental increases driven by inflation and capitalize on potential rent reversion opportunities.
- In the industrial sector, despite the ongoing strength of e-commerce, the primary drivers for demand growth are anticipated to be an intensified focus on **nearshoring, onshoring, and supply-chain security**.
- Nearshoring in Mexico has led to a 14% increase in industrial rents, outpacing the 10-year average of 2%. Booming sectors like electric vehicles and medical devices fuel this growth. Border and non-border markets are flourishing with increased export demand.
- The rapid aging of the global population and increasing demand for aged care homes has outstripped supply, presenting an opportunity for a portfolio of senior housing assets in global cities, offering robust risk-adjusted returns supported by long-term structural trends.
- Real estate sectors like self-storage, manufactured housing, and outpatient care are gaining popularity due to demographics, healthcare demands, and tech progress. They have lower maintenance costs (13% vs. 20% for traditional real estate) and enhance diversification and resilience in real estate portfolios.

December 2023

HMC CAPITAL

Asset Allocation Report – Real Assets

Infrastructure

Infrastructure presents several advantages, including resilience against inflation, delivering essential services, and a steady demand unaffected by economic cycles.

As a reference, institutional investors are turning to infrastructure to address current challenges, leveraging it for inflation protection, reliable yields, impact goals, and climate risk mitigation.

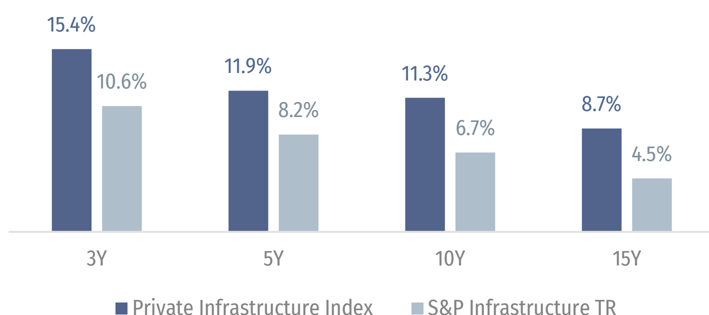
Here are some advantages of the asset class in this context:

- Infrastructure assets, often **monopolistic or quasi-monopolistic,** provide essential services, leading to stable demand. Their limited competition and inelastic demand make them less sensitive to economic cycles and market change.
- Infrastructure serves as a reliable income source through **long-term contracts,** concessions, or stable fee-based revenue streams. Many infrastructure assets adjust returns with inflation and the cost of capital, ensuring stability and capital preservation. These characteristics result in low correlation and beta, making infrastructure investments appealing for stable returns.
- This asset class thrives under **giga themes.** The thematic investing approach focuses on Decarbonization and sustainability, New Living, Digitization, and automation.

Given the relatively recent emergence of infrastructure private funds, there aren't sufficient constituents to establish a comprehensive track record by vintage regarding the asset class's performance. Consequently, to accurately reflect their performance, it is more effective to consider private infrastructure indices and compare them with their public counterparts.

As shown, infrastructure private investments have consistently outperformed public indices across all reviewed periods. This trend highlights infrastructure's robust performance and potential as an asset class, offering evidence of its capacity to deliver superior returns relative to the broader public market.

Performance Private and Public Infrastructure Indexes



Source: Preqin, HMC, as of june 2023. Infrastructure index captures the return earned by investors on average in their private capital portfolios, based on the actual amount of money invested in private capital partnerships. Public Infrastructure is represented by the S&P index.

Areas of focus

- **Brownfield projects**: the surge in inflation and rates has heightened costs for greenfield projects and capital expenditure, potentially impacting outcomes.
- **Utilities focus:** Funds with utility exposure benefit from their inherent resilience. Utilities typically offer services with inelastic demand, meaning consistent demand irrespective of economic or political conditions.
- Managers who **steer clear of politically uncertain regions** to avoid potential changes in regulations or government policies that may impact the operational environment for regulated assets.
- Prioritize managers avoiding non-traditional infrastructure assets (e.g., service-oriented businesses) like entertainment venues and healthcare facilities, as they may be sensitive to economic cycles. Consumer spending reductions during economic downturns in these sectors can result in a higher correlation with broader economic trends.
- The growth potential of infrastructure, attributing it to three driving forces represented by the three Ds:
  - ✓ **Digitalization** plays a pivotal role as technology revolutionizes various facets of contemporary life, with digital assets becoming integral to modern economies. These assets encompass physical components like data centers, communication towers, and fiber networks.
  - ✓ **Decoupling** involves companies aiming to mitigate concentration, costs, or risks within their supply chains. This could include relocating offshore production closer to end markets.
  - ✓ **Decarbonization** reflects the widespread push by companies, governments, and consumers to reduce carbon emissions and transition toward a net-zero world. This movement presents extensive implications and significant investment opportunities in clean energy and associated infrastructure.
- Geographically, both the USA and Europe offer benefits to investors:
  - ✓ In Europe, a diversified infrastructure portfolio provides resilience to economic cycles, with different sectors offering varied risk-return profiles. Stable regulatory environments enhance clarity for investors, though some assets may offer lower yields.
  - ✓ In the USA, government incentives for renewable energy projects make them financially attractive, but increased popularity introduces competition and may challenge investors in finding high-quality opportunities.

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Real Assets Debt

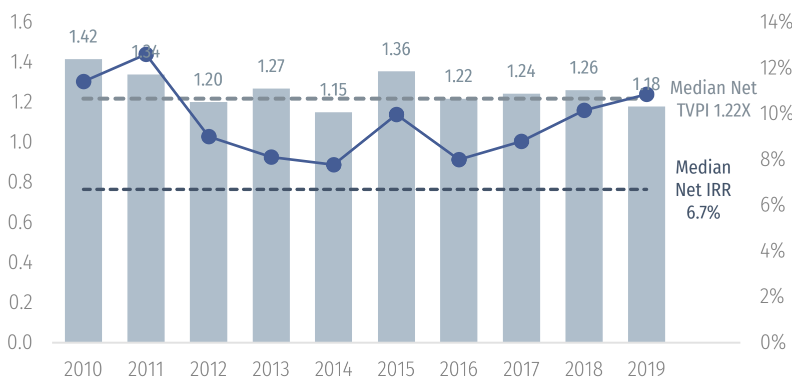
Private Debt is thriving amid rising risk aversion and stricter lending standards by commercial banks.

Approximately USD 1.9 trillion in U.S. commercial and residential loans, constituting 42% of outstanding debt, will mature in the next few years. This creates a tremendous demand for refinancing and new financing, but the market presents significant challenges.

Falling property values, stricter lending standards, and cautious investors have formed a perfect storm of illiquidity, creating the most stagnant real estate debt market since the Global Financial Crisis. As banks appear reluctant to re-enter the market given the current banking sector situation and tighter credit conditions, non-bank lenders such as Private Debts Real Estate funds can fill the gap left. They offer flexible financing solutions, such as mezzanine financing and preferred equity, that are tailored to the needs of borrowers in this challenging market.

This approach is complemented by a well-balanced risk-return profile, which will be clearly demonstrated in the following exhibit:

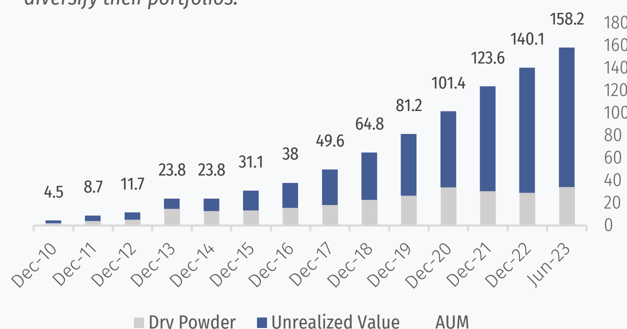
Real Estate Debt Performance by vintage (Vintage 2010-2019)



Source: Preqin Pro, HMC, as of most-up-to-date. Left axis corresponds to Net TVPI, and right axis to Net IRR

Infrastructure Debt

Since its emergence in 2013, the infrastructure debt strategy has become an integral part of the asset class's overall evolution. Its distinct risk profile has expanded the range of investment opportunities within the sector, providing investors a means to diversify their portfolios.



Infrastructure debt is particularly appealing in the current economic climate of fluctuating interest rates and ongoing inflation due to its potential for floating rate structures that hedge against rate shifts. It also provides a hedge against market volatility with its predictable cash flow, solid collateral, and low reliance on equity valuations, making it an attractive investment, particularly in the expanding sustainable energy sector, while mitigating interest and inflation risks.

Furthermore, infrastructure debt is emerging as a critical financing mechanism for sustainable energy supply chain investments. Data from Preqin suggests that infrastructure debt is expected to provide a substantial share of the necessary funding, potentially accounting for 50 to 70 percent of the capital, tailored to the specific structure and risk profile of the project. This underscores its strategic importance in supporting sustainable energy initiatives.

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We offer customized services to our clients, with unique academic and educational approach. Access to specific on demand technical trainings and Masterclasses in partnership with the best universities of the world.

More than **US$ 14 Bn** in assets under management and distribution from institutional, multilateral & private investors.

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