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Real Estate Risk Management at BPI GA

Nova SBE Consulting Project

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Abstract: This paper determines the fundamental drivers that impact the CRE asset class, based on the analysis of a Portuguese Real Estate open-end fund. We developed a tailored risk management approach that considers both macro and micro risks – market and asset-specific, respectively. The material micro drivers analysed are vacancy, tenant, asset concentration, liquidity and ESG (environmental, social and governance factors). The results support the previous drivers' relevance on CRE capitalization rates and demonstrate the significant benefits inherent to adding Real Estate Investment Trusts to the portfolio.

Keywords: Commercial Real Estate; Risk Management; Macro Risks; Micro Risks; Fundamental Drivers; Capitalization Rates; REITs; ESG.

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1 Introduction

Alternative investments have seen a rapid growth since the mid-1990s due to an increased interest by institutions and high-net-worth individuals seeking either absolute returns, relative returns or higher diversification. According to DTZ Research, the most significant share of global assets under management (AuM) in alternative investments belongs to Commercial Real Estate investments (Fisher and MacGregor 2020). Nonetheless, even though Commercial Real Estate has long been an important asset class, its growing position was rattled by the 2007 global financial crisis. The recession has revealed that these assets, as other alternative investments, are not free of risk – with the diversification benefits vanishing as correlations among various assets increased dramatically. As a result, it is of utmost importance to understand which drivers are behind the Commercial Real Estate industry, identifying its key risk indicators and how they should be monitored and mitigated.

The current research is part of a consulting project developed in collaboration with the Portuguese Asset Management company *BPI Gestão de Activos (BPI GA)*, where we aimed to identify both macro and micro fundamental drivers that affect Commercial Real Estate funds. Therefore, we developed a detailed risk assessment and suggested several risk-management processes and tools for future implementation, applied to *Imofomento*'s portfolio – an open-end Commercial Real Estate fund managed by BPI GA. Through a well-established econometric model, we analysed whether Real Estate performance is sensitive to different economic variables. However, this analysis covers the macro risk component solely, requiring a further assessment of specific material risks. From the previous, we analysed tenant, vacancy, asset concentration, liquidity and ESG (environmental, social and governance). The current research also suggests some strategies to mitigate the risks affecting the client's portfolio. More precisely, we propose adopting an equity-based investment in Real Estate investment trusts

(REITs) through public markets, which seeks to maximise the risk-adjusted financial return, while not compromising the fund's investment style in core strategies. Moreover, we recommended an action plan for future implementation that aligns its risk management processes with the United Nations Principles for Responsible Investment (UNPRI) assessment's score maximisation.

2 Asset Class Characterization

Real Estate is a type of "real property" that includes the land, all its natural components, and everything permanently attached to it, such as human-made buildings and site improvements, below and above the ground. According to the RICS Valuation Professional Group (2019), a title of interest represents the Real Estate ownership over one of the main categories of Real Estate: residential, commercial, industrial, raw land and particular use.

While a big slice of Real Estate is residential, commercial properties – such as shopping centres, offices, hotels and educational buildings – are a critical component in institutional investors' portfolios, owned to generate income. In 2018, according to Property Funds Research, institutionally owned global Real Estate property represented US\$ 3.48 trillion. Investors increasingly perceive Real Estate as an alternative to fixed income and equities, with potential for competitive long-term returns and lower volatility, due to its unique characteristics that lessen cash flow's exposure to economic shocks.

Moreover, investing in Real Estate helps investors achieving steady profits driven by income generation and capital appreciation. It also guarantees inflation protection if rents adjust for inflation, and diversification benefits from less-than-perfect correlation with traditional asset classes (Fisher and MacGregor 2020). Therefore, to better understand this asset class's underlying characteristics, we performed a more in-depth analysis based on the CFA Institute's readings for its Level 1 exam.

2.1 Asset Characteristics

The Real Estate asset class has some unique characteristics: heterogeneity, fixed location, illiquidity, indivisibility (being a high unit value), high transaction costs, depreciation, debt dependence and price determination. Heterogeneity arises since two properties are never wholly

identical, differing in size, location, age, type of construction, quality, tenant, leasing arrangements, among others. The illiquidity comes from its fixed location, allied with its high unit value, exposure to government regulations, and local factors, thus requiring a substantial amount of time to sell the asset at a fair market price.

Moreover, Real Estate is associated with high transaction costs and active day-to-day management. Buying and selling immovable property is often expensive and time-consuming, given that it requires appraisers, attorneys and architects, and debt capital financing in some cases. As a result, the prices of Real Estate are vulnerable to debt capital costs and supply. Real Estate valuation is lower when debt capital is scarce or interest rates are high, versus a scenario where debt capital is readily available, or interest rates are low. Lastly, the price determination is a difficult task to be made due to the heterogeneity and the limited frequency of sales. Those who possess superior experience and expertise in determining assets' prices can have an advantage in a less competitive market.

2.2 Alternatives for Real Estate Exposure

There are different forms to get exposure to Real Estate, classified within a four-quadrant matrix divided into equity or debt investment, in public or private markets. This thesis focuses on the equity-based investments made through private and public markets (debt investments are further explained in Appendix 2.1). The former implies investing in shares with Real Estate as the underlying investment – such as Real Estate Investment Trusts (REITs) – getting exposure to the asset class without owning the asset itself. In private equity, Real Estate investments comprehend private assets invested in the property market, implying the control (either direct or indirect) of private investors' properties. Private equity investors may create pooled vehicles arranged by intermediaries, such as joint ventures, Real Estate limited partnerships or indirect

ownership via a Real Estate fund. To buy assets when interest rates dropped, private equity Real Estate funds became common in the 1990s amid declining property prices.

REITs invest in various Real Estate segments, having a well-diversified portfolio generally professionally managed, producing a stable income stream and being a highly liquid investment (publicly traded like stocks). Moreover, these trusts are required to transfer most of the taxable profits to investors as dividends. There are three types of REITs worth highlighting, namely the publicly traded ones, listed on a national securities exchange, the non-traded REITs (less liquid yet not subject to market fluctuations) and the privately traded REITs (in the United States of America are not registered with the Securities and Exchange Commission and do not trade on national securities exchanges).

2.3 The Market for CRE Investment Funds

Various investment product vehicles are available to Commercial Real Estate investors, such as Real Estate mutual funds, listed property companies or non-listed funds. We can divide the latter into two types: closed-end funds and open-end funds. Closed-end funds raise money at creation with an initial issue of a defined number of shares, and after that, no more shares are issued. Existing investors have to liquidate by selling to new investors, with the number of outstanding shares always remaining the same, with supply and demand determining the share's overall price. Its fixed share characteristic results in closed-end funds selling at rates above or below the current net asset value per share. Contrarily, open-end funds exchange at its current net asset value per share, and investors do not pay a premium or discount, given that the new shares are issued at a value equal to the NAV of the fund. Besides, there is no limit to how many shares can be sold by an open-end fund.

2.4 The Variety of RE Funds

Real Estate funds can adopt three main strategies for their investments: core strategies, value-added strategies and opportunistic investment strategies. This section focuses on the former, as we developed this thesis for a Portuguese Real Estate fund with a core profile (the remaining strategies are explained in Appendix 2.2). Investments in core Real Estate funds are considered the least volatile, since they mostly focus on large core markets for stabilized, fully leased, secure investments. Such funds typically have a conservative investment profile, with a portfolio of properties with high credit tenants, long-term contracts and Class A buildings in desirable locations, often well-preserved on behalf of the current owner, requiring minor changes or adjustments. Thus, Real Estate investments adopting a core strategy do not typically undergo a substantial valuation appreciation, but rather have a steady and reliable cash flow with reasonably low risk. Therefore, management improvements are limited. Such characteristics suit investors pursuing capital accumulation over a long-term horizon. Investors tend to consider them favourable assets based on their risk profile, relative to other retail investment options such as corporate bonds and publicly traded equities.

2.5 Contract Type and Revenue Structure

There are different types of contracts used in Commercial Real Estate, such as the Single Net Lease (N), the Double Net Lease (NN) and the Triple Net Lease (NNN). In the Single Net Lease – the less common lease type – the tenant agrees to pay property taxes in addition to rent. At the same time, the owner is liable to pay the remaining administrative costs incurred in property maintenance. Furthermore, the Double Net Leases (also known as Net-net or NN leases) are highly common in Commercial Real Estate where the tenant pays the rent, property taxes and insurance premiums. At the same time, all repair expenses remain the responsibility of the landlord. Due to the tenant's extra costs, the base rent charged for space itself is usually smaller.

Lastly, the Triple Net Rent absolves the landlord from significant risk, thus assuring a specific revenue stream with no costs involved. In addition to leasing, property taxes, and insurance premiums, the tenant must also cover the expenses of building upkeep and repairs; thus, there is a reduced base rent charged by the landlord.

3 Company Overview

3.1 BPI GA

At the beginning of September 2020, BPI GA was placed as the third major Portuguese mutual fund management firm, with over €2.5 billion worth of assets under management, which represents a domestic market share of 23.67 percent. At the same time, concerning the Real Estate Fund Industry, the overall market registered an upward trend in 2020, in terms of assets under management. As for BPI GA, at the beginning of September of the same year, the firm was managing €542 million worth of assets and had a domestic market share of 6.68 percent. Therefore, BPI GA was the fifth largest player within the Real Estate Fund Portuguese Industry. However, when narrowing the industry by only considering Open Real Estate Funds, BPI GA maintained its third position, as it did in 2019 and 2018 (Associação Portuguesa de Fundos de Investimento, Pensões e Patrimónios 2020).

Regarding the Real Estate Funds which BPI GA manages, there are three funds that require a specific focus and detailed description. First of all, there is the *Imofomento* fund, which is an open-ended Real Estate fund. Secondly, there is *Josiba Florestal* fund, which is a special closed-end Real Estate fund, and lastly there is the Pension Fund, which the portfolio is composed by equities, bonds, and Real Estate. Each one of them presents very distinct characteristics, but for the purpose of this thesis only the first fund will be considered.

Regarding responsible investment practices within the Real Estate sector, BPI GA did not have enduring responsible investment policies neither integrated ESG factors in the overall decision-making process. The company is developing a strong Socially Responsible Investment (SRI) area, with adequate policies and procedures in place mostly directed towards equities and fixed income. Yet, the goal is to expand the SRI scope in order to reach the Real Estate asset class. It shall be noted that BPI GA reported to the UNPRI (United Nations' Principles of Responsible

Investing) in 2019 without filling the requirements for the Real Estate, thus maximizing such score is one of the major concerns considering the 2020 Report.

3.2 Imofomento Fund

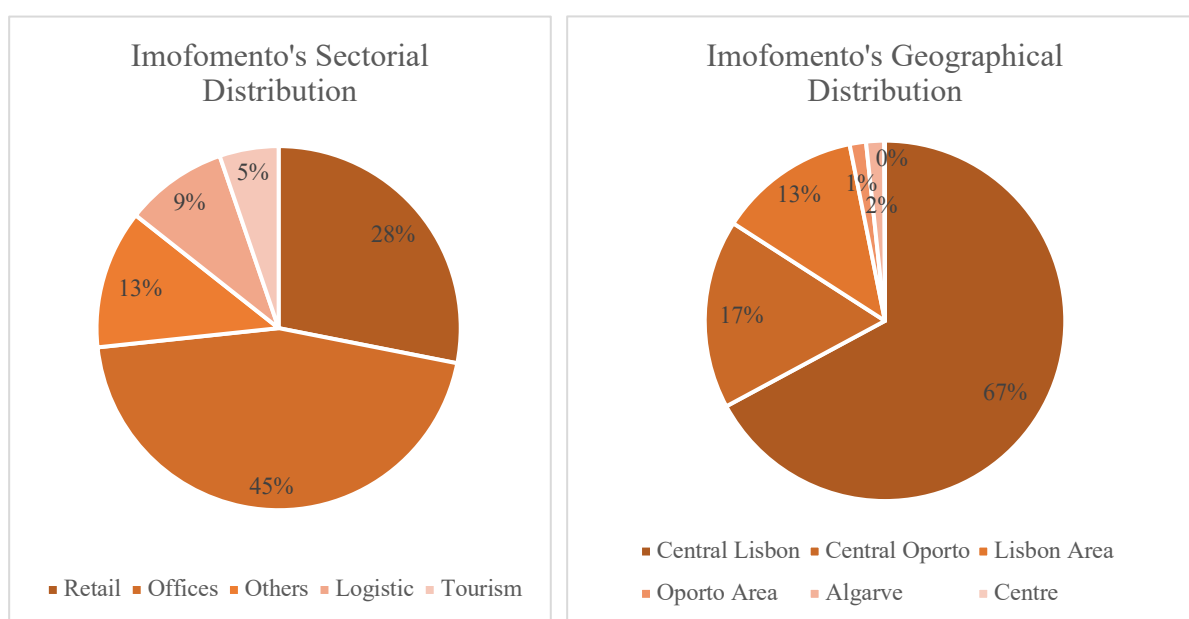
Imofomento's Profile

The *Imofomento* Fund is a diversified, core, open-ended Real Estate fund, consisting mostly of stabilized, income-producing, Commercial Real Estate. As it is considered a core fund, its investment objective is to provide investors, in the medium and long-term spectrum, with attractive returns, while not incurring significant risk levels. To achieve this goal, the fund seeks capital appreciation through diversified investments in Real Estate, both in property type and geographically, and by prioritizing stable rents among possible tenants. The fund has provided semi-annual cash flow distributions, accepts contributions with a minimum value of €500, and needs to meet redemptions both on a daily (Class A) and semi-annually (Class B) basis.

In terms of compliance, there are a few rules which, according to CMVM and the Portuguese Legislation, the fund must comply with, namely: (1) the value of the Real Estate assets cannot represent less than 66.67% of the fund's NAV; (2) the value of the rented Real Estate must be at least 10% of the fund's value; (3) the limit for the investment in contributions/units is 25% of the fund's value; (4) the number of units should be at least 25% of the overall units in the market; the value of a single building or another Real Estate instrument cannot surpass 20% of the fund's value; (5) the value of properties outside Europe but still within the OECD must not be higher than 25% of the fund's value; (6) the NAV of the fund after 12 months must be at least €5 million; (7) the fund's leverage level must not surpass 25% of the fund's value; (8) the value of properties rented to a single entity must not be above 20% of the fund's value; (9) shares in Real Estate companies must not be above 25% of the fund's value.

Imofomento's Composition

Concerning the fund's sectoral concentration, offices represent the major weight given the total value of properties. Additionally, offices combined with retail correspond to around 70% of the Real Estate portfolio, even though it also considers tourism and logistics, among others (figure 1). As for the geographical distribution, as shown in figure 2, the fund's properties are mostly concentrated in Lisbon Centre (67%) and Porto Centre (17%). Indeed, this can be said to be the fund's management team's more relevant spots, since these areas represent the most profitable investments and comprehend the most reliable tenants, compared to the rest of the country.



Figures 1 and 2 - Sectorial and Geographical distribution of Imofomento's portfolio, for 2020.

The tenant concentration is also a significant risk to consider. To guarantee the fund's profitability and maintaining its low-risk profile, *Imofomento's* properties are leased to tenants who demonstrate healthy economic activity and financial capacity to comply with the different conditions specified on the respective contracts. Among other tenants, as of the end of September, the top five are *EDP Distribuição - Energia S.A.*, *Modelo Continente*

Hipermercados S.A., Logic Logistica Integrada S.A., O Parque Ensino de Crianças S.A., and Vila Avenida Hotel S.A.

Imofomento's Performance

By the end of 2019, *Imofomento* represented 15% of market share among the domestic open-ended Real Estate funds. Most recently, by the end of September 2020, the fund reported a value of €512.95 million, with €314.54 million worth of Real Estate holdings and €198.41 million in liquid assets such as cash and Government Bonds. The fund's liquidity has been a concerning issue as the European interest rates have been negative for the past years. Consequently, the fund's returns may not expose the investors entirely to direct Real Estate returns, which are expected to be higher than the ones reported. The 1-year, 3-year, 5-year and 10-year gross returns of *Imofomento* are, respectively, 2.29%, 3.67%, 3.08%, and 2.38%. These are still impressive returns when compared to the volatility of the fund for the same horizons. For instance, the 1-year, 3-year, 5-year and 10-year volatility are, respectively, 0.99%, 1.20%, 1.06%, and 1.26%. Therefore, the risk-adjusted returns are attractive to investors who do not seek extremely volatile investments.

Compared to the *Associação Portuguesa de Fundos de Investimento, Pensões e Patrimónios* (APFIPP) open-ended fund index, *Imofomento* has performed relatively better over the years – as represented in Appendix 3.1 – even between 2008 and 2011 when the country was severely affected by the Global Financial Crisis. This is mostly because *Imofomento* is a core fund and does not make risky investments neither relies on tenants with high default probabilities. Nonetheless, the Covid-19 crisis had quite an impact on *Imofomento's* returns, as since May until September 2020 the index has outperformed the fund. The healthcare crises affected the fund's returns, as the vacancy rates increased compared to the previous year – because in March 2020 a vital tenant, EDP, moved out of Edifício Niña – and several tenants requested the delay of rent payments, hence decreasing the monthly income.

By the end of September 2020, the vacancy rate was 10.13% higher than the 6.96% observed in the same month in 2019. As shown in Appendix 3.2, the vacancy rate has been following a downturn trend with a slight increase in 2020.

4 Market and Industry Overview

This section comprehends an analysis of the Commercial Real Estate market, in which the CRE fund's industry operates, with an emphasis in the Portuguese case. The overview starts with a market analysis prior to the pandemic. We perform a more in-depth view of the different CRE sub-segments for Lisbon and Porto and the key stakeholders' assessments. This is followed by an industry analysis assessing performance, size and gearing features. We then compare performance with several Portuguese macro-economic variables. The chapter concludes by evaluating the impact of Covid-19 in the sector.

4.1 The Market

4.1.1 Overall Look

The Portuguese Real Estate market has been following a strong upward trend since 2012, mostly driven by the low interest rates verified in the country and a significant improvement in economic figures and good financing conditions for all economic sectors. There has been a notorious growth in external demand for investors who seek to diversify their portfolios. For such purposes, Commercial Real Estate has been a clear target for generating consistent long-term yields. Commercial rental yields often outperform housing ones, plus tax benefits and inflation-hedging purposes, being a secure asset during both high and low cycles.

Moreover, this market entered 2020 in a healthy shape. In 2019, Portugal's commercial property sales exceeded €3.5 billion, a new record mostly driven by the office and retail sectors. It also invested around €1.5 billion in land for development and assets for renovation (Athena Advisers 2020). Additionally, according to the INE (2020) the Commercial Property Price Index (CPPI), which measures the price developments of the commercial properties transacted in Portugal, displays a continuously growing trend for transaction prices. Yet, the previous verifies a

decreasing growth rate since 2018. As shown in Appendix 4.1, prime yields for the different CRE segments have followed a slightly decreasing trend. Overall, we should highlight that in 2019, according to JLL, the number of new investments overpassed €400 million, mostly targeting student residencies and co-living spaces. Moreover, the touristic sector's strong demand in *Costa Alentejana* and *Algarve*, and the higher rents from new office buildings, led to a scenario where the demand surpasses the supply (JLL 2019).

4.1.2 Lisbon and Porto in Detail

Focusing on the two main Portuguese markets, Lisbon and Porto, we performed a more in-depth analysis for the different CRE sub-segments, namely offices, retail and industrials. This analysis is based on a Savills research made in the first quarter of 2020, which does not include any significant Covid-19 impact since the Real Estate sector verified a slowdown only at the end of March.

Offices

According to this research, Lisbon offices summed up to 44,671 sqm in total market take-up, representing a 6.5% increase compared to the first quarter of 2018. The most relevant areas for Commercial Real Estate activity are the Prime Central Business District (CBD) and the CBD, which compromises the most central part of Lisbon, as well as the *Parque das Nações*. The former two are the best-performing ones (Appendix 4.2 shows the different areas for Lisbon and Porto). Rents have been increasing for the past years, reaching a monthly average of €23/sqm in the Prime CBD, as shown in Appendix 4.3. Also, vacancy rates averaged 5.42%. Even though the Western Corridor still faces a high rate, the entire market is following a downward trend that converges to zero, meaning that it is reaching a saturation point. Moreover, it is worth mentioning that the growing number of start-ups increases the demand for coworking spaces.

On the other hand, the demand for office buildings in Porto has been slightly falling. Yet, between 2019 and 2020 the take-up was of 19,123 sqm, representing a change in this paradigm. Even though with a lower magnitude compared to Lisbon, many multinationals see Porto as a business destination, targeting the city when expanding to the Portuguese market. Thus, the demand is still high, reinforced by the new projects' increasing quality, leading to the rise in prime monthly rents. In the first quarter of 2020, office prime rents ranged between €12.5/sqm and €18/sqm (shown in Appendix 4.4).

Retail

Regarding the retail sector, high street retail continued to expand in the main touristic areas of Lisbon and Porto. There has been a predominance in new spaces for the food and beverage sector, mainly driven by the positive consumption spending trend. Prime rents have been rising steadily in the high street segment, reaching a monthly amount of €160/sqm in Lisbon, and €70/sqm in Porto. Shopping centres in both main cities show a more stable rent value, which only grew from €85 to €100/sqm (monthly).

Logistics

At last, the Logistics and Industrials segment suffer from a lack of supply. Spaces with more than 10,000 sqm are particularly scarce, leading to an overall increase in market prices. The trend for e-commerce increases the need for sufficient spaces nearer city centres. Also, the increase in sustainability, energy efficiency and interconnection with other platforms and means of transport, differentiates a new type of demand. The sector summed a take-up of 80,000 sqm in the first quarter of 2020 (16% concerning new occupations and 84% for renegotiation of contracts). In the same period, the prime yield was 6.25%, and the main logistics centres can be found in *Carregado, Alverca, Loures*, in the Western Corridor, in *Prior Velho, Montijo* and *Palmela*.

4.1.3 Key Stakeholders

The key stakeholders involved in the Commercial Real Estate industry are divided into internal and external ones (Caputo 2013). Based on literature, examples of internal stakeholders are the customers (tenants), shareholders, workers, financial sponsors, suppliers (mostly sellers), the project team, and support teams and organizations (such as appraisers). External stakeholders are, among others, Real Estate asset owners (competitors), political and organizations, local communities, local and national authorities and environmentalists. Therefore, this section comprehends an analysis of both competition and appraisal experts.

Global Competitors

In general terms, the professionally managed global industry of Real Estate funds comprised around €3.2 trillion in 2019 (INREV 2020). Moreover, as of 2019, European Real Estate investors made up over one third in the top 100 ranked by AuM (Statista 2019), much driven by the German market. The top three European listed Real Estate funds worth mentioning are *Allianz*, *Bayerisch Versorgungskammer* and *MEAG Munich ERGO*, summing US\$ 88.41 billion of AuM (the data regarding the leading Real Estate investment managers in Europe as of 2018 by AuM was retrieved from Statista). The German *Allianz* was the top investor with over US\$ 72 billion in AuM, followed by *APG* of the Netherlands summing over US\$ 48 billion in AuM, and the French *Axa*, with over US\$ 36 billion in AuM. Furthermore, when looking at the non-listed market, the top three Real Estate managers of 2019 were Blackstone, PGIM and Brookfield, in tandem with the overall top ten AuM chart (INREV 2019).

Portuguese Competitors

The most important asset management firms operating in the market for Portuguese non-listed Commercial Real Estate funds are the following (ranked by market share): *Interfundos* (13.20%), Square Asset Management (10.40%), *Norfin* (10.10%), *Fundger* (5.20%) and BPI

GA (5.00%) – summarized in Appendix 4.5. Among the previous, only *Norfin* does not manage open-end funds. Thus, we analyzed the top open-end funds managed by the players mentioned above, concerning their AuM, returns, participation unit price, volatility, sharpe ratio and investment style (summarized in Appendix 4.6¹)

Firstly, *AF Portfólio Imobiliário* managed by *Interfundos* sums € 261.72 million of AuM and an annual return of 3.43%. The fund seeks geographical dispersion in the national space (Appendix 4.7), predominantly in urban areas, favouring Real Estate acquisition for leasing. The latter are mostly directed for office services, retail and industrials.

Secondly, *CA Património Crescente* is managed by Square Asset Management, summing € 817 million of AuM and facing a 4.07% annual return. The favourable results associated with low volatility levels conferred the fund with national and international recognition. It was awarded for the tenth consecutive time by MSCI with the "Best Balanced Real Estate Portfolio", as well as with the "Best Open Real Estate Investment Fund" by APFIPP three times so far. The fund mostly invests in shopping centres (31.2%), office spaces (24.1%), retail (15%) and warehouses (12.9%) (shown in Appendix 4.8).

Thirdly, *Fundimo* is a fund managed by *Fundger*, with € 608 million of AuM and 6.03% annual returns. This fund is similar to *Imofomento* in terms of segment distribution, with a 55% amount allocated to office spaces, 18% to industrial areas, 18% to retail and the remaining 10% assigned to other segments (Appendix 4.9).

Lastly, *Vip Real Estate Fund* is managed by *Silvip*, with an annual return of 3.85% and holding approximately € 308 million worth of assets, with 54% of the portfolio invested on offices, as shown in Appendix 4.10.

¹ The market data was retrieved from Fund's People (2019 market data) and the information from each fund and corresponding asset manager was obtained through their websites.

Appraisers

An appraisal expert is a crucial Real Estate stakeholder, since the industry relies on the constant valuation of its physical assets for financial reporting purposes, tax reporting, transaction support, or support over a litigation procedure. In Portugal, rules² are set by the securities regulator CMVM (*Comissão do Mercado de Valores Mobiliários*), which makes the final decision over the valuer's ability to engage in valuation activity. The decision considers the binding opinion of the Bank of Portugal and the ASF (*Autoridade de Supervisão de Seguros e Fundos de Pensões*). In 2020, according to the CMVM, there were a total of 1670 valuers comprising both individuals (around 87%) and firms.

There is a growing importance of combining professional, technical and performance standards allied with transparency, consistency and the ability to interpret market dynamics and trends, such as the ever-increasing relevance of sustainability. Thus, valuers look for implementation guides and follow international standards for ethics and measurement. In Portugal, there is a total of 116 RICS-qualified valuers that comply with a well-established system of regulations, positioning them as the leading providers of IVS-compliant valuations (Royal Institution of Chartered Surveyors 2020).

According to the CMVM regulation n° 1/2017, valuers are required to report their activity results – namely the number of valuations performed, the global value of assets subject to valuation and the total revenue obtained from the valuation services. As a result, according to the Circular Letter released by CMVM on May 2020, a total of €87.8 billion in assets belonging to entities of the Portuguese financial system were subject to valuations (a total of 222 thousand

² Valuers must comply with article 2° of DL n° 153/2015 of 14th September in order to engage in a valuation procedure of assets belonging to entities of the Portuguese financial system.

valuations³). In 2018, the revenues from valuation practices amounted to €23.5 million, facing a decrease of around 4% compared to 2017.

Regarding the market environment in 2018, 41 valuers registered as professional appraising firms had around 83% of market share, representing 181 thousand assets with €72.5 billion in value. Besides, the major appraising firms in Portugal generated €18.9 million. Regarding the clients requesting valuations, 84% were credit entities and 12% were entities responsible for the Collective Investment Organization management – corresponding to 68% and 26% of the global value subject to valuation, respectively. According to the CMCV (2020), most evaluations performed were located in the Portuguese most popular Real Estate regions, namely Lisbon, Porto and Algarve. Lastly, 80% of the assets subject to valuation were residential, corresponding to 47% of the total value subject to valuation.

4.2 The Industry

This section overviews the Portuguese CRE non-listed funds' industry by assessing their performance, size, and gearing, being the previous two considered fund characteristics. The analysis was made for fifteen years, from 2004 to 2019, providing a clear picture of this market's behaviour. APFIPP non-listed fund indexes were the data used for the analysis on non-listed funds. One should note that APFIPP has indexes for closed-end, open-end and mixed funds⁴. Yet, concerning fund characteristics, we make a distinction between open-end and closed-end funds (only in 2018 and 2019).

³ Data released in the Circular Letter refers to 2018, given that valuers' reported data for the year 2019 is not yet available.

⁴ By 2019, the index closed-end funds incorporated 182 members with a total NAV of around €5,959 million, the index for open-end funds had 12 members and a NAV of around €3,807 million, and the aggregate index of both closed-end and open-end funds alongside other smaller types such as F.I.I.A.H's, FUNGEPI and Forest Funds, summed 210 funds with a NAV of around €10,511 million.

4.2.1 Performance

We measured Performance based on APFIPP-MSCI time-series indexes with monthly data. The previous were annualized by creating an index with December 2003 as the base. Accounting for the fifteen years under analysis, open-end non-listed funds had the best performance, with higher returns and lower volatility (Appendix 4.11). This performance derives from the higher flexibility that characterizes this vehicle structure, allowing for better time investment opportunities. Besides their high flexibility levels, open-end funds traditionally tend to have an investment style in core properties that have a higher degree of liquidity and usually diversify better their portfolios. The core investment style results in a lower negative impact in returns during times of crisis, such as the subprime crisis of 2007-2009 and the European debt crisis of 2012, which created a period of negative returns until 2016 across the three indices.

Overall, from 2004 to 2019, the APFIPP open-end funds presented an average annualized return of 1.56% and a standard deviation of 2.92%. Closed-end funds were highly penalized by the two crises, facing a lower average annualized return (-0.80%) and higher volatility (4.05%). The aggregate index of APFIPP-MSCI had an average annualized return of 1.04% and a standard deviation of 2.92%.

4.2.2 Fund Characteristics: Size and Gearing

The Size of Portuguese non-listed funds (average fund size) is a function of the historical NAV (net asset value) of the APFIPP index divided by the total number of funds – described in Appendix 4.12. Analyzing the inputs, we verified a steep growth in both NAV and number of funds until the end of the subprime crisis, with the NAV doubling from around €6,000 million to €12,000 million, between 2003 and 2009. This growth was driven by the rapid development of new funds, particularly closed-end funds, during the period known as a booming market for

the Real Estate fund industry (non-listed funds increased from 51 in 2003 to 261 in 2010). The market was highly competitive until the European debt crisis arrived in 2012. Consequently, a market consolidation was observed, with some funds closing operations. The total NAV stabilized around €10,500 million, between 2012 and 2019. As a result of the inputs' development, we observed a gradual reduction in average fund size, from €115 million in 2003 to €50 million in 2006, remaining stable around the previous value until 2019.

In 2018 and 2019, we performed a distinction between open-end and closed-end funds. Open-end funds were, on average, nine times larger than closed-end funds. In 2019, there were 12 open-end funds which summed to €3,807 million in NAV, resulting in an average fund size of around €317 million. Closed-end funds were much smaller, while representing an overwhelming percentage of the overall market (182 players). Their average size is around €33 million, similar to the one verified for the combined APFIPP index. By being larger, open-end funds can seize better opportunities and invest in prime locations, a characteristic of their typical core investment style. Additionally, size provides the benefits of economies of scale and the ability to acquire more considerable numbers of assets, generating diversification benefits that allow for higher returns and better protection in times of crisis.

We also analyzed the Gearing of Portuguese non-listed funds, which is defined as the level of a fund's debt as a percentage of its NAV, being a proxy for fund leverage. The impact of gearing on performance verified an asymmetric effect, depending on whether the period considered is one that comprehends gains or a crisis (Appendix 4.13). When considering the segmentation performed in 2018 and 2019, we observed that €1,068 million debt is incurred by closed-end funds, resulting in a Gearing level of 17.93%. In contrast, open-end funds faced around €36 million in loans and much higher liquidity levels (around €358 million), resulting in a Gearing of only 0.96%. Moreover, the performance verified in each vehicle structure reinforces the Gearing's impact on returns, since closed-end funds face higher Gearing levels and lower

returns during the two periods of crisis. Open-end funds, which are relatively healthier in financial terms, displayed enough liquidity to cover the loans incurred.

4.2.3 Impact of the Portuguese Economy

In this section, we crossed the Portuguese macroeconomic factors with industry performance. The variables addressed are motivated by the academic literature exposed in Chapter 5.2.1 and comprise the following: real GDP growth, inflation growth (CPI) and inflation surprise, 10-year Portuguese real interest rate growth, money supply real growth, stock market excess return, the unemployment rate⁵ and industry performance (measured through the APFIPP indexes' returns⁶).

The Portuguese economy has been growing steadily in recent years, facing a 2.53% and 2.29% real GDP growth rate in 2018 and 2019, respectively. The latter, together with a 0.2% government surplus budget in 2019, created a positive environment that contributes to the low volatility and relatively high returns of around 3% of the Portuguese non-listed funds. Real GDP growth demonstrates a positive correlation with non-listed funds' performance (Appendix 4.14 plots real GDP growth against the APFIPP index return). Intuitively, as real GDP grows, firms expand their production levels and the demand for space increases, pressuring rents upwards. This factor is specific to the Real Estate industry since construction is time-consuming. Therefore, supply levels are unable to rapidly adjust to steep and upward movements in demand, increasing the rent's level of the existing buildings. As a consequence of higher rents, demand increases and more investors aim to own high return generating assets, which increases both asset prices and fund returns.

⁵ The data is obtained from different sources, namely the Federal Reserve Economic Database for real GDP growth, money supply real growth and 10-year Portuguese interest rate growth. We used BPstat to obtain inflation and Bloomberg to get inflation surprise and stock market excess return. Lastly, the unemployment rate comes from the Ameco database.

⁶ Considering the sample period of 15 years (from 2004 to 2019) and using annualized indexes with December 2003 as the base year, in order to uniformize the data with different release frequencies.

Inflation (growth rate of the Consumer Price Index, CPI) has been decreasing in the last three years, reaching values near 0%. The European Commission forecasted inflation to become extremely close to the previous amount in 2020, while growing to 1.2% in 2021. Inflation has a positive correlation with the returns of non-listed funds since Real Estate assets are traditionally perceived as safe investments, being able to hedge inflation (Appendix 4.15 plots inflation against the APFIPP index return). Various Real Estate properties generate a rental revenue indexed to inflation growth, and therefore owners can gain from the movements in the CPI index.

Further assessing the topic of inflation, unexpected (or surprise) inflation has been negative in the Portuguese market. This implies that actual inflation was lower than expected, according to Bloomberg, in the last two years. Compared to inflation growth, this variable has the opposite effect on returns since investors ideally wish to hedge against both expected and unexpected movements of inflation (Appendix 4.16). The higher the inflation surprise, the lower will be the expected inflation relative to the actual inflation, and the lower will be the allocation towards Real Estate funds based on expected inflation, given that the anticipated inflation hedging attractiveness of this asset class is lower.

Another significant macro variable worth analysing is the 10-year interest rate growth. In recent years, interest rates have verified a decreasing trend, much similar to the European panorama where the European Central Bank (ECB) has been cutting rates down. This variable negatively correlates with the annual returns of non-listed funds because a higher cost of capital negatively impacts Real Estate valuations, difficult the access to capital and pressures Real Estate yields (Appendix 4.17). As interest rates increase, Real Estate investors require higher yields to compensate for the more attractive investment opportunities in fixed income. As investors might be unable to catch up with the high fixed income yields, they give up on their Real Estate investments, influencing negatively returns.

Money supply (M1) has been increasing steadily throughout the years, with a sharper increase driven by the pandemic scenario. Money supply's real growth has a positive correlation with non-listed funds' performance when the former is lagged, due to fact that a higher supply of money implies easier access to capital, decreasing interest rates (Appendix 4.18). This enables investors to use leverage at a lower cost, which increases the demand for Real Estate assets. The macro variable positively impacts APFIPP returns, even though this impact takes time to materialize.

The unemployment rate has maintained its strong downward trend, facing a 6.5% level in 2019, a notorious recovery since the peak of the European debt crisis in 2012. This indicator reflects the state of the economy and is negatively correlated with non-listed fund's returns (Appendix 4.19). A growing unemployment rate is a product of the deterioration of several macroeconomic factors, resulting in lower production, with Real Estate asset prices and fund returns decreasing.

The stock market is represented in this analysis by the stock market's excess returns, calculated by subtracting the Portuguese MSCI index return by the Portuguese three-month risk-free interest rate (Lisbon's interbank offer rate). The excess return of this index has been positive from 2015 until 2019, except for 2018, when a 10% negative excess return was verified mostly attributed to geopolitical risks. This variable has a mild positive correlation with non-listed funds' returns, showing the impact of Portuguese equity market's gains in other asset classes (Appendix 4.20).

4.2.4 Five Forces Shaping the Industry

To complement the CRE industry assessment, this chapter studies the paper developed by Michael Porter that defines five different forces shaping the industry (summarized in Appendix 4.21). The analysis applies Porter's strategic model to the non-listed funds' Portuguese Commercial Real Estate industry and for direct Real Estate exposure. It distinguishes between

factors that affect the fund (for instance, new entrants, substitutes and competitors) and others linked to the subjacent asset class (such as suppliers and buyers).

Overall, entry barriers for all CRE players tend to be high since Real Estate investments are connected with high entry and transaction costs, while being illiquid and time-consuming to be traded. The previous implies that small players face difficulties thriving in this market. Moreover, suppliers' bargaining power is seen from two perspectives: suppliers of existing buildings and providers of external services (such as cleaning services and security companies, and the ones related to constructions). Among the previous, suppliers of existing buildings have moderately high bargaining power, since CRE buildings don not trade frequently. The remaining suppliers have a low negotiating power.

The bargaining power of buyers tends to be moderately low, given the Portuguese market's current excess demand. Besides, the threat of substitutes may be increasing, since the Covid-19 pandemic is changing the status-quo of CRE. Alternative solutions are rising, such as REITs that enable investors to get indirect exposure market. Lastly, the rivalry between existing significant competitors in the CRE fund's industry is fierce, composed by similar market shares in a fragmented market.

4.3 The Impact of Covid-19

At the beginning of 2020, low interest rates and low unemployment levels allowed Commercial Real Estate investors and asset owners to benefit from a favourable and profitable economic environment. However, the Covid-19 pandemic affected the overall economy, and new trends have been emerging in the industry. According to JP Morgan's head of Commercial Real Estate, there is a prominent concern among investors and tenants. The latter is caused by the notorious decrease in the overall activity levels when compared to 2019 and the uncertainty regarding the possibility of future stronger economic downturns. The investment in global Commercial Real

Estate summed \$109 billion in the second quarter of 2020, an abrupt 57% reduction compared to its homologous period in 2019 – and the lowest since 2012. More precisely, in the second quarter, Americas reported significant negative growth of 69% in Real Estate investments, with APAC countries registering the second-largest decline of 46%, and the EMEA facing a 38% drop.

The performance of the Portuguese economy was impacted by the global pandemic, consequently affecting the Portuguese property market. Yet, the latter faces an optimistic shape, due to a sustained demand for properties. Lisbon is one of the few world cities where prime property prices are expected to rise throughout the following months, caused by a constant demand from international investors. The analysis of pandemic impact in the Portuguese Commercial Real Estate industry is based on a study produced by Cushman & Wakefield (2020), that indicated a total of €1,670 million worth of investments registered in the first quarter – a record amount that represents a 50% increase when compared to the homologous period. The high performance was mainly attributed to the sale of 50% of the *Sierra Prime* joint venture between *Sonae Sierra* and *APG*, to *Allianz Real Estate* and *Elo*, for approximately €800 million. However, a sharper decline of 88% was verified in the second quarter, when the pandemic's economic consequences became more notorious.

Overall, the Commercial Real Estate industry's performance in the first half of 2020 was mostly influenced by the retail sector, representing 56% of the total amount invested. The sale of *Finsolutia's* PREOF portfolio to *Cerberus* (€150-170 million) and the acquisition of *Natura Towers* by *Cofidis* (€46 million) were the main transactions, retail was followed by office (21%) and hotel (18%) sectors, which are expected to be the two most affected sectors. Furthermore, the total investment volume is expected to sum € 2,500 million at the end of the year, a 20% drop compared to 2019. The previous highlights that the high activity levels at the beginning of the year were insufficient to compensate the enormous economic decline.

Focusing on the office sector, its performance was quite distinct for the two main Portuguese areas of Greater Lisbon and Greater Porto. In Greater Lisbon, the conclusion of some large-scale transactions undertaken during the pre-pandemic period, essentially between January and March 2020, smoothed the decrease in the Real Estate investment volume. Yet, it was insufficient to avoid the poor sector's performance. During the period of high transactions, 84,400 sqm were traded⁷ – a statistical record within the office sector performance – much driven by the Prime CBD (26% of the total area traded). In Greater Porto, the transactions held and concluded before the pandemic were broad enough to prevent a decrease in performance compared to the previous year. The investment volume in the first half of 2020 was 38% higher⁸ than the one verified in the homologous period.

Regarding the retail and logistics sectors, the former verified a 64% decline in transactions in the first half of 2020, while facing a significant 82% downturn in the second quarter (compared to the same period in 2019). Concerning the logistics sector, the first half of 2020 was also characterized by a marginal decline in demand compared to the previous year. The previous corresponds to a 9%⁹ decrease in the sector's investment volume. Nonetheless, the present shortfall in the availability of quality properties should be covered by new projects, among which the *Lisbon North Logistics Network* of *Merlin Properties* stands out with a total area of 225,000 sqm.

All in all, even though the pandemic is largely affecting the global Real Estate investment activity, Portugal is one of the least affected markets due to its specific features that fascinate a significant number of international investors. Still, we expect that a full recovery will require some time to materialize.

⁷ Representing a total of 57 transactions and an average area traded per transaction of 1,480 sqm.

⁸ The percentage corresponds to 28,400 sqm traded in Porto during Q1 2010, summing to a total of 24 transactions and an average area traded per transaction of 1,180 sqm.

⁹ Between January and June of 2020 64,400 sqm of logistics Real Estate assets were transacted.

5 Literature Review

The term “factor” is commonly used to any characteristic that is proved to be essential to explain either risk or returns. Even though academic researchers have found significant factors that explain returns, they may not earn a premium in the long run (Bender, et al. 2013). Several academic researchers and investors in all the financial field have attempted to build factor models with significant explanatory power to measure risk premiums of both bonds and stocks. The most coherent frameworks are the Capital Asset Pricing Model (CAPM), which became a modern financial theory in the 1960’s by Treynor (1961), Sharpe (1964), Lintner (1965) and Mossin (1966); the Arbitrage pricing theory (APT) developed by Ross (1976), which is a theory that considers the expected return of a financial asset can be computed as a function of different macroeconomic factors or theoretical market indexes (Bender, et al. 2013); the Fama and French three factor model (FF3M), and, finally, in 1997, Mark Carhart proposed adding an extra factor to the FF3M: momentum factor, and the model was known as the Fama-French-Carhart Factor Model (FFCM) (Bodie , Kane and Marcus 2013).

Asset managers usually rely on factor models for investment decisions as there is quite strong evidence those factors are statistically significant. Therefore, it creates a special interest in investigating whether factor models can also be relied upon when considering alternative asset classes, such as Real Estate.

5.1 Macro Factor Models for Real Estate

5.1.1 Macroeconomic Risk

Regarding equities, as mentioned before, there are some well-known macro factors from academic research such as value, low size, momentum, low volatility, among others. Nonetheless, factor analysis has also been a useful model in Real Estate research to identify

factors that explain Real Estate risk and returns, investment decisions, and risk management (Gupta, et al. 2018). Economic models give some understanding of the fundamentals behind prices, mainly demand indicators and supply limitations. Macroeconomic drivers are essential as Real Estate investments tend to have a long-term perspective. Indeed, most academic studies focus on macroeconomic factors as macro risk measures at which most Commercial Real Estate securities are exposed. Even though there is no clear consensus on which macro factors are indeed relevant, some researchers defend similar conclusions.

Delfim and Hoesli (2016), who studied the European non-listed Real Estate funds, built a panel data with returns from French, Italian, English, and Dutch funds and analysed how the following variables affected their performance: real GDP growth, inflation, unexpected inflation, interest rates (10-year Treasury Bond), credit spread, money supply and the stock market excess return, among other specific portfolio variables such as gearing, size, and age. The model's explanatory power was strong, with an adjusted R squared of 63.8%, demonstrating that these variables influence European non-listed funds' returns. Likewise, Matysiak and Fuerst (2013) built a dataset with panel configuration, aiming to capture the relation between non-listed Real Estate funds' performance and market movements. The results indicate that factors like real GDP, interest rates and stocks are important drivers. Also, the authors state that usually Real Estate funds do not account for high levels of diversification. Thus, the fund's micro risk adds to the overall volatility.

Additionally, Hoskins et al.'s article (2004) aimed to identify patterns between macroeconomic indicators and Commercial Real Estate indexes performance in major economies such as American, English, Canadian and Australian ones. The authors chose some key-leading macroeconomic indicators: real GDP growth, unemployment rate, inflation, exchange rates with USD, interest rates and stock market performance. The article concluded the Commercial

Real Estate indexes returns align with these factors, even though the relation might have taken longer to show in some cases.

Furthermore, Devaney et al. (2017) studied the transaction activity variation between Commercial Real Estate markets as a proxy for market liquidity. More precisely, the authors examine over 38 economies in Europe and Asia-Pacific from 2000 to 2014 and developed a framework by estimating a fixed effect panel model. The independent variable was the turnover rates, and the vector of dependent variables included the investment in property stock, the GDP *per capita*, vacancy rate, bond yield spread, net inward FDI, change in the current account balance as a percentage of GDP, property rights index, and a dummy variable for the period of the Global Financial Crisis (2008-2010). The results showed that all variables were statistically significant.

However, Gupta and Tiwari (2016) found that in an emerging market like India, market risks as interest rate movements, rental movement, and occupier demand were not considered significant elements of risk. Nonetheless, according to Li and Chen (2015), who investigated the correlation between Commercial Real Estate returns and macroeconomic variables in China, concluded that money supply, employment rate, long-term interest rates, inflation, and GDP growth had relatively high levels of correlation.

Overall, leading research on Real Estate and macroeconomic variables conclude on some consistent fundamental drivers throughout the study years. Some studies link direct Real Estate to listed Real Estate and prove that the latter should be incorporated in models to predict future direct Real Estate returns, considering that such indicator should be lagged (Ling and Naranjo 2015) (Gyourko and Keim 1992). The previous conclusions are quite relevant for non-listed Real Estate funds as they are highly dependent on the performance of the underlying properties.

5.2 Micro Factors – Portfolio Level Variables

Even though macroeconomic factors proved to be statistically significant Real Estate performance indicators, they cannot fully explain it. For instance, Delfim and Hoesli (2016) model has an adjusted R squared of 63.8%. Hence, one should consider more micro factors of Real Estate funds' underlying assets as Real Estate returns' significant performance drivers.

5.2.1 Tenant Risk

Real Estate returns are highly dependent on the income-producing part of the investment, meaning that rents received enhance the attractiveness of having direct Real Estate holdings. Therefore, leased properties face the risk that tenants may not meet their obligations as expected, and late payments can generate cash flow problems for property owners. However, the scenario can be aggravated if the tenant declares bankruptcy and is forced out of the space (Grenadier 1996). Consequently, the property owner faces an unexpected shortfall in lease income along with additional costs of finding a new tenant to occupy the space.

Moreover, tenant concentration represents another risk to Real Estate investors (Blundell, Fairchild and Goodchild 2005). If the portfolio is highly concentrated in a certain or a small group of tenants, its returns are deeply dependent on those tenants' performance and creditworthiness. There is no proven compensatory association between tenant concentration and higher returns, but quite the opposite because of possible significant losses (Blundell, Fairchild and Goodchild 2005). Also, there is a relation between the tenants' credit quality and the inherent default risk in the rent payment. Reliable tenants could be considered as the ones who have investment-grade bonds. Usually, the higher the credit risk, the higher is the asked yield for a particular bond due to the risk premium. Hence, in the Real Estate case, riskier tenants should pay a rental premium. In most cases, a collateral warranty is required for tenants

with a poor credit quality as a way of owners protecting themselves in case of default (Grenadier 1996).

Several well-established models can measure companies' credit risk, such as the Merton's Model, Moody's-KMV EDF, and Credit Metrics. Also, credit rating agencies such as Moody's, S&P or Fitch may have a rating for specific tenants, which could be used as a way to measure credit risk. However, these models require data that might not be available for small/mid-cap private companies. Nonetheless, as an income-producing investment, Real Estate cash flows depend on the tenants' capacity to pay in order to meet its future obligations according to the lease terms (Short, et al. 2003). Thus, the previous is a risk that must be monitored closely.

5.2.2 *Vacancy Risk*

Real Estate investors look forward to owning and most often actively managing income-producing properties in different sectors, such as offices, shopping malls, parking lots, among others. When considering income-producing properties, it is crucial to consider three risks: vacancy risk, tenants' default, and the risk of renting the property out again or selling it after the contract expires (Giannotti and Mattarocci 2009). The authors also support the idea that vacancy rates depend on the building's owners' requested rent and potential tenants' commitment to pay. Furthermore, there is a belief that the vacancy rate equilibrium in the medium/long-term mainly relies on the number of available properties on the market, which offer similar traits, and on the tenants' capacity to pay the required rent (McDonald 2000). Moreover, as an income-producing investment, the cash flows depend on the tenants' ability to meet its future obligations according to the lease terms (Short, et al. 2003).

According to the empirical methodology involved in the research made by Sivitanides et al. (2003), the office market fundamentals are the vacancies and market rents, which long-term historical trends explain the behaviour of privately held property net operating income (NOI)

and property values (P). The ratio of the property's NOI over value (P) corresponds to the capitalization rate (C). The strong behavioural relation observed between the two previously mentioned market fundamentals are the research's main findings. As vacancy rates decrease, real office rent increases, added to the fact that there is a high degree of inertia in market adjustments and a pronounced mean-reverting behaviour.

According to Giannotti and Mattarocci (2009) and Short et al. (2003) the vacancy rates and consequent level of occupancy in Real Estate properties depend mainly on the rent asked by the property owner and the tenant's capacity to pay it throughout the full contract's lifetime. This means that the vacancy rate and consequent risk derives directly from the tenant's rating and respective probability (risk) of being unable to correctly pay the rental's total amount during the contract's full period. According to the same studies referred above, property's owners face a high chance of not being fully paid by the tenant when accepting low rated tenants regarding their financial sustainability capacity. Typically, when such situations occur, tenants start to delay their rental payments until they have enough financial resources. This means that the property owner will not receive the full annual amount of rent in each year of the rental contract but just a portion of it.

When negotiating a new contract for a period with an already existing tenant, it is crucial to carefully analyse if, according to historical tenant payments' records, this tenant is financially capable of supporting the full rental's value for the total period of the contract. If the property owner concludes that the historical records indicate that it is a considerable risk to extend this tenant's contract due to its lack of financial capacity (high level of tenant risk) to pay the full rental amount for the entire contract lifetime, then the hypothesis of finding a new and wealthier tenant for that building might be preferable (Giannotti and Mattarocci 2009). Nevertheless, until a more financially stable tenant is found, the building will stay vacant and not producing any income. In this case, this vacancy rate might represent a valuable opportunity if in the end a

better tenant is found and the property's owner can receive the building's full rental amount throughout the entire contract's period, which would not happen with the first tenant. On the other hand, if a wealthier or more financially stable tenant is not found, the owner will lose the rental's amount. Even if not the full amount, it represents the value that the owner could have received during the search time if he/she had initially accepted the already existed tenant. All in all, the valuation of this option to wait to search for new and wealthier tenants must be made before terminating the relation with the existing tenant.

As reported by Oppenheimer (2002), Discounted Cash Flow (DCF) models have been criticised mainly for using risky discount rates and subjective cash flows estimates. Moreover, it states that this type of valuation model doesn't include specific valuations of implicit options embedded in Real Estate capital projects. To overcome this issue, Oppenheimer (2002) recommends using real options pricing models when analysing Real Estate projects or decision moments. Nevertheless, since Real Estate presents a vast and significant subjectivity factor in every single valuation model that might be considered to use, the former paper suggests a complementary sensitivity analysis when performing such a study. The user can clearly understand the model's inputs' effects in the final output.

Considering the issue previously addressed, a Real Estate option pricing model should be used to understand if the option to wait is valuable or not. Consequently, this would increase a particular building's vacancy rate until finding a more financially stable tenant, instead of extending the existing tenant's contract right away. However, having a percentage of vacant space for a certain period may present itself as an opportunity for the property owner to find a more reliable tenant.

This academically based reasoning aims to determine whether a specific building's vacancy rate is always a signal of poor performance (consequently a risk) or if the vacant building owner is taking advantage of a valuable option/opportunity to improve its returns.

5.2.3 *Asset Concentration Risk*

Firstly, according to an informal survey applied to some UK property investment managers that aimed to seek their views on the factors that contribute for the riskiness of a property portfolio, excessive concentration on specific property types is one of the three primary sources of concentration risk (Adair and Hutchison 2005). This type of asset concentration risk measures the percentage of a fund's capital value allocated to each property type (offices, industry, retail, etc.) and evaluates how dependent the fund's value is on one specific property type.

Secondly, and still based on the previous survey, the over-concentration on large value assets is also a significant risk factor that needs to be managed in order to control for the volatility of fund's returns. Moreover, based on a study over risk management on a Real Estate portfolio, size concentration risk measures the percentage of fund's capital value that is bound up in the fund's five biggest assets (Blundell, Fairchild and Goodchild 2005). The higher is the size concentration, the more vulnerable the fund becomes to events affecting those properties. Also, concentration on large assets seems to have no significant correlation with higher returns – verifying a 0.10 correlation with the 10-Year Returns – therefore not compensating for the additional risk of not having a diversified portfolio in terms of assets size.

Lastly, location concentration is an important metric to consider when analysing Real Estate investment opportunities inside a fund's portfolio. Location concentration risk measures the percentage of each fund's capital value invested in the ten most essential locations to each fund (Blundell, Fairchild and Goodchild 2005). However, contrary to the size factor, the location concentration is mildly correlated with returns – 0.18 correlation with the 10-Year Returns – suggesting that there is some pay off for location concentration within a Real Estate portfolio. Furthermore, a portfolio may be exposed to various location concentration risks. On the one hand, flooding is related to the risk of a specific location. However, it should not only be

associated with proximity to rivers or the sea, given the increasing threat of localised flooding due to extreme rainfall situations occurred in the last decade, which is expected to aggravate in the future (Pottinger and Tanton 2014). Thus, the flooding risk factor should be included when analysing a particular geography's Real Estate investment opportunity. On the other hand, as pointed out in a study on economic seismic risk for buildings, the seismic risk is a factor taken into account during the real-estate decision process (Porter, Beck and Shaikhutdinov 2004). Therefore, the authors stress the importance of considering this factor when assessing a particular portfolio's overall concentration risk exposure.

5.2.4 *Liquidity Risk*

As previously mentioned when describing the asset class, Real Estate is deemed to have relatively low liquidity, thus high liquidity risk. The previous derived from the considerable value a single Real Estate investment requires and the time and cost it takes to sell the underlying property for the current value. On the one hand, liquidity can convert a specific asset into cash reasonably quickly while not incurring a significant price discount or principal loss. In the Real Estate case, investors are improbable to agree to immediate purchase of a property, unless there is a discount on the price. On the other hand, illiquidity incorporates both a long time to turn the asset into cash and also the risk that the selling price may diverge from the owner's perceived fair price (Fisher and MacGregor 2020).

In Real Estate funds, liquidity takes an even more critical role, relating to the amount of cash detained as a percentage of the fund's total value (Tira and Marcato 2010). As Ling and Naranjo (2002) mentioned, cash does not provide any return increase to the fund's performance. However, it is still advantageous to keep the fund flexible and prepared to deal with negative flows from fund redemptions. Indeed, the Real Estate funds are vulnerable to liquidity shocks as in severe liquidity crises asset managers may be forced to sell properties at a significant

discount in order to meet their obligations to investors, which may take months or even a year to finalise the selling process (Tira and Marcato 2010).

Measuring liquidity risk in private Real Estate markets has been studied by some scholars. For instance, liquidity risk could be measured by the volatility in asset returns over the (uncertain) time to sale (time-on-market) (Cheng, Lin and Liu 2010). Otherwise, the liquidity proxy for Commercial Real Estate could be the difference between an index imputed seller reservation prices and the estimate of the buyer's reservation prices level (Fisher, Geltner and Pollakowski 2007). Nonetheless, these suggested mechanisms require high-frequency data, which may be hard to obtain in countries that are not so developed in terms of research. Thus, some other processes may be applied in order to evaluate the liquidity risk in Real Estate.

The Association of the Luxembourg Fund Industry (ALFI) (2018) developed liquidity stress testing guidelines for Real Estate funds. Specifically, regarding open-ended Real Estate funds, one should stress different redemption scenarios, for instance considering the largest investor redeeming, the type of investor redemption, the redemptions based on historical experience or even a redemption of a fixed percentage. Moreover, in terms of asset liquidity, they suggest evaluating which properties should be sold first through a liquidity score. Finally, as one of the primary sources of liquidity are the monthly rents received from the Real Estate investments as mentioned by Bannier et al. (2007) rental growth should serve as a measure of the fund's liquidity level and should be monitored closely.

Property Liquidity Score

During liquidity crises, Real Estate funds are usually forced to sell properties in order to pay the investors' redemptions. As a result, funds must evaluate which properties on their portfolio would be easily sold in the market. There are some crucial determinants of Real Estate transaction frequency to consider when building a property liquidity score.

For instance, Fisher et al. (2004) developed a probit model with the goal to determine the probability of a property being sold. The authors found that this probability would be a function of three leading groups of factors: market conditions, property characteristics, and ownership characteristics. Considering the former, economic growth and prosperity are expected to be positively correlated with the likelihood of a property being sold. Also, government intervention takes a crucial role in influencing the transaction frequency, for example, by reducing tax benefits. The authors also analyse the motivation behind the owner's willingness to sell as well as the difference between buyers' and sellers' reservation prices. Lastly, within the property characteristics, factors such as property condition, age, location, property type, and occupancy are extremely relevant variables as they influence mostly the buying part of the deal. Furthermore, Klimczak (2010) analyses the determinants of Real Estate investments, stressing that it is essential to understand the factors buyers value the most to evaluate which property could be sold faster in the market. Therefore, from a profitability point of view, investors are also concerned about the capitalization rate and the return on the investment, as well as the income from the Real Estate.

5.2.5 Valuation Risk

Differentiating Price and Value

Valuation risk is a major topic in fund management that influences investment decisions. Firstly, there are two concepts worth clarifying – the price and the value of an asset. On the one hand, the price is the outcome of a negotiation process, resulting from the purchase and sale transactions that occur regularly in the Real Estate industry. Understanding the fair price requires accurate information related to the particular asset, mostly obtained through intermediaries with professional investment expertise and specialist knowledge, giving rise to asymmetries in information regarding asset quality and fund manager behaviour (Morgan

2002). On the other hand, value is the judgement of the appraisal expert concerning an estimated amount based on fundamental premises – which are the basis of value – that are appropriate to the purpose of the valuation, resulting in the ultimate appraisal expert's opinion of value (RICS Valuation Professional Group 2019). In other words, the value of an asset results from an appraisal process which depends both on several criteria established by the regulated appraisal expert and on the particular Real Estate property subject to a valuation engagement.

Quantifying Risk: Capitalization Rate

The capitalization rate reflects the risks perceived by the market participants when a purchase occurs. The capitalization rate choice is either made through a statistical or analogical procedure, with the latter being the most common (Manganelli, Morano and Tajani 2014). The analogical procedure is usually a comparison between the capitalization rate of investments made in similar properties, concerning both the investment risk and duration. The assumed cap rate is then adjusted up or down under the possible differences in investment risk.

However, the low transaction volume verified in the public domain and the imperfections of the Real Estate and capital markets result in various challenges when estimating risk-adjusted discount rates for valuations through historical data (Weber, Siebenmorgen and Weber 2005), restricting the analysis of pricing and performance measured through the analogical procedure. The previous exposes the need for a refined pricing model that can fully reflect both complex characteristics of each specific asset's Real Estate market and attributes that most influence the capitalization rate.

Valuation Methods: General Overview

The valuation of a property is an estimation process of the market value of a Real Estate asset, which can be performed through a variety of approaches, with the most common ones being the comparable sales, the cost approach and the income approach, which are defined by Fisher

and MacGregor (2020). The comparable sales approach involves determining an approximate value for the asset-based on recent sales of comparable properties. Then, valuers adjust for differences in key characteristics, including the condition of the property, age, location and size, also contemplating price changes in the market between sales dates. Moreover, the cost approach evaluates the property's replacement cost, therefore considering estimating the market value of land and costs associated with the construction, such as labour, architectural and engineering costs, among others. The adjustments allow valuers to reach the building's final replacement cost in new conditions by considering the existing building's location and condition.

Lastly, the income approach targets income-producing properties, subdivided into two different methods: direct capitalization and discounted cash flow. The former estimates a property's value using the net operating income (NOI) – the income of the property net of operating expenses such as property taxes, insurance, maintenance, utilities and repairs – divided by the capitalization rate (cap rate) – the discount rate less the growth rate. The estimated cap rate for a specific property depends on relevant information, such as general business conditions and property qualities. Oppositely, the discount cash flow method values an income-producing property through the present value of projected future cash flows, considering the resale value at the end of the total holding period, which is often estimated using the direct capitalization approach.

Valuation Risks Associated with the Income Approach

In property investments, exchanging capital at the current purchasing power for future benefits – namely income, capital growth or a combination of both – is a source of risk, due to the uncertainty of such benefits (Baum, Mackmin and Nunnington 2011). Hence, there are four relevant property risks worth mentioning when adopting the income approach. Firstly, there is the risk that expected rents might not be realised. Thus, the expected rental income is lower

than previously anticipated. Secondly, rental increases may not occur when expected, and properties might become suddenly vacant due to a crisis, requiring additional time to find new tenants, compromising rental growth. Thirdly, it can be the case when the expected capital value growth of the property is not realised, facing either a continuous fall or a lower increase than previously expected before being sold to another investor. Finally, the costs associated with property holding may be unexpectedly high, thus compromising investors' future benefits.

The DCF Income Approach in Detail

The explicit DCF method builds upon the well-established yield pricing model – an extension of previous works (Fisher 1930) (Gordon 1959) – which defines the capitalization rate through the following equation:

$$K = R_f + R_p - g \quad (1)$$

where K is the cap rate; R_f is the nominal risk-free rate; R_p is the risk premium; and g is the growth rate.

The model has two components: the risk-adjusted discount rate and growth, with some literature extending the model to include depreciation. The risk-adjusted discount rate comprehends the risk-free rate and the risk premium. The former is the redemption yield on government bonds matched to the investment life (Baum and Crosby 2008), representing the compensating return for an investor's time preference.

Moreover, the risk premium is disaggregated by Baum and Crosby (2008) into various components that include the Real Estate market, sector, location and specific asset characteristics. The authors divide the risk premium determinants into macro risks (market) and micro risks (asset-specific). On one side of the risk spectrum, the Real Estate market risk represents the sensitivity of cash flows to economic shocks and derives from macroeconomic

indicators. Therefore, portfolio diversification in terms of asset selection does not actively reduce market risk. The sector and location components are in the middle of the spectrum that divides the risk premium between macro and micro levels of influence. Investors should consider demand and supply factors at the market's sector and the location's economic structure to assess these two components' impact on market quality and on a liquid investment opportunity. Finally, the specific asset characteristics are the last component of risk premium, which Baum and Crosby (2008) further disaggregate into tenant risk, lease risk, location risk and building risk. These components are drawn at an individual property level and represent the specific investment's liquidity, are micro factors and can be reduced through diversification.

In addition to the risk-adjusted discount rate, cap rates reflect the expected future growth and the Real Estate depreciation. However, some scholars defend that factors underpinning growth and depreciation are already present across the risk scale and wrapped into the risk premium estimation, proposing that these elements' expectations are a function of the specific asset attributes. Therefore, the measurement of such attributes reflects investors' expectations in terms of growth and depreciation (Jackson and Orr 2011) (Crosby, Jackson and Orr 2016).

Crosby et al. (2016) set out a conceptual model unravelling the complexities within a Real Estate pricing model – summarised in Appendix 5.1 – which distributes its several components along a risk scale. The authors performed an empirical analysis using observed transactions in a significant global investment market, the office sector market in central London¹⁰, and found that specific risks largely contribute towards the investment risk attached to an asset, as well as that tenant characteristics drive default and void risks. They also verified that the significant variables driving transaction cap rates were the risk-free rate, the type of Real Estate interest, the existence of residential and retail in the buildings, and the tenant's covenants strength. The

¹⁰ The analysis explores 497 transactions in the central London office market over the period 2010 Q2 – 2012 Q3, before the 2016 UK Referendum on the EU membership.

authors were surprised by the low impact on cap rates of building quality, submarket location and weighted average term to lease expiry. Moreover, the investors' perceptions explained the previous findings concerning the central London market's safe-haven characteristics and the data collected to determine the building quality detailed in Appendix 5.2, a new initiative with a significant subjectivity¹¹.

Limitations

Several scholars stress the problem of estimating the appropriate cost of capital for Real Estate investments (Ibbotson and Siegel 1984) (Quan and Quigley 1991). In a perfect capital market, it would be best practice to derive a value of an asset from the capital market data and assume that the historical returns and their fluctuations reflect all risks considered relevant for valuation. In the case of the Real Estate industry, due to the high presence of asset-specific factors on performance (Esrig, Hudgins and Cerreta 2011), there is the need for an approach which assesses the Real Estate investments and the associated risk by predicting future uncertainty. This approach should account for cash flow volatilities – the asset's income risk – and the impact of insolvency risk on an asset's value.

The income approach is the most common practice in Real Estate appraisals (Pagourtzi, et al. 2003). However, traditional DCF valuations are subject to several problems when applied to the Real Estate industry, since income and insolvency risks are generally not well-reflected. The value of an asset calculated using the DCF method can deviate substantially from the market value obtained by the appraisal companies and official expert reports as well as the prices practised by the market, something that can be viewed as a purchase or sale signal. Only in perfectly efficient markets, with equal levels and quick adjustments of information, as well

¹¹ The CoStar building quality rating is a single categorical variable that represents the first opportunity to fully explore the pricing of Real Estate attributes. This rating measures the condition of the building based on its specification, architectural quality, energy performance, quality of maintenance and prominence of its location. The building quality grading data is a new initiative and is collected by observation.

as with investors' homogeneous expectations and access to properties, there is a match between market prices and DCF values. Nonetheless, academic research points out to conceptual frameworks that assess Real Estate investments based on modern stochastic DCF model, which incorporates the nature and extent of risks that are often asymmetric (Szumilo, et al. 2016). In practice, despite these issues, institutional investors still rely on traditional approaches for investment criteria.

5.2.6 ESG Risk

Socially Responsible Investing

Financial markets have adapted to Socially Responsible Investing (SRI) 's increasing popularity and the growing concerns regarding the Sustainable Development Goals (SDGs). The incorporation of non-financial considerations, nowadays described as SRI concerns, can be traced back to the 1950s and 1960s. Even though being more focused on specific social needs – such as affordable housing and equality – the SRI sphere has grown further. The SDGs stress the trend around sustainability. The United Nations established 17 Sustainable Development Goals that aim, according to the European Central Bank, to provide a worldwide policy for eradicating all forms of poverty, fight inequalities and tackle climate change, while ensuring that no one is left behind. As a result of this popularity, there is a need to increase transparency and protect investors' value by adopting best practices. In fact, institutional investors are under increasing pressure from governments, regulators and other stakeholders, in order to contribute to a wide variety of goals concerning SRI (Brounen and Marcato 2018).

The Real Estate market plays an essential role in the SRI sphere. Large institutional investors have more than 8% of their assets invested in this asset class, and the trend is for this allocation to increase in the coming years, with public Real Estate firms allowing for a more liquid exposure to the sector (Brounen and Marcato 2018). Moreover, around 30% of total CO²

emissions are originated from the sector, stressing its importance in the fight against global warming (Green Building Council 2019). Real Estate firms see their market value derived from the underlying Real Estate assets. The previous is directly linked to ESG decisions, therefore making an impact by achieving both UN and climate goals (Brounen and Marcato 2018). Moreover, the United Nations and the RICS (2018) stress that the buildings' demand is becoming more sustainable in their design and infrastructure quality, representing a more efficient land use. The benefits of considering ESG factors are attractive for future investors, buyers and tenants.

ESG Definition

Since the beginning of the 21st century, the world has seen significant growth in the number of companies measuring, engaging and reporting according to ESG standards – Environmental, Social and Governance. The PRI (2018) associated environmental factors with the natural environment and natural systems' quality and functioning. Social factors are related to the rights, well-being and interests of people and communities. Lastly, the PRI links companies and other investee entities' governance to the relation between a company's management, its board, its shareholders, and its other stakeholders.

Sustainable versus Responsible Investing

Sustainable and responsible investing are currently common concepts used in the finance industry, yet sometimes misunderstood. On the one hand, the Brundtland's Report established the most accepted definition for sustainable development as *"the development that meets the needs of the present without compromising future generations' ability to meet their own needs"* (World Commission on Environment and Development 1987). Consequently, sustainable investing is the ideology where investment decisions focus on the well-positioning of assets to future challenges, in order to be long-term sustainable while committing efforts towards solving

the current global sustainability challenges (Nordea 2020). Although many investors believe that most sustainable challenges are faced within a long-term horizon, short-term risks highlight companies' urgency to consider them in their investment decisions.

On the other hand, the PRI defines responsible investing as a process in which companies include ESG information in investment decision-making stewardship practices, to ensure that all factors – both financial and non-financial – are taken into account when assessing risk and return (PRI 2019). Several forces have been contributing towards the progress of responsible investing, namely the growing client's demand for greater transparency about the way their money is invested, the increasing recognition that ESG factors can affect risk and return, as well as the tighter regulation that considers ESG issues as a growing investor's fiduciary duty. One should note that responsible investing is a concept broader than sustainable investing, given that the former accounts for moral or ethical goals as a primary purpose, while the latter has the sole focus of improving financial performance (PRI 2018).

ESG Disclosure

The growing demand among investors for transparency and disclosure regarding ESG issues is driving a worldwide transformation in fiduciary responsibility and corporate governance. The number of public companies reporting ESG data grew from fewer than 20 in the 90s to 8,500 by 2014, a year where more than 1,400 institutional investors managing around 60 trillion USD in assets had signed the UNPRI, United Nations Principles for Responsible Investing (Kotsantonis, Pinney and Serafeim 2016). As a further sign of ESG data's institutionalisation, Bloomberg terminals integrated ESG data in 2010 with hundreds of rating agencies, including large data providers such as Thomson Reuters and Morgan Stanley Capital International (MSCI), vigorously increasing the diffusion of ESG information. In fact, there were 44 million hits to the ESG metrics in the Bloomberg database between from November 2010 to April 2011 (Eccles, Krzus and Serafeim 2011).

At the policy level, guidelines and suggestions on non-financial ESG disclosures are adopted to enhance sustainability subjects' business transparency. The European Union adopted the Non-Financial Reporting Directive in 2014, pressing listed companies, companies over 500 employees and public-interest companies to disclose information related with environmental, social and governmental aspects of their operations (European Union 2014). Following this mobilisation of policymakers and the growing importance of sustainable issues among investors, non-financial disclosure requirements are expected to be supplemented and expanded in order to boost transparency and longevity in financial and economic activity.

Strategies for Sustainable and Responsible Investing

In this section, we detail three strategies that aim to respond to the goal of becoming a sustainable and responsible investor: screening (an ex-ante to the investment decision), ESG integration (used mostly for ex-ante considerations, yet not exclusively) and active ownership (a post-investment strategy).

Strategy 1 – Screening Investing

Screening is one of several widely used strategies to implement a responsible investment policy across a manager's investment. According to the PRI (2020), screening is a tool that uses filters to determine which companies, sectors or industries are eligible to be included in a specific portfolio, based on investors' preferences, values or/and ethics. Three screening techniques worth mentioning are negative Screening, positive Screening and norms-based Screening, which are assessed through ESG quantitative and objective measurements (PRI 2018). Negative screening is an approach based on the direct exclusion of specific sectors, issuers or securities for poor ESG performance, or based on specific ESG criteria to avoid particular activities, such as alcohol and weapons. This approach frequently sets a materiality threshold based on the business's revenue exposure to avoid worst-in-class investments.

Moreover, positive screening is focused on investing based on a positive ESG performance, comprehending a continuous and active inclusion of companies based upon the ESG benefits of their products, services and processes – thus endorsing best-in-class against a peer group. Lastly, while some screens depend on the values of the investor, the norms-based screening is a specific strategy in which the underlying assets are screened against minimum standards of business practises based on international norms – such as UN treaties, Security Council sanctions, UN Global Compact, UN Human Rights Declaration and OECD guidelines. Norms-based screening is a sub-category of negative screening which excludes companies or securities that fail to meet internationally accepted norms.

Screening is a broad strategy that can incorporate ESG integration. As reported by a study made on ESG embracement level by institutional investors (CoreData Research 2019), most early-stage 'adopters' of responsible investment deploy a combination of screening and ESG integration into their investment decision-making. This process identifies a universe of assets with a particular set of attributes, which the fund manager believes contributes to outperform a specific pre-defined benchmark. Nevertheless, this technique also depends on the demand of specific clients, reflecting the values outlined in a mission statement. Finally, regulation might also be the reason why screening is increasingly being used since, in some countries, financial regulators prohibit investments in certain asset classes or in companies engaged in certain activities, which makes screening a mandatory technique. This point is also essential for investors to understand which companies are ahead of evolving regulatory expectations and standards.

Strategy 2 – ESG Integration

ESG integration, also referred to as "integrated analysis", is a strategy based on the use of quantitative and qualitative ESG information in the investment processes to enhance investment decision-making, thus being linked to business risks and opportunities. The strategy can be used

to inform at a macroeconomic, industrial and even portfolio analysis by considering ESG-related trends such as climate change, or even at the stock, issuer or investee level – relevant for active and passive investment strategies. Concerning active strategies, integrating ESG in equity investments includes assessing the impact on financial performance and respective metrics – by changing costs, revenues and business growth assumptions – and evaluating the effect on the issuer's creditworthiness for debt-related investments. Furthermore, for passive strategies, ESG integration is made by allocating a portion of the portfolio to ESG indexes, that represent ESG characteristics of its underlying companies. Overall, the main idea is that it is possible to integrate ESG issues whatever the investment philosophy is (PRI 2018).

Strategy 3 – Active Ownership: Voting and Engagement

Active ownership is the consistent exercise of shareholder rights, built upon two keyways that complement one another (PRI 2018), namely voting at board meetings and participating with investment firms in an active conversation – also known as engagement. In order to protect long-term investment capital and increase long-term profitability, involved shareholders raise environmental, social or corporate governance issues with the business they participate. Dimson et al. (2015) stress the success of active ownership by examining engagements made with US public corporations during the period between 1999 and 2009, finding an abnormal average return in the company's stocks of plus 1.8%, during the year following the initial engagement. The previous is divided in returns of plus 4.4% for successful commitments and facing no change in returns for failed commitments, highlighting that companies are seeing changes in financial performance, sustainability performance, productivity and governance, through successful collaborations.

Active ownership is particularly important in Real Estate investments, benefiting economically and socially all parties involved, through an efficient use of resources and improvements in social issues. A report developed by the UNEP FI Property Working Group (2009) exemplifies

owner-tenant engagement strategies employed by large Real Estate funds – listed and non-listed – and well-known managers, from all across the world. For instance, Land Securities (UK) adopted Sustainable Leasing with free energy audits and related services; GTP (Australia) required retail customers to have green leases and to use an ecological footprint calculator; Hermes (UK) performed tenant surveys, shared ESG related data with the client, developed carbon-reducing programmes; also, CB Richard Ellis (US) implemented the Planet Building Programme, which educates tenants on various aspects related to sustainability practices. Among many others, these examples clearly indicate the trend towards sustainable tenant engagements in the Real Estate asset class.

Strategy 4 – Impact Investing

The Global Impact Investment Network (2019) defines impactful investments as the ones made with the intention to generate positive, measurable social and environmental impact alongside a financial return. The market for impact investing has been providing enough resources and capital to address the world's most critical challenges in sectors such as renewable energy and sustainable agriculture, conservation. In fact, impact investing challenges the long-held view that social and environmental concerns should be only addressed in very sporadic moments through donations or isolated projects, and that market investments should solely focus on achieving financial returns. To overcome this old-fashioned perspective, impact investing offers viable and diverse opportunities for achieving good financial returns, while contributing to social and environmental solutions. A survey performed by the GIIN (2020) emphasises that portfolio performance strongly meets or even exceeds investors' expectations for both social and environmental impact and financial return. Moreover, it is worth mentioning that the mission-aligned investment strategy and thematic investing – when its impact is quantitatively measured – are fundamental practical drivers of this investment philosophy (Bérubé, Gai and Tétrault 2015).

ESG and Financial Performance

The quest for a significant relation between ESG ratings and financial performance is a popular topic among researchers – and a relatively complex interlink. On the one hand, ESG criteria are responsible, in the short-run, for reducing the investment universe significantly, lowering the benefits from diversification and augmenting the risk for ESG frontrunners, to which the additional costs from ESG screening are added (Brounen and Marcato 2018). On the other hand, when considering longer investment horizons, the benefits of ESG integration gain relevance.

Derwall et al. (2011) considered a sample of US stocks (1992-2008) and MSCI KLD¹² metrics to distinguish ESG leaders and exposed that firms with low ESG scores outperformed those with high scores in the short-run, but the authors could not find such relation in the long-run. Furthermore, an exhaustive paper that combines the findings of 2200 original ESG-related papers – a substantially large data set – concludes that around 90% of the studies find a non-negative relation between corporate financial performance and ESG, with the majority reporting positive findings (Friede, Busch and Bassen 2015). Lastly, the empirical result from a paper produced on the impact of ESG certification in Malaysian listed firms with Bloomberg ratings (2005-2018) highlights the value-added for firms displaying an ESG certification, by facing a lower cost of capital, while their associated Tobin's Q increases considerably (Wong, et al. 2020). To sum, all findings point towards the long-term benefits that surpass short-term costs for investors that account for the SRI trend in their investment decisions, capturing the value improving ESG factors.

For Real Estate, the analysis of benefits and costs should be even more focused in the long-term, since changes in ESG factors can be priced instantaneously in the capital markets, whilst real effects are likely to be lagged (Cajias, et al. 2014). Cajias et al. (2014) investigated the link

¹² The MSCI KLD 400 Social Index is a market-cap-weighted index concerning SRI. Source: MSCI.

between social, environmental and financial performance of Real Estate, using a sample of publicly traded US Real Estate companies and considering the MSCI database's ratings. The results stress the impact of ESG concerns and indicate a positive relation between ESG rating and Tobin's Q, showing that good ESG ratings impact positively market values, but concerns on ESG issues have more substantial effects than strengths, linked to lower returns and lower market values. Moreover, a study conducted on the Australian REITs' market (2007-2016) links high corporate social responsibility ratings to risk mitigation (Westermann, Niblock and Kortt 2019).

The existence of a green premium in valuations and rents is another vital research question among various studies. Fuerst and McAllister (2008) draw their conclusions upon the CoStar database of US Commercial Real Estate assets and determined that certified buildings have a rental premium when compared to buildings in the same metropolitan region. In fact, the authors found that the higher the rate in terms of environmental impact, the higher the rental premium (Fuerst and McAllister 2008). Likewise, a study conducted in the UK Real Estate office market found that environmental labels are related to price premiums compared to non-labelled offices, using the quality indicator BREEAM (Fuerst and Wetering 2015).

Material ESG Factors in Real Estate

The SASB materiality map is a widely used tool that allows investors to filter the ESG and financially material sustainable information. In other words, material issues are the ones who will have a reasonable impact on financials and operating performance, thus being the important ones to be considered by investors in their decisions. In fact, concerning the Real Estate asset class, the SASB considers energy and water management to be material factors, as well as product design and lifecycle management, the physical impacts of climate change and business ethics. Moreover, regarding engineering and construction services, the SASB considers the ecological impacts of performed interventions, product quality and safety, employee health and

safety, product design and life cycle management, as well as business ethics, to be material sources of risk exposure.

A report developed on ESG factor materiality for private Real Estate portfolios concluded that environment is the most measurable, as well as the most dominant ESG dimension, triggering the need to account for energy efficiency, water efficiency, waste efficiency and greenhouse gas emissions, when considering relevant ESG dimensions for this asset class (Allianz Global Investors 2015). To the previous, one can also add the choice of materials, impact on biodiversity, proximity to public transportation and accessibility (UN Global Compact & RICS 2018). Following the EU directives, the energy performance certificate (EPC) of buildings is a mandatory measuring tool, containing measurements on water efficiency, proximity to public transportation and indoor environmental quality. The LEED (Leadership in Energy and Environmental Design, US), BREEAM (Building Research Establishment Environmental Assessment Methodology, UK) and NABERS (National Australian Built Environment Rating System, Australia) are widely used examples of EPCs.

The social component of Real Estate affects all stakeholders involved in the sector. Aspects such as child labour, labour standards, human rights and controversial weapons are ranked as the most critical social issues among alternative investors in Europe (Mercer Capital Partners 2015). Following the same line of thought, Allianz (2015) enforces measuring the CAPEX used to provide a building with the necessary installations for it to become accessible for handicapped, as well as for security, healthiness and safety purposes. Moreover, the United Nations and the RICS (2018) highlight the importance of establishing a good relationship with tenants, in order to improve their retention, therefore reducing vacancy rates and void periods.

The concept of governance in Real Estate funds is linked to its internal organisation, as well as to external managers, external services' providers and tenants. According to the UNPRI, compromises the firm's managing standards, including bribery and corruption levels, as well as

the selection and monitorisation of third-party external managers, external services providers and tenants, through ESG contract clauses and leases. Corruption tends to be more relevant in countries where the institutional gaps are more notorious, with decision-making processes less transparent, but are not limited to them (UN Global Compact & RICS 2018). According to the United Nations, the global cost of corruption and mismanagement corresponds to 0.05 of the total world GDP, highlighting the need to address this risk. Moreover, transparency in the Real Estate market implies openness and organisation around a regulatory framework that can enforce rules, regulations and property rights, be exempt from corruption practices, and ensure a clear availability of information.

The UN Global Compact, together with the RICS, developed an approach to ESG that considers the three phases of the Real Estate life cycle, namely development, use and recovery, and considers the most significant factors for each of them. Focusing on the development phase, it comprehends the land's acquisition, planning, approvals, and construction while responding to the local communities' needs. The critical material ESG risks, which apply to overall improvements and significant renovations, are human rights, the environmental impact of the development, whether direct or indirect, in the ecosystems, biodiversity and local communities, transparency and corruption and the quality of the construction.

The construction quality is crucial when planning for developments or the need for future interventions since it represents a short-term to long-term risk for the property user (for instance, higher energy and water bills) and a long-term risk for the society. The mitigation and adaptation strategies for climate change are also relevant, comprehending location, infrastructure and safety systems. In fact, brownfield developments, such as improvements and renovations, should be preferred to greenfield developments.

5.3 Real Estate Investment Trusts

As previously defined, Real Estate Investment Trusts (REITs) are companies that own and operate income-producing Real Estate. They own several types of Commercial Real Estate: offices, warehouses, hospitals, hotels, shopping centres, among others. This type of investment vehicle has gained popularity among investors as an alternative of publicly traded stocks as REITs have provided considerable higher dividend yields (Block 2011).

There is a common topic regarding REITs, which is whether they behave more like equities or direct Real Estate. Ang (2014) analysed the direct Real Estate returns provided by National Council of Real Estate Investment Fiduciaries (NCREIF), the REITs' returns by using the FTSE NAREIT All Equity returns, and lastly, the S&P500 returns for equities, at a quarterly frequency. The author concluded that direct Real Estate was poorly correlated with REITs (15%), while REITs were highly correlated with equities (63%). Nonetheless, as the holding period increases, so does the correlation between REITs and direct Real Estate, while the correlation with equities starts decreasing. Moreover, Stevenson (2000) has proposed constructing hedged indexes of indirect Real Estate vehicles as a proxy for the direct Real Estate market. The main idea to create such indexes is to cut the effect of the stock market on indirect securities in order to obtain more representative returns of direct Real Estate.

Furthermore, literature has studied the inclusion of REITs in multi-asset portfolios intensively. Indeed, several studies have sought to provide evidence that allocating capital in REITs in a multi-asset portfolio can provide higher returns, as well as risk reduction due to its diversification benefit (Moss and Baum 2013). Yet, these conclusions do not assume a combination of both REITs and direct holdings, because the result may be somewhat different. MacKinnon and Zaman (2009) concluded that when REITs and direct Real Estate holdings are put together in a portfolio, REITs have a minor, if any, role in the optimal portfolio allocation.

Likewise, Stevenson (2001) concluded that when considering an optimal direct Real Estate portfolio as the base of Real Estate allocation, adding REITs to the portfolio does not improve the performance appreciably.

Nonetheless, Kennedy and Baum (2012) conducted the same analysis using a sub-optimal and poorly diversified direct Real Estate portfolio. They found that adding REITs to the portfolio its performance starts improving. The National Association of Real Estate Investment Trusts (2011) examined the advantages of blending both private and listed Real Estate investments. The previous concluded that by blending the optimal portfolio, with a 70:30 allocation respectively, risk-adjusted returns substantially improve when compared to only investing in private vehicles. Moss and Farrelly (2014) conducted the same analysis for a 70:30 blend of UK unlisted Real Estate funds and global listed Real Estate funds, respectively, considering the period between 1998-2013.

Moreover, the previous authors performed a portfolio split of 70:25:5 between unlisted Real Estate, global listed Real Estate and cash, respectively. They concluded that by adding global listed Real Estate resulted in return's improvement of over 19% for the whole period. Similarly, Lee (2014) studied whether including REITs in a blended Real Estate portfolio would produce better risk-adjusted returns. The previous author found that including REITs indeed enhanced the portfolio's sharpe ratio. However, Lee (2014) advocated that REITs in a blended portfolio are the primary source of risk, and the portfolio manager should keep track of its performance.

More recently, Ametefe et al. (2018) examined the repercussions of open-ended Real Estate funds holding different types of liquid assets in their portfolios along with the existing direct Real Estate holdings. In this study, the authors test different combinations of capital allocation in Real Estate and liquidity components of each portfolio, for instance: 90:10, 80:20, 70:30 and a pure replication of direct Real Estate investments with 100% liquid assets. According to Ametefe, managers of open-ended Real Estate funds use mainly cash and at times listed Real

Estate securities in order to improve the liquid characteristics of the portfolio. Yet, each of these has some drawbacks. The use of cash to endorse the liquidity of the portfolio can cause substantial drags. In contrast, the use of listed Real Estate results in higher tracking errors than direct Real Estate benchmarks and may not provide investors with property-like returns.

Nonetheless, Ametefe et al. (2018) concluded that, for each combination of capital allocation, the use of a range of liquid assets as a liquidity buffer results in smaller tracking errors than those obtained using cash-only. Besides, due to the significant volatility and drawdown of listed Real Estate as a stand-alone asset, the direct-listed Real Estate portfolio did not perform so well, even though most studies proved that this combination should improve returns.

6 Macroeconomic Risk – Systematic Factors

Academic literature points to Real Estate performance being a function of macro and micro factors. This performance can be explained through the exposure to systemic risk factors, such as macroeconomic ones, as well as to idiosyncratic risk factors, namely micro traits that are asset specific and play a role in influencing risk perceptions. In this chapter, we will analyze the macro variables that drive Real Estate performance through a well-established econometric model at a global scale and through a model connected with Delfim and Hoesli's research (2016) in order to better understand the Portuguese Real Estate market.

6.1 CRE Prices – A Cross-Country Analysis

Variations in Commercial Real Estate prices have significant implications for Real Estate funds, specifically affecting investment strategies and risk management. Therefore, it is crucial to identify which systematic variables impact the respective prices to predict Commercial Real Estate price variations. The model examines five countries worldwide from 2006 to 2015 to capture a multi-country perspective of price variations. We developed a conceptual framework that aims to study the potential determinants of annual price variations of Commercial Real Estate in those countries, and then estimate the correspondent coefficients.

Data

This paper studies the fundamental macroeconomic factors that, according to the literature review, are proven to be significant in explaining price variations of Commercial Real Estate. Regarding the dependent variable, we gathered data of Commercial Real Estate price variations for the following countries: United States of America, Australia, Brazil, Denmark, and Euro Area (19 countries). We retrieved information from the *Federal Bank of Saint Louis Economic Database* for the first three countries and the *Bank of International Settlements* for the other

two economies quarterly. The independent variables included in the model are real GDP growth, inflation, 10-year interest rate growth, stock excess return, unemployment, money supply growth and a dummy variable for the Global Financial Crisis. We obtained the quarterly data for these variables from the *Federal Bank of Saint Louis Economic Database* between the 1st quarter of 2006 and the 4th quarter of 2015.

The real GDP growth (*GDP*) represents the percentage change from a year ago of the real Gross Domestic Product of each country considered (Hoskins, Higgins e Cardew 2004), (Matysiak e Fuerst 2013), (Delfim e Hoesli 2016). Inflation (*CPI*) is the annual change of the Consumer Price Index for all items in a given country. The inflation measure is based on Delfim and Hoesli (2016) and, consequently, the model does not account for anticipated or expected inflation. The 10-year interest rate growth (*10Y*) is the annual change of the 10-year Government Bond rate (Delfim and Hoesli 2016). Furthermore, the stock excess return (*STOCK*) represents the annual capital gains of the equity index of a given country¹³ minus the risk-free, which is assumed to be the 10-year interest rate. Contrary to other macroeconomic variables, we obtained the data regarding interest rates and the stock market from *Bloomberg's* terminal. Then, unemployment growth (*UNEM*) represents the annual change of the unemployment rate at the quarter-end rate (Hoskins, Higgins and Cardew 2004) (Li and Chen 2015). The money supply growth (*M3*) reflects the broadest monetary aggregate's annual percentage change (Delfim and Hoesli 2016). Finally, the Global Financial Crisis dummy (*dgfc*) equals one if the year considered is between 2008 and 2010, and zero otherwise (Delfim e Hoesli 2016) (Devaney, McAllister and Nanda 2017). We present the descriptive statistics in Appendix 6.1.

¹³ Delfim and Hoesli's (2016) model compute the stock market variable by subtracting the MSCI stock market return, ex Real Estate stocks, by the risk-free rate. However, due to the lack of public data regarding the MSCI stock market returns, we used the equity index for each country/economic area as a proxy, which are described in Appendix 6.2.

Econometric Model

Drawing upon well-established econometric models, the purpose of this model is to test the influence of a series of possible determinants for Commercial Real Estate prices variations. We used the fixed-effects (FE) regression, which is represented in the following formula:

$$CREP_{it} = \alpha + \beta X_{it} + \delta_i + \mu_{it} \quad (2)$$

Where $CREP_{it}$ is the annual Commercial Real Estate Price change of country i in quarter t and X_{it} is the vector of national macroeconomic attributes of country i in quarter t . In this model, we divided the error term into two components. The δ_i represents the stable country-specific characteristics which are usually unobservable and often related to the covariates. In other words, it represents the unobserved effects capturing time-constant individual heterogeneity. The second component, μ_{it} is the idiosyncratic error that differs across subjects and time.

The fixed-effects (FE) regression is used instead of the pooled ordinary least squares (POLS) because the FE estimator captures the country-specific effect under weaker assumptions. The consistency of POLS estimated depends on the exogeneity of time-constant individual heterogeneity and idiosyncratic error. The estimation does not make a distinction between the two components of the error, which is replaced by the composite error term $v_{it} = \delta_i + \mu_{it}$. Thus, for the estimates to consistent $E(X'_{it}, v_{it}) = 0$. The consistency also requires that the idiosyncratic errors be exogenous. While this assumption is often reasonable, the first one is not and, if violated, the estimates are considered biased and inconsistent. On the other hand, the FE only requires the assumption of no unit-specific heterogeneity, meaning that just the strict exogeneity assumption is enough for the FE estimator consistency¹⁴ (Best and Wolf 2014)

¹⁴ The assumption that $E(X'_{it}, \delta_i) = 0$ is no longer necessary.

The following equation specifies the model in more detail, capturing the main macroeconomic variables affecting Commercial Real Estate prices variations:

$$CREP_{it} = \alpha_0 + \beta_1 GDP_{it} + \beta_2 CPI_{it} + \beta_3 10Y_{it} + \beta_4 STOCK_{it} + \beta_5 UNEM_{it} \quad (3)$$

$$+ \beta_6 M3_{it} + \beta_6 dgfc + \delta_i + \mu_{it}$$

However, to develop a robust model, we conducted a unit-root test for each variable to test whether the variables were stationary or not. As a result, using the Levin-Lin-Chu unit-root test for all variables, it was possible to reject the null hypothesis¹⁵ with 95% confidence. Also, we found the UNEM variable is correlated with the GDP factor (a correlation equal to -73%); thus, the unemployment variable was dropped from the model.

Findings

We present the econometric model results for Commercial Real Estate annual price changes in the following table. Model 1 coefficients are the POLS regression estimates, while Model 2 and 3 present the results of the FE regression with robust standards errors, with the difference that the latter includes the dummy variable for the Global Financial Crisis years while the other does not. Model 3 has the highest explanatory power with a relatively good R² of approximately 25%. Yet, it is evident that there remains a significant unexplained variation.

¹⁵ The null hypothesis states that the variable contains unit roots, which means it is an unpredictable variable. By rejecting the null hypothesis one can say, with 95% confidence that the variable is stationary (statistical properties do not change over time).

	Period 2006-2015		
	Model 1 Coefficients	Model 2 Coefficients	Model 3 Coefficients
<i>GDP</i>	1.15 *** (0.27)	1.59 ** (0.48)	1.44 *** (0.28)
<i>CPI</i>	0.42 (0.37)	0.78 (0.41)	0.77 * (0.36)
<i>STOCK</i>	0.07 *** (0.02)	0.06 ** (0.02)	0.06 ** (0.02)
<i>M3</i>	0.24 ** (0.11)	0.27 * (0.13)	0.31 ** (0.10)
<i>10Y</i>	0.03 (0.02)	0.03 (0.03)	0.03 (0.03)
<i>dgfc</i>	-3.06 ** (1.31)	- -	-2.85 (3.15)
Intercept	-1.05 (1.31)	-3.94 (2.10)	-3.10 (1.47)
<i>Country Fixed Effects</i>	NO	YES	YES
<i>R-sq:</i>	23.25%	23.12%	24.89%
<i>Number of observations</i>	200	200	200
<i>Groups</i>	5	5	5

Notes: Robust standard errors are computed are reported within
***p < 0.01; **p < 0.05; *p < 0.1;

Table 1 - The results of the econometric models for Commercial Real Estate annual price changes.

The conclusions extracted from the previous table are consistent with the literature (Delfim and Hoesli 2016). A positive relationship between real GDP growth and the price change in Commercial Real Estate was already expected. Indeed, the real GDP growth is significant and positive, suggesting that a 1% increase in real GDP growth translates into an annual price change of Commercial Real Estate of 1.44%, *ceteris paribus*. The intuition behind this result is that, as previously mentioned in Chapter 4 – Market and Industry Overview –, if firms expand production activity and output, and consequently the demand for space increases, given a fixed supply, there is an increasing pressure on rents. Accordingly, and because of construction prices and delays, the supply cannot adjust rapidly, rents will increase and so will Commercial Real Estate prices.

Regarding inflation growth, the relation is significant and positive once again, suggesting that when inflation increases, so do the Commercial Real Estate prices. Intuitively, this result makes sense since rents are deeply affected by inflation, meaning that when inflation rate increase so do rents. As a result, Commercial Real Estate price increase. By interpreting the coefficient, one could state that a 1% increase in the inflation growth leads to an annual price change of Commercial Real Estate by 0.77%, *ceteris paribus*. Therefore, with 90% confidence, we find that Commercial Real Estate does present inflation hedging characteristics.

The relation between the stock market and Commercial Real Estate price variations is significant and positive. This finding is consistent with Quan and Titman (1997) who conclude that on an international/aggregate analysis, the relation between Real Estate prices and stock returns is strong and positive. Therefore, a 1% increase in the stock market excess return translates into an annual price change of Commercial Real Estate of 0.06%, *ceteris paribus*. We also find that the money supply growth (M3) and Commercial Real Estate price variations relation is significant and positive, which is economically intuitive as it reflects the easier access to credit which should lead to higher demand and consequently higher Real Estate prices. A 1% increase in the M3 growth translates into an annual price change of Commercial Real Estate of 0.31%, *ceteris paribus*.

Furthermore, concerning the 10-year interest rate growth, we conclude that the variable is not statistically significant, so we do not draw any conclusions. Also, the *dgfc* variable does not capture any additional negative impact that is not already apprehended in the other macroeconomic variables. However, these variables should be kept as the R^2 is higher when they are considered.

6.2 CRE Funds' and Direct Properties' Returns – Model

Literature showed that European non-listed funds' performance reacts significantly to macroeconomic factors and to fund specific characteristics. The lack of data on the Portuguese Real Estate non-listed funds' market imposes a challenge when inferring macroeconomic factors' relevance on returns through traditional econometric models. To overcome this problem, we adopted a practitioner approach suggested by the client based on the study performed by Delfim and Hoesli (2016), which considers a vast database of the most important European Real Estate markets and finds evidence on the relevance of several macroeconomic factors. Our approach comprehends a model, whose outcome is the total annual excess return derived from Delfim and Hoesli's research applied to the Portuguese market, which is then compared to actual market data obtained from APFIPP.

Data

While the Delfim and Hoesli (2016) research analyses three types of Real Estate exposures, namely listed, non-listed funds and direct Real Estate, the following analysis disregards the former due to their low presence in the Portuguese market. Moreover, as Delfim and Hoesli (2016) consider data from the most important European Real Estate markets¹⁶, we will adapt their model to the Portuguese market. There are three data categories: fund's performance, macroeconomic data and numerical data on non-listed fund's characteristics (Size and Gearing). In our model, the former comprises the returns from the APFIPP-MSCI indexes for open-end and closed-end funds, between 2004 and 2019, studied through the construction of an annualised index with December 2003 as the base year. Moreover, for the particular case of

¹⁶ The study uses data from the United Kingdom, France, Germany, Italy, and the Netherlands. The final sample for non-listed funds contains 1285 fund-year observations provided by the European Association for Investors in non-listed Real Estate vehicles, while the direct Real Estate is provided by MSCI-IPD data at index level and contains a sample of 414 index-year observations.

analysing the client's Real Estate fund and pension fund's returns, we applied the latter approach to *Imofomento* and BPI Pension Fund, generating two indexes with the annualised total returns.

Furthermore, we considered two numerical variables, Size and Gearing, to characterise Portuguese non-listed funds, using the historical Net Asset Value (NAV) of the aggregate APFIPP index. We also considered a segmentation for closed and open-end funds for the year of 2018 and 2019 – thoroughly analysed in Chapter 4.2.2. Size is the average fund size, a function of the number of existing funds, and Gearing is the level of each fund's debt as a percentage of its NAV.

The model also incorporates several macroeconomic variables considered significant by Delfim and Hoesli (2016), which display a strong relation with both non-listed funds and direct Real Estate returns in the European market. More precisely, we used the following variables: Inflation growth (CPI), Inflation Surprise (which accounts for the Expected Inflation variable), Money Supply Real growth (M1), 10-year Real Interest Rate growth, Real GDP growth and Stock Market excess returns (MSCI's Portugal Index returns discounted by 3-month Risk-Free rate), Money Supply Real growth, the 10-year Real Interest Rate growth and the 3-month Risk-Free rate were provided by the *Federal Reserve Economic Database* with a monthly frequency. Real GDP growth comes from the same source but with a quarterly frequency, implying that the yearly returns had October as the reference month. Inflation growth was provided by *BPstat*, while both Expected Inflation and MSCI's Portugal Index returns extracted from *Bloomberg*.

The methodology for modelling the macro data with different frequencies and release months, encompassed the creation of indexes according to their frequency, then obtaining the yearly returns as of December to achieve the same time frame as the APFIPP indexes – as we previously analysed in Chapter 4.2.1.

Model

We based our model in Delfim and Hoesli's (2016) study on the European Real Estate market¹⁷, adapted to the Portuguese market, considering Portuguese macroeconomic variables and the characteristics of its non-listed funds (Size and Gearing). The model's outcome is the Portuguese Real Estate excess returns of non-listed funds exposure (open- and closed-end) and direct Real Estate exposure. It is essential to highlight that the model's excess returns derive from the sum of the product of each variable's coefficient from Delfim and Hoesli's (2016) research (numerical and macroeconomic) and the respective Portuguese data.

This model's primary goal is to compare the results obtained from the adaptation of the author's results with the Portuguese market's actual excess return, given by the APFIPP indexes (discounted by the risk-free rate of Euribor 12 month). Furthermore, we compared those results with the client's funds' performance for *Imofomento* and BPI Pension fund. In other words, this model allows to determine the level of correlation between the two time-series that would explain the relevance of macroeconomic risk factors and fund characteristics, in the particular case of the Portuguese market. Following Delfim and Hoesli's conclusions, the returns of non-listed funds react to changes in macroeconomic risks in a similar way to direct Real Estate. Thus, findings on the returns obtained through direct Real Estate exposure can be inferred, considering the same significant macro variables as the authors indicate in their study.

We adjusted the model to consider the research's dummy variables¹⁸ that allow for an adaptation to the characteristics of the Portuguese market and the client's funds. The adaptations range the vehicle structure, country, subperiod, sector and investment style (Appendix 6.3 details the

¹⁷ The cross-sectional dimension of Delfim and Hoesli's research with access to data of 200 funds enables the reach of a good explanatory power with an adjusted R-squared of 63.8% in the case of non-listed funds and 65.5% for direct Real Estate.

¹⁸ The Delfim and Hoesli (2016) research considers categorical variables, namely country variables, sector, investment style, vehicle structure and subperiod, with reference levels that are then controlled by summing the coefficients obtained in a different category of the reference.

rationale behind the dummy variables). Moreover, the model considers the numerical variables of Gearing and Size to assess fund characteristics' impact in the excess return of non-listed funds. However, there is an exception for direct Real Estate exposure, where the numerical variables and the open-end dummy do not apply.

As for the macroeconomic variables, we used the ones with a significance level in Delfim and Hoesli's research of at least 5%. Therefore, non-listed funds exposure considers Real GDP growth, Inflation growth, Inflation Surprise, Real Interest Rate growth, Money Supply Real growth and Stock Market excess return. In contrast, direct Real Estate exposure considers all the previous variables with the exception of Inflation Surprise and Stock Market excess return.

Furthermore, we developed two models which differ in the lags applied to the macro variables. In the first model, Real GDP growth is the only variable being one quarter lagged. In the second model, all variables are lagged one quarter, except for Interest Rate growth and Stock Market excess returns, allowing to conclude on the impact of lagged macroeconomic variables.

Findings

The following models allow to determine the significance of macroeconomic variables on the Portuguese Real Estate non-listed funds' returns and the exposure to direct Real Estate.

Findings Part 1 – Results from the First Model

According to the first model (no lags), we verified the strongest correlation for non-listed funds exposure with the actual excess annual returns of APFIPP closed-end funds – presented in Appendix 6.4. In other words, the correlation is the highest between our model with the reference for closed-end funds (an adaptation of Delfim and Hoesli's research) and the actual excess returns obtained by APFIPP closed-end funds index during the sample period. The result was a 0.5881 correlation, a moderate positive relation that confirms the macroeconomic variables' relevance in closed-end Portuguese non-listed funds' returns. According to the second

model, the correlation results were weaker (with the reference for vehicle structure to consider open-end funds). The previous is verified for the total annual excess returns of the open-end funds and for the aggregate APFIPP indexes with the excess returns, obtaining a correlation with the model of 0.4313 and 0.5186, respectively.

We also tested the model at a fund level, using *Imofomento* and BPI Pension Fund. We concluded that the previous two are more correlated with the reference model which expresses the excess returns of closed-end funds (does not consider the dummy for open-end funds during the subprime crisis). The correlation of *BPI Pension Fund* with the model is of 0.4870, while *Imofomento's* is of 0.4432. The fact that *Imofomento* was not better correlated with our model when considering the open-end dummy suggests that it did not benefit from the characteristics of flexibility and Size that enabled European open-end non-listed funds to avoid such heavy drops during the period of the subprime crisis.

To assess direct Real Estate exposure, the model does not consider fund characteristics and drops some non-significant macroeconomic variables. In this case, we observed a stronger correlation of the model with all the APFIPP indexes. This was most notorious for closed-end funds, where the model's correlation with total actual excess annual returns of closed-end funds provided by APFIPP is of 0.6507 (Appendix 6.5 shows the results for the first model concerning direct Real Estate exposure). For *Imofomento*, we performed an adjustment by subtracting the impact of liquidity on the fund's returns, in order to obtain a proxy for the returns of its direct Real Estate investment component. For the case of *Imofomento*, even after the adjustment, there was a decrease in the correlation strength with the model when considering direct Real Estate exposure.

Findings Part 2 – Results from the Second Model

The second model comprises an alternative analysis that explores the macroeconomic variables when lagged in time by one quarter. Besides the previously lagged variable (real GDP growth) we applied a one-quarter lag to other variables that showed a sluggish characteristic, such as inflation and money supply, to observe if we could obtain a better fitted value.

The result was weaker for the non-listed funds' exposure than the first model, while for direct Real Estate exposure results improved, as shown in Appendix 6.6. The correlation of the model's total excess returns when considering direct Real Estate exposure with the actual excess annual returns of APFIPP closed-end funds presents a strong positive relation of 0.7554. The client's Pension Fund also improved its correlation to 0.5512 in the second model with a correlation pointing towards a moderate positive relation that suggests the predictability power of some macroeconomic variables, such as Real GDP growth, Inflation growth, 10-year Portuguese Real Interest Rate growth and Real Money Supply growth on the returns of the Real Estate investments of the fund.

Findings Part 3 – Further Remarks

The results suggest that the Portuguese non-listed fund's performance (given by the APFIPP indexes) is better correlated with the model for the direct Real Estate exposure, that only considers macroeconomic variables applied to direct Real Estate investments (excludes Stock Market excess returns, Inflation Surprise and fund's characteristics). We believe that Portuguese fund characteristics' irrelevance can explain these results since Portuguese funds are insignificant in Size and face much lower Gearing levels than their European counterparts. As for macroeconomic variables, the result suggests the lower impact that Portuguese equity returns have on Real Estate performance. The previous also indicate the lack of significance that Portuguese investors attribute to expected inflation, with Real Estate performance verifying

a lack of reaction to Inflation Surprise. It is also important to mention that the coefficients of the macroeconomic variables obtained for direct Real Estate investments and non-listed funds differ from Delfim and Hoesli's (2016) research, even though keeping the same sign. Real GDP growth, inflation, and money supply decrease their absolute impact on the excess returns of direct Real Estate exposure relative to non-listed funds. In contrast, the 10-year real interest rate growth increases its negative impact, which might explain the results mentioned before.

Key Takeaways

This model was helpful to understand that the Portuguese non-listed funds' performance reacts similarly to the macroeconomic factors that drive the major Real Estate European markets. The positive correlation of 0.5881 between the model and APFIPP closed-end funds excess returns highlights the previous conclusion. However, Portuguese closed-end funds actual excess returns presented an even higher correlation of 0.6507 with the model that considers direct Real Estate exposure.

The fact that direct Real Estate exposure better explains Portuguese non-listed funds emphasises the reduced impact on Portuguese funds' performance of fund characteristics variables and some macroeconomic factors such as Inflation Surprise and Stock market excess returns. Even though these variables significantly contribute to major European markets' non-listed funds' excess returns, we recommend that BPI GA focus their risk monitoring only on the core macroeconomic factors that retain significance in the European direct Real Estate market.

Additionally, we verified a more robust correlation result of 0.7554 between the model and the actual excess return of APFIPP closed-end index when considering the direct Real Estate exposure through the alternative model with lagged macroeconomic variables. Therefore, BPI

GA can monitor in advance those macroeconomic variables that have a predictable impact on Real Estate investments' performance.

Regarding the client's funds under study, *Imofomento* presented a weaker correlation than APFIPP indexes with the models, given that micro factors contributed significantly to its excess return. The results suggest that the Portuguese market's aggregate excess returns can be explained mainly by macro variables. At the same time, individual funds are also partly explained by micro levels of influence. Nevertheless, BPI Pension fund demonstrated a higher degree of reaction to the model, especially when considering the alternative one with lagged macroeconomic variables, presenting a 0.5512 correlation.

6.3 Conclusions from the Macroeconomic Models

The econometric model based on a FE approach concludes that macroeconomic variables such as real GDP growth, inflation, money supply (M3), and the stock market excess returns are statistically relevant explaining Commercial Real Estate prices. Likewise, the model applied for the Portuguese market concludes that the direct Real Estate exposure was the one that better explained the Portuguese non-listed funds' returns. Therefore, we consider real GDP growth, inflation, money supply growth and the 10-year interest rates growth as significant variables.

It is possible to infer a common list of macroeconomic factors that drive Commercial Real Estate price variations and non-listed funds' performance. These are real GDP growth, inflation, and money supply. Nonetheless, even though we concluded that, with the FE regression, the 10-year interest rate growth is not significant in explaining the Commercial Real Estate price variations, BPI GA should keep track of this variable as Delfim and Hoesli (2016) proved it is statistically significant for non-listed funds, which is the case of *Imofomento*.

All in all, it is highly recommended that BPI GA monitors the performance of such variables closely to foresee the performance of the Portuguese Real Estate market, which we expected to

impact both *Imofomento* and BPI Pension Fund. Furthermore, even though these factors can represent the macro risk around Real Estate, they do not entirely explain the performance of Real Estate returns. Thus, it is crucial to supervise micro risks associated with investments within the Real Estate asset class.

7 Tenant Risk

Finding reliable tenants usually translates into minimizing the loss and maximizing the income produced by renting the underlying properties. However, by investing in Real Estate, the property owner is always exposed to the risk of one or more tenants defaulting. In order to reduce the loss in cases of default, the property owner can request, in the contract signed by the two parties, collateral or warranty to the tenant. Due to the importance of this risk on the overall direct Real Estate investment, it is crucial to monitor and evaluate which tenants are expected to default closely and the loss incurred in that scenario.

As of September 2020, *Imofomento's* portfolio accounted for 41 properties and around 83 tenants. Even though the fund has a considerable number of tenants, there is clear evidence that the portfolio is highly concentrated on the top fifteen tenants. More precisely, the top fifteen tenants represent over 81% of the total rents *Imofomento* receives per month. Even when reducing the top tenants to the top five, they represent around 57% of the total rents – Appendix 7.1 states this current scenario.

As Blundell et al. (2005) stated, there is no evidence of compensatory returns due to tenant concentration. This is because if one major tenant defaults, then the fund incurs a significant loss. Defaulting may be represented by the tenant declaring bankruptcy or delaying rent payments.

7.1 Probability of Default

As mentioned in the literature review, there are a few well-established models that measure credit risk. Nevertheless, in the specific case of *Imofomento*, most tenants are private companies which do not disclose any data about their financial performance. Also, because they are mostly small and mid-cap companies, debt instruments data such as bonds, is not available. Thus, there

is little public information that limits more complex models to evaluate default probability. To overcome this problem, BPI GA relies on Informa D&B, a company that offers data and know-how about the corporate segment, more precisely for small and medium-size firms in Portugal and Spain. The company provides a credit risk valuation of *Imofomento's* tenants by presenting two main scores: the delinquency score, which determines the probability that the tenant may delay its payments in the next 12 months to, at least, one of its creditors; and the failure score, which determines the probability the tenant will go out of business in the next 12 months. However, these scores provide only a number within a specific range and not the likelihood of default.

Nonetheless, there is an opportunity to expand the tenant risk evaluation. Consequently, we developed jointly with BPI's risk management team, a table that matches the Failure Score provided by Informa D&B and the ratings from S&P, presented in Appendix 7.2. Furthermore, rating agencies provide information regarding the probability of default for each rating in a transition matrix. The following table summarises the One-year Global Corporate Average Transition Rates from 1981 to 2018 (Global Credit Data 2019).

(%)

From/to	AAA	AA	A	BBB	BB	B	CCC/C	D	NR
AAA	86.99	9.12	0.53	0.05	0.08	0.03	0.05	0.00	3.15
AA	0.50	87.06	7.85	0.49	0.05	0.06	0.02	0.02	3.94
A	0.03	1.69	88.17	5.16	0.29	0.12	0.02	0.06	4.48
BBB	0.01	0.09	3.42	85.44	3.62	0.46	0.11	0.17	6.10
BB	0.01	0.03	0.14	4.83	77.50	6.65	0.55	0.65	9.67
B	0.00	0.02	0.08	0.17	4.93	74.53	4.42	3.44	12.41
CCC/C	0.00	0.00	0.11	0.20	0.59	13.21	43.51	26.89	15.50

Table 2 - One-year Global Corporate Average Transition Rates for 1981-2018 (source: S&P).

Each entry represents the probability of migrating from the row-class to the column-class. For example, one year from now, a BBB-rated obligor will have the following rating: BBB with 85.44% probability; BB with 3.62% probability; etc.; and defaulted with 0.17% probability. The NR column corresponds to the likelihood of the firm not being rated in the following year.

To obtain an n-period transition matrix, given a single-period square transition¹⁹ - available in Appendix 7.3. – matrix P , the n-period transition matrix, $P^{(n)}$ is the n-th power of P :

$$P^{(n)} = P^n \tag{4}$$

Therefore, it is possible to calculate the probability of default for n periods given the transition matrix. The longer the horizon, the higher the probability of default, as verified in the following table.

Year/Ratings	AAA	AA	A	BBB	BB	B	CCC/C	D
P(0,1)	0.00%	0.02%	0.06%	0.18%	0.72%	3.93%	31.82%	100.00%
P(0,2)	0.02%	0.06%	0.14%	0.44%	1.83%	8.92%	48.82%	100.00%
P(0,3)	0.05%	0.10%	0.25%	0.76%	3.26%	14.08%	58.36%	100.00%
P(0,4)	0.10%	0.16%	0.37%	1.15%	4.95%	19.04%	64.09%	100.00%
P(0,5)	0.15%	0.23%	0.53%	1.61%	6.82%	23.64%	67.83%	100.00%
P(0,6)	0.21%	0.31%	0.70%	2.14%	8.81%	27.86%	70.49%	100.00%
P(0,7)	0.27%	0.41%	0.91%	2.73%	10.87%	31.69%	72.53%	100.00%
P(0,8)	0.35%	0.52%	1.14%	3.38%	12.96%	35.17%	74.20%	100.00%
P(0,9)	0.43%	0.65%	1.41%	4.08%	15.06%	38.33%	75.62%	100.00%
P(0,10)	0.52%	0.80%	1.71%	4.83%	17.14%	41.22%	76.86%	100.00%

Table 3 - Computed probabilities of default for ten periods

As mentioned before, *Imofomento* is highly dependent on the performance of its top 15 tenants. We applied the previous methodology, and the results can be found in Appendix 7.4. Except for *Logic Logistica Integrada S.A*, which has a rating of CCC/C, and *Vila Avenida Hotel SA*, *Banco BPI SA*, and *Entrepuesto VM, SA*, which have no data available on the D&B platform, the other 11 tenants show an investment-grade rating. This means that the probability of them defaulting ranges between 0% to 1%. More precisely, we computed the PD of the portfolio using the following formula:

¹⁹ To obtain the square transition matrix we eliminated the *NR* column and normalizing each transition frequency and then added a row a row – called *Default* - at the end with zeros in each entry except the last one which is equal to 100% (assuming default is an absorbing state).

$$PD_{portfolio} = \sum_{i=1}^n w_i \times PD_i \quad (5)$$

Where w_i is the weight of tenant i on the portfolio of tenants– computed by dividing the rent per month of tenant i by the sum of the rents per month of the tenants, and PD_i is the probability of default of tenant i . Therefore, considering the 12 tenants with available data, the portfolio's PD is 2.35%.

7.2 Key Take-Aways

All in all, the most relevant tenants are quite reliable with stable financial performance. For instance, in 2019, the tenants who kept on defaulting and delaying their payments represented a small percentage of *Imofomento's* rents. However, due to the Covid-19 healthcare crisis, specific sectors were severely affected, which compromised their ability to meet their obligations. This is the case of hotels, restaurants, and other retail stores who asked to delay the payment.

8 Vacancy Risk

The expected rental cash flows for Real Estate investments depend on the tenants' capacity and willingness to afford that cost during the lease contract's lifetime (Short, et al. 2003). Nonetheless, as rents are only received for non-vacant properties, Real Estate investors aim to maximize occupancy rates. Vacant spaces represent a cost by not generating the investment's potential cash flows. Typically, high vacancy rates are an indirect consequence of economic downturns, with tenants facing a higher probability of defaulting on their payments. As stated by Giannotti and Mattarocci (2009), the cash flow of a Real Estate investment depends not only on the vacancy rate but also on the tenants' commitment and capacity to pay the required rent. Even if a property is fully occupied, the owner may not receive the contracted rents entirely.

Conceptually, a negative relation exists between vacancy rate and the total rents received by the fund. Hence, we obtained a -20.1% correlation between *Imofomento's* vacancy rate and total rental growth (between 2015 to 2020). Even though rental growth depends on various factors (such as inflation and tenant's defaulting on their payments), we consider that high vacancies impact negatively the fund through lower rents. Thus, *Imofomento's* managers should monitor the non-vacant properties and respective tenants, as well as attempt to decrease the fund's overall vacancy rate.

8.1 Vacancy in Imofomento's portfolio

In order to evaluate whether *Imofomento's* vacancy rate was effective, we conducted a peer analysis. We considered *Fundimo* and *CA Patrimônio Crescente* that verified a vacancy rate in 2019 of 6% and 7%, respectively (Jornal de Negócios 2020). In the same period, *Imofomento* registered a similar vacancy rate of 6.64%. Nonetheless, in September 2020, the vacancy rate was a significantly higher (10.1%) due to the vacancy of *Edifício Niña* – one of the most

valuable *Imofomento*'s properties previously rented to *EDP* until the beginning of the current year, when its lease contract expired and was not renovated.

From an historical perspective, *Imofomento*'s vacancy has been following a downward trend since January 2017, as shown in appendix 8.1. Yet, this rate increased in each month of 2020. To better understand the vacancy rate behaviour, we conducted a deep dive analysis on the fund's most critical properties and concluded that the buildings with the highest vacancy rate are *Coimbra* (Retail), *Quinta Grande* (Offices) and *Edificio Galiza* (Offices) – all being 100% vacant. Concerning the first two properties, BPI GA has not been successful in finding new tenants and should evaluate whether a potential sale would be beneficial.

There are several *Imofomento*'s buildings with a high punctual vacancy rate. *Edificio Monsanto* and *Edificio Sagres* reported, as of September 2020, a vacancy rate of 77.3% and 89.57%, respectively. Contrarily to what was mentioned for *Coimbra*, *Quinta Grande* and *Edificio Galiza*, these are attractive buildings already returning income from its non-vacant portions. Hence, we consider that the best approach to tackle vacancy in the two buildings is to find new tenants rather than selling. Next, we analyse vacancy with the previous characteristics, allowing the client to efficiently understand in what partially vacant properties can returns still be optimised without having to divest completely from those vacant spaces.

In order to determine the most urging properties to tackle in terms of vacancy, we computed the correspondent vacancy rates and yields for 2019 (since 2020 was an atypical year) – the top 5 properties with the highest vacancy rates are shown Appendix 8.2 (excluding *Coimbra*, *Quinta Grande* and *Edificio Galiza*) and the respective yields in Appendix 8.3. Moreover, we evaluated which properties generate the lowest relative returns. Thus, the fund's management team should focus its efforts on *Edificio Monsanto* and *Edificio Parque Oceano* since those are the ones with the lowest rental yields within the top five highest vacancy level's buildings –

1.70% and 2.41%, respectively. Solving vacancy for these two properties allows for BPI GA to simultaneously counter the highest vacancy levels and improve the fund's performance.

8.2 Strategies to Mitigate Vacancy Risk

To overcome its current vacancy exposures, BPI GA can implement some specific strategies in *Imofomento's* portfolio. The following analysis identifies four feasible solutions and exemplifies where these could be applied.

Firstly, we consider that a building's vacancy rate may be tackled by aligning the client's asked rents with the ones currently asked for comparable properties with similar location. This strategy allows to reach a vacancy rate closer to the client's target (Shilling, Sirmarns and Corgel 1987). The previous could be effectively implemented in *Edificio Peninsula* – a shopping centre that operates in the premium retail sector with a 22% vacancy rate verified for almost nine years. By operating in the premium segment, it targets tenants recognised as premium brands, with the asked rents being considerably higher compared to non-premium shopping centres. *Edificio Peninsula* faces strong competition from the nearby *Shopping Cidade do Porto* – a shopping centre that does not operate solely in the premium segment, including more affordable retail brands and office spaces, thus attracting more diversified tenants. *Edificio Peninsula* should align its rental pricing strategy to the one practiced by this close competitor, attracting tenants that do not operate in the premium retail segment.

Secondly, the implementation of a renovations-based strategy allows for improving the oldest building's features. We expect that modern features attract a larger number of tenants, decreasing vacancy rates (Bollo 2019), as tenants are increasingly demanding more efficient solutions and the inclusion of smart buildings' features. This strategy could be efficiently implemented in *Edificio Galiza*, an offices' property currently fully vacant. The property was

built 50 years ago, verifying a less modern construction quality compared to more recently properties from the same segment.

A property's vacancy rate also depends on a building's specificities. A specific property is a Real Estate asset physically designed for a particular tenant's activities. To illustrate, *Estádio Bessa* is a football stadium constructed to undertake sporting events. Due to its specific characteristics, the range of tenants who might be interested in renting this property is not vast. Moreover, this asset's physical conditions are not easily adapted for supporting other professional activity without incurring in large construction costs. We recommend that BPI GA adopts a strategy of continuous engagement with the property's current tenant.

Finally, *Imofomento* may consider selling the properties which have been vacant for large periods. Nevertheless, the sale should be carefully evaluated in order to avoid selling below the property's fair value due to current unfavourable market conditions. As this strategy increases *Imofomento's* liquidity, we advise managers for investing the new capital in more profitable properties or to invest in alternative solutions. The latter include a REITs' investment strategy, diversifying the fund's risk exposure and increasing total returns – a strategy further explained in Chapter 13.

8.3 Vacancy as a Valuable Opportunity

Considering the previous analysis, we concluded that having vacancy has a negative effect on the potential cash flows from Real Estate investments. The common belief is that property owners should minimise the vacancy rate to maximise the return and generate the most income possible to their investors. Nevertheless, one could only assume this proposition to be valid under the assumption that all tenants have a zero probability of default.

Typically, having vacant spaces means that the property is not returning any income for the investor. However, having a certain vacant space level may be an opportunity if the tenant(s) are financially unstable or keep defaulting/delaying the rental payment. The property owner can decide to leave a percentage of the space vacant to find a more reliable tenant willing to pay premium rent.

Therefore, we study whether having a part of the property vacant is considered a risk solely, or it could be seen as an opportunity. The answer to this question depends enormously on the likelihood of finding a more trustworthy tenant after ceasing the contract with the current one. This probability will depend mostly on the economic conditions and rental premium targeted by the property owner. To study this topic further, we use real options in Real Estate, which is presented in the following segments.

Real Options

As Oppenheimer (2002) states, the real options is a great framework to accurately account for specific valuations of the implicit options embedded in Real Estate capital projects. Therefore, we present an accurate options model and apply it to one of *Imofomento's* properties: *Edificio Península*.

The option we use is related to the option to wait. In other words, it is the option of, after ceasing the contract of a specific unstable tenant, leaving that occupied fraction of the building vacant for one year to find a better tenant who is willing to pay, or not, a premium. If the option's value is positive, then we conclude having a particular vacancy may be valuable. Otherwise, the property owner should keep the current tenant and extend its contract.

In order to compute the option's value, we considered three possible scenarios of action at the moment of renegotiating the lease contract, which we present in Appendix 8.4. *Scenario 1* represents the case where the fund's management team decides to remain with the current tenant

and extend the contract for another eight years²⁰. By keeping the same tenant, the fund is exposed to the tenant's financial stability and the capacity to pay the contracted rent. If, for instance, the tenant usually defaults or delays the payment for three months, then the property owner will receive the rental correspondent to nine out of twelve months in that year. We assume that the tenant will keep defaulting/delaying the three-month rent for the following eight years.

Scenario 2 considers the case where the fund's managers decide to cease the contract with the current tenant and wait for one year to find a better tenant willing to pay a certain premium. We assume that the fund indeed finds a tenant with a better credit rating and stable financial performance who will pay entirely the rent contracted with the previous tenant plus a requested premium.

Scenario 3 represents the case where the fund decides to cease the contract with the existing tenant and leaves the space vacant for a year in order to find a better tenant. However, in this scenario, the fund considers only a stable tenant willing to pay the rent at a discount. To compute the value of the option, we establish some assumptions:

- a) The average horizon of a Real Estate's lease agreement is 8 years.
- b) After one year of searching for a new tenant, the fund's managers have to decide which tenant they will assign to the vacant property.
- c) In order to compare all scenarios, the same time period of eight years must be held.

By applying this real options model, *Imofomento's* managers will analyse the option's value to extend or cease the contract with the current and wait a year to find a new one. Yet, the model requires some inputs in order to compute a final result, which is presented in Appendix 8.5.

²⁰ The average of *Imofomento* current lease contract's duration is 8 years.

Detailed Computations

To clearly understand how the model works, we present the detailed computations we performed to get the option's value. Firstly, we calculate the level of annual rents for each of the possible described scenarios. Based on the user's inputs, we achieve the rental for each scenario during the next eight years through the following formulas:

$$\mathbf{Expected\ Yearly\ Rent}_{Scenario\ 1} = (12 - DM) \times \frac{Annual\ Rent}{12} \quad (6)$$

$$\mathbf{Expected\ Yearly\ Rent}_{Scenario\ 2} = Annual\ Rent \times (1 + premium) \quad (7)$$

$$\mathbf{Expected\ Yearly\ Rent}_{Scenario\ 3} = Annual\ Rent \times (1 - premium) \quad (8)$$

Where DM represents the number of months the tenant has defaulted or delayed the rental payment, the *Annual Rent* (AR) is equal to the annual rent assuming no default²¹, and the *premium* is the premium rate the property owner requires or expects.

These variables are inputs that *Imofomento's* management team must be defined considering the tenant and building under analysis. Additionally, we adjust the expected yearly rent for each scenario based on the inflation rate. Specifically, we compute the final annual rent for each year following calculations:

$$\mathbf{Expected\ Annual\ Rent}_{Scenario\ i} = EYR_{Scenario\ i} \times (1 + IR)^n \quad (9)$$

Where $i = 1, 2, 3$, the $EYR_{Scenario\ i}$ is the Expected Yearly Rent for scenario i , IR is the current annual inflation rate, and $n = 1, 2, \dots, 8$.

It is fundamental to mention that in *Scenario 1* the fund will receive eight annual rental payments since it is extending the lease contract with the existing tenant, which guarantees that the property will be occupied throughout the entire lease contract lifetime (eight years). However, both in *Scenario 2* and *Scenario 3*, the fund will only receive seven annual rental

²¹ $Annual\ Rent = Contracted\ Monthly\ Rent \times 12$.

payments since it is ceasing the contract with the current existing tenant and the respective property is assumed to stay vacant for one year while a better tenant is searched. This is the same as saying that *Scenario 1* will present a rental payment at Year 1, unlike *Scenario 2* and *Scenario 3* where rental payments will only start at Year 2.

Furthermore, we calculate the net present value (NPV) of each scenario by applying the following equation:

$$NPV_{No\ Option,t=0} = \sum_{i=1}^8 \frac{EYR_{Scenario\ 1,i}}{(1 + R_f)^i} \quad (10)$$

Where R_f is the 10-year Portuguese Government yield²². Additionally, we also calculate the Net Present Value with the option. To do so, we computed the NPV for Scenario 2 and Scenario 3 by using the previous formula. We calculate the NPV with the option as:

$$NPV_{Option,t=0} = \frac{P \times NPV_{Scenario\ 2,t=1} + (1 - P) \times NPV_{Scenario\ 3,t=1}}{(1 + R_f)} \quad (11)$$

Where P is the probability of finding a better tenant within one year that will pay an additional premium.

All in all, the final value of this option will come from the difference between the Net Present Value of the case with the option and the Net Present Value of the case with no option:

$$Option\ Value = NPV_{Option} - NPV_{No\ Option} \quad (12)$$

The option's value will largely depend on three main variables: the probability of finding a better tenant within one year, the premium requested by the fund's management team and the number of months the current tenant is expected to default. Suppose the existing tenant presents an historical large delay in rental payments and the probability of finding a new and better

²² We selected the 10 Year Portuguese Government Bond as the best proxy to the risk-free rate to use when discounting each rental payment to the present moment as its duration is quite similar to the average lease contract's duration within *Imofomento's* properties.

tenant that pays a certain requested premium is large. In that case, the option will be valuable, and the vacancy rate during that following year will be seen as an opportunity to find a better tenant and improve the fund's returns.

As Oppenheimer (2002) defends, a complementary sensitivity analysis is crucial to overcome the significant subjectivity factor implicitly present in every Real Estate's valuation model. Therefore, we propose *Imofomento's* management team to conduct this sensitivity analysis with different probabilities and targeted premiums.

Real Options: The Case of Edificio Península

In order to demonstrate how this option can be valuable to the client in certain specific cases, we conducted the following analysis by using the particular *Imofomento's* situation of *The Gentleman Square*. This is a tenant from *Edificio Península* that, according to the model presented in Chapter 7, carries a low rate in terms of tenant's risk (BB), which is confirmed by its constant delay and default in the full rental payments throughout previous years. We used the inputs taken from this tenant's case when conducting the option's analysis mentioned before, which we present in Appendix 8.6.

For *Edificio Península*, the value of the option is positive – €22,415.97 (Appendix 8.7) – under the assumptions we made for this example. However, in Appendix 8.8 we present a sensitivity analysis, which a matrix entry represents the value of the option for different levels of premium and probabilities. In this case, no matter what premium is requested, for any probability equal or higher than 40%, the option is valuable.

As one might expect, this option's value primarily depends on the current tenant's capacity to pay the rent. The more stable is the current tenant in paying its contracted rent, the less valuable will be the option. For instance, if the current tenant presented in this example has some monthly rental payments delayed of one (Appendix 8.9) instead of three (Appendix 8.8), then

the option value will only be positive in less possible scenarios since the current tenant has an already good rating in terms of paying its respective rent on time. In this case, the probability of finding a better tenant is lower, and then the option has a negative value: -€4,403.32 (Appendix 8.9). Hence, if the option has a negative value, it is worth remaining with the same tenant and rolling the contract.

Key Takeaways

To sum up, this tool allows the client to have a clearer view of whether the lease contract of an existing tenant should be extended or not at the moment that it expires. By imputing the variables previously mentioned, the client can evaluate whether the option to find a better tenant is truly valuable or not. Suppose the green area in the sensitivity analysis increases throughout the time for a particular tenant. In that case, it means that the probability of taking some real value out of the option increases due to the positive value of the option in a larger group of possible situations (probability-premium relation).

We conclude that having a specific percentage of vacancy can be a valuable opportunity to *Imofomento*. Notwithstanding, due to the existing subjectivity of the Real Estate industry, we recommend *Imofomento's* management team to use this model solely as an extra tool to decide whether to keep or exclude the existing tenant, always complemented by the fundamental knowledge of the skilled fund's managers that already have strong expertise

9 Asset Concentration Risk

As mentioned in the literature, too much investment concentration on a specific property type, geographical location or top valued assets might lead to poor performance results of any real state fund, and *Imofomento* is not an exception. Thus, this chapter analyses *Imofomento's* portfolio's actual exposure to three different types of asset concentration risk: sector, size and location. We also propose several risk management strategies to tackle them. For this analysis, which is made for 2020 and considering the yields of 2019²³, we only considered the total capital actually invested in properties of € 314.6 million. Moreover, we compared *Imofomento* with a close competitor – *Fundimo*, a core and open-ended Real Estate fund managed by *Caixa Gestão de Ativos*, with a similar value of assets under management (AuM).

9.1 Sector Concentration

In order to study the fund's exposure to sector concentration, we performed an analysis considering five main sectors, namely retail, office, logistics, tourism and others. As mentioned in Chapter 3, there is an explicit portfolio's concentration in the office sector of 45.22%, followed by the retail sector with a 28.09% concentration. Nevertheless, when assessing *Fundimo's* portfolio composition, a similar concentration was verified, with the latter investing 54% of its total AuM in the office sector. As inferred from the market analysis, the office space market has been booming in the past years. Thus, the sector tends to guarantee long-term and steady revenue streams through tenants that engage in long-term lease agreements – a high- and steady-income source for investors – which may justify the choice for both *Imofomento* and *Fundimo* to allocate a high percentage of their portfolios to the sector.

²³ The 2019 individual building's yields were considered and used in this analysis as these are assumed to better reflect the fund's reality in a regular economy's reality. Indeed, the respective yields from 2020 are largely affected by the current pandemic situation and do not reflect the normal performance's behaviour of the fund.

Moreover, the proportion of total AuM currently vacant in *Imofomento* sums up to 10.13%. The office sector is the one that mostly contributes to this percentage, where 13.57% of the sector's properties are vacant, stressing the importance of tackling this risk exposure with new tenants. Furthermore, to avoid the exposure to poor performance scenarios in the office market, a strategy focused on REITs investing may lead to a higher portfolio sector diversification and hedge the fund's performance against possible losses – a strategy further discussed in Chapter 13.

9.2 Size Concentration

The analysis of size concentration aims to assess whether a fund's returns are too dependent on a few specific assets. According to the literature, the approach to perform such analysis is focused on considering the top five most valued assets within the overall portfolio (listed in Appendix 9.1) and using them as the proxy to evaluate the size exposure. Currently, *Imofomento* faces a 50.18% value concentration in these five main properties. Furthermore, the top five buildings sum 5.64% of the fund's overall – a positive picture for the fund since it means that portfolio's largest investments are being well managed and returning an exceptional income value. More precisely, among the top five, *Edificio Península* and *Picoas Plaza* are the ones that currently face the highest vacancy rates, and therefore should be more closely monitored.

9.3 Geographical Concentration

General Location

In order to obtain a clear picture of *Imofomento*'s geographical concentration, we performed an analysis considering seven locations, namely *Central Lisbon*, *Central Porto*, *Lisbon Area* (which excludes *Central Lisbon* zones), *Porto Area* (which excludes *Central Porto* zones),

Algarve and *Centre*²⁴. As mentioned under Chapter 3, it is possible to verify an intense concentration of *Imofomento* Real Estate's assets in Central Lisbon, namely of 67.13%, which is likely to be triggered by the high level of economic activity verified in this location. Moreover, when evaluating each location in terms of vacancy, we found that the *Lisbon Area* demonstrates the largest percentage of vacant assets, summing 27.33%, followed by *Central Porto* with 14.51% of vacancy within this location's assets. Therefore, managers should take a closer look at the previous two locations so that both investments can be optimised.

Seismic Location

This section comprehends a strategy for BPI GA to measure and overcome *Imofomento's* exposure to earthquake risk. Thus, seven different seismic regions are defined (explained in Appendix 9.2), to which a certain level of earthquake risk is assigned, from a scale from 0 to 3, being 3 the riskiest. The previous are based on a study presented by *Agência Portuguesa do Ambiente (2014)* and in the analysis of the historical earthquake occurrences in Portugal (Publico 2017). Overall, there is a clear concentration of properties in the regions of Lisbon, as well as in the riskiest parts of Lisbon (shown in Appendix 9.3), stressing the high exposure of the fund to earthquake risk. However, when analysing the portfolio's overall risk exposure – as shown in the following table – we verified an overall earthquake risk level of 2.1, which is a relatively risky score.

Finally, it is fundamental to analyse whether larger returns are compensating the portfolio's considerable risk exposure. Based on the following table one can conclude that the riskiest assets in seismic exposure are not getting an overall higher return when compared to lower-risk assets to compensate for the extra risk. Moreover, those riskiest assets represent 32.68% of the

²⁴ The 7 locations were determined in accordance with the client's previous geographical divisions.

overall portfolio's value, showing that a substantial share of the portfolio does not generate the needed returns to compensate for its risk.

	0	1	2	3
Return	0.00%	5.49%	5.06%	5.48%
% Value	0.07%	19.08%	48.12%	32.68%

Table 3 – Portfolio’s exposure to each level of seismic risk (in % value of AuM) and the weighted average return (2019) for each level of seismic risk.

Flood Location

In order to analyse *Imofomento's* portfolio exposure to flood risk, we considered nine different flood zones to which different levels of flood risk were assigned, based on research developed by (Agência Portuguesa do Ambiente 2014). The flood score ranges from 0 to 2, with 2 being the riskiest score (explained in Appendix 9.4). We found that *Grande Lisboa* is the flood location with the highest portfolio's weight (54.95%) – as shown in Appendix 9.5 – which is also a risky location in terms of flood occurrences despite being an area strong in economic activity.

There is significant exposure to this risk (shown in the following table), with 70.45% of the portfolio's assets located in the areas with the highest flood risk – an overall portfolio exposure of 1.44. Moreover, we concluded that the riskiest flood areas do not compensate *Imofomento* with higher returns, since the assets located in less risky locations are returning higher yields than those in riskiest locations, as shown in table 4. As the riskiest assets represent 70.45% of the overall portfolio's value, a big pie does not generate a fair amount of income in terms of risk-return trade-off.

	0	1	2
Return	5.15%	6.63%	5.26%
% Value	26.20%	3.35%	70.45%

Table 4 – Portfolio’s exposure to each level of seismic risk (in % value of AuM)) and the weighted average return (2019) for each level of seismic risk.

Recommendations

The sub-chapters of the geographical concentration section – general, seismic and flood – lead to very similar recommendations. Firstly, the risk exposure may be diversified through REITs' investment, a topic further developed in Chapter 13. The underlying assets of these instruments are located in various areas, thus expanding *Imofomento's* geographical coverage. Secondly, BPI GA can consider divesting in some of the assets located in the riskiest areas while investing the divested capital and/or the fund's excess liquidity in lower risk exposure areas.

However, as there is a tendency for the riskiest locations to face high economic activities and more stable returns, the client may not be willing to adopt the previous divestment recommendation. Alternatively, BPI GA should adopt a preventive strategy by continuously evaluating the building's physical conditions, in order to perform the necessary renovations and implement appropriate security policies – a topic further explained in Chapter 11 concerning ESG risk management.

10 Liquidity Risk

10.1 *Imofomento's* Liquidity Profile

Real Estate funds are usually under the scrutiny of a structural vulnerability risk, which is explained by the fact that Real Estate funds offer daily liquidity, but the respective investments do not integrate such liquid assets. This raises the concern of balancing funds' liquidity with the expected number of redemptions in a certain period. For instance, during the 2008 Financial Crisis and when the Brexit decision was announced, UK property funds were deeply desperate for cash and, consequently, were forced to sell properties and catalyse steep drops in prices – Commercial Real Estate values fell more than a third (Williams and Evans 2017).

Imofomento's management team is well aware of these types of liquidity crunches. Thus, it ensures a sufficient liquidity level in the portfolio to meet its obligations to investors comfortably. We compared *Imofomento* to its peers, and the fund shows significantly different liquidity profiles. In terms of NAV, the major fund in the open-ended Real Estate market is *CA Património Crescente* - managed by Square AM - with over € 807.57 million of assets under management. Nonetheless, in terms of liquidity, the fund reported 9.82% of cash as a percentage of the NAV, much lower than *Imofomento's* 40.59% result. However, *CA Património Crescente* is a value-added open-ended Real Estate fund, which means it has a different investment style from *Imofomento*, which may explain this huge difference. On the other hand, if one considers the second leading open-ended Real Estate fund, *Fundimo* - managed by *Caixa Gestão de Ativos* – which is also a core Real Estate fund, the liquidity profile is again surprisingly different, as of August 2020, *Fundimo* presented a result of 0.89%²⁵.

²⁵ CMVM requires that funds keep a liquidity ratio of 33.33% minimum. However, funds must keep proving to CMVM that they are working on meeting the requirements, as some deals take a long time to be finished and the inflows are not immediate. That is why CMVM may accept lower liquidity ratios for a certain period of time.

Therefore, it is possible to conclude that *Imofomento* takes liquidity as one of the industry's key risks. Yet, as Li and Naranjo (2002) mention, cash does not provide return increase, especially now that interest rates in Europe are negative. Hence, the issue is not the lack of liquidity but rather the excess of liquidity. Even though the Real Estate market has been growing, *BPI Gestão de Ativos* has not found investment opportunities adequate to the fund's investment style. This is because some investment opportunities offer high yields and, consequently, high-risk levels that do not fall in line with *Imofomento's* risk profile.

10.2 Liquidity Stress

Even though *Imofomento* has presented relatively high liquidity ratios in the past three years, that has not always been the case, as shown in Appendix 10.1. When facing periods of low liquidity levels, the fund must be aware of possible scenarios it may face in the future. Consequently, *Imofomento* must test its performance under certain conditions, for instance, if the number of redemptions increases or the rental income decreases. Also, if the fund is forced to sell assets, it must evaluate which properties are more liquid and sold faster in the market. Therefore, the following sections will be focused on analysing situations in which the fund is under stress, as well as the evaluation of the liquidity profile of the *Imofomento's* portfolio.

10.2.1 Liquidity Score

Considering a scenario of liquidity stress where the fund is forced to sell one or more properties to meet the respective redemptions, it is crucial to evaluate which building should be sold first. BPI's Risk Management team had previously constructed a liquidity score in order to solve this issue. Nonetheless, it needed improvement due to its lack of academic background and market analysis.

Therefore, we improved the score by defining the most important determinants of Real Estate transaction frequency. Fisher et al. (2014) prove that factors such as age, location, property type

and vacancy rate increase the probability of transaction of a specific building. On the other hand, Klimczak (2010) added that rental income is also an essential factor that buyer consider, which is proxied by the price per square meter since not all properties are fully occupied. Furthermore, when investing in Real Estate property owners expect stable cash flows, which is only possible if the tenant is reliable (Klimczak 2010). Therefore, we consider tenant risk to be a good proxy for the stability of future cash flows.

The weight attributed to each factor should reflect its importance on the final investment decision. Therefore, after we presented the model to the client, the latter determined the final weights following its investment preferences and experience.

Location (25%)

According to Fisher et al. (2014), as one of the property's relevant characteristics explaining property transaction frequency, the buildings' location held significant value. Furthermore, the CFA Institute (2018) highlights the importance of location as a critical factor in determining the property value. For instance, properties with the highest value per unit of space are in the best areas and have modern features and functionality.

In Portugal, there are two main metropolitan areas: Lisbon and Porto. Lisbon, Portugal's capital, and Porto, its second biggest city, are the main cities where employment, GDP per capita, prime rents, and investment opportunities are more significant (Cushman & Wakefield 2020). Furthermore, increasingly new international companies are settling part of their business in Portugal, particularly in Lisbon and Porto, a choice aided by the country's favourable conditions and quality of life. Companies such as BNP Paribas, UBER, Google, Microsoft, and many others already have offices in these two cities (JLL 2020).

Taking the office segment as the standard example, Portugal's average rents are higher in Lisbon and Porto, respectively. Specifically, one will consider a top 9 zones in terms of rent per square

meter per month being, from higher to lower, the Prime CBD, *Parque das Nações*, CBD, New Office Zone, Historic and Riverside Zone, *Porto Boavista*, Downtown, Western Corridor, *Matosinhos* – summarized in Appendix 10.2. It is possible to conclude that in city centres, both in Lisbon and Porto, the rents are higher than the city surroundings.

Also, in terms of demand per square meter, all zones in Lisbon, except the Historical Zone, had a higher demand compared to Porto's zones – represented in Appendix 10.3. Therefore, it is reasonable to assume the properties located in Lisbon's city centre are more liquid than properties located in Porto's city centre. From a score from 1-5, with 5 representing the highest liquidity level, in terms of location, the distribution would be 5 – Lisbon City Center; 4 – Porto City Center; 3 – Lisbon Surroundings; 2 – Porto Surroundings; 1 – Other.

One should consider that Tourism in Portugal has been growing significantly over the past years, particularly in Algarve. For instance, in 2019 the Trade Balance was positive (€ 817.9 M) due to the Service Segment performance (€ 17 483. 7 M) compared to the Goods Segment (- € 16 665.9 M) (PORDATA 2019). Therefore, if BPI GA is considering selling a hotel, Algarve should have a higher score in location.

Property Type (25%)

As CFA Institute (2018) states, the property types are important for institutional investors, mainly for diversification purposes, but also to create a portfolio with low risk, assuming the properties are in a good location and well leased, meaning that the tenants are reliable and responsible, the vacancy rate is low and are fiscally sound. Moreover, according to a report made by Cushman & Wakefield (2020), the investment volume in Portugal per sector between January and September 2020 was distributed the following way: Retail (46%), Offices (35%), Hotels (13%), Industrial (3%), and Alternatives (4%).

Hence, it is possible to conclude that the Retail segment followed by the Office segment are the ones with higher demand, in terms of investment volume, followed by Tourism/Hotels, and Industrial/Logistics, respectively. Thus, from a score from 1-5, with 5 representing the highest liquidity level, the distribution would be the following: 5 – Retail; 4 – Offices; 3 – Tourism/Hotels; 2 – Industrial/Logistics; 1 – Others.

Nonetheless, some properties operate in different segments simultaneously. Therefore, the segment attributed to each building is based on the value of each segment represented on the overall building. If that value was higher than 50% of the building's value as a whole, then the corresponding segment was assumed.

Age (10%)

A New York Times' article written by Kolomatsky (2017) proves that the age of a building indeed affects rents, as the age of the building increases the rents charged will decrease. This theory does not apply to historic merit buildings, as the rents may be higher than newer properties. Moreover, Fisher et al. (2004) find that as the age of a building increases, the property holder's likelihood to sell also increases. On the other hand, institutional investors prefer holding newer buildings, or the so-called "institutional-grade" properties. Thus, the older the building, the less liquid it is in the market as investors are looking for modern Real Estate. Nonetheless, as Kolomatsky (2017) mentions, there might be an exception for buildings that hold historical merit.

So, to hold a scale from 1-5, the distribution of years of age of each building in the *Imofomento's* portfolio was conducted to obtain each quartile's value. The results are, in years, 5 – [0; 19]; 4 – [19;25]; 3 – [25;30]; 2 – [30;60]; 1 – Age > 60. It is important to notice that *Imofomento* holds historic properties, hence when deciding upon a sale, these buildings require a more exhaustive analysis. That is the case of *Palácio Condes Azevedo* and the buildings in the street of São José

161 until 167, built in the XII and XIII centuries, respectively. Furthermore, some properties have been reconstructed, expanded or even modulated. Therefore, the age component must reflect the changes undertaken of each building in terms of renovations. Thus, if a property was reconstructed in the past ten years, then it must have the highest score in this category.

Price per square meter (15%)

Property transactions incorporate the sales price, which directly affects the decision to buy or/and sell. As the CFA Institute (2018) mentions, the higher the value per unit of space the most interested would institutional investors be to acquire a property, particularly if it has a core property type (office, industrial and warehouse, retail, and apartments) due to its low risk.

Therefore, it is fair to assume the higher the price per square meter, the higher the demand for that property and the higher the income. We calculated the price per square meter by dividing the value of the building by its area. Thus, based on all properties in the portfolio, the quartiles and the minimum value were computed, and the results originated the following score reasoning: 1 – [€ 0; € 596.01]; 2 –]€ 596.01; € 953.42]; 3 –]€ 953.42; €1 726.43]; 4 –]€1 726.43; €3 068.22]; 5 – Price per square meter > €3 068.22.

Vacancy Rate (15%)

Fisher et al. (2004) proved that the building's occupancy is positively correlated with the probability of sale, which indicates that the buyer does not intend to incur an added risk of the leasing and absorption of space. Also, the CFA Institute (2018) emphasizes the importance of a low vacancy. If the property is occupied, then the rental income is stable (assuming no credit risk), and the buyer's reservation price may be higher if the building is at full occupancy.

Considering the European office market as a standard example, according to a research report developed by Savills (2020), the vacancy rate of the leading European cities in the second quarter of 2020 were as follow: London West End - 4.70%; Paris CBD - 1.52%; Dublin - 8.10%;

Milan - 10%; Frankfurt - 6.50%; Berlin - 1.20%; Munich - 2.30%; Hamburg - 3.40%; Madrid CBC – 8.35%; Barcelona – 4.57%; Budapest – 7.50%; Lisbon – 6.27%; Warsaw – 7.90%; Prague – 5.40%; Bucharest – 10.50%. By analysing the quartile distribution, it is possible to conclude that the first quartile corresponds to a vacancy rate of 3.99%. The second quartile corresponds to 6.37%, and the third and fourth quartile corresponds to 8.00% and 10.50%, respectively.

Nonetheless, *Imofomento* accounts for higher vacancy rates than the average of European cities. For instance, *Edificio Peninsula* reported a vacancy rate of 22.21% by the end of September, while *Edificio Galiza* reported a vacancy rate of 100%. These two buildings should not have the same score in this category, and hence, from a scale from 1-5, with 5 representing the highest liquidity level, the allocation would be: 5 – [0%; 4.00%]; 4 -]4.00%; 8.00%]; 3 –]8.00%; 10.50%]; 2 –]10.50%; 30.00%]; 1 – Vacancy rate > 30.00% (which represents one-third of the building).

Tenant Risk (10%)

The tenant risk is one of the property's characteristics that affect a sale's likelihood (Klimczak 2010). This is because the buyer is concerned whether or not it has to add the risk of having a tenant low credit credibility. If the tenant defaults the owner loses its income and, in the chance of tenant solvency, the owner must find another tenant for occupying the space.

Based on the tenant risk evaluation, the tenants rating is based on the failure score attributed by Informa D&B. Therefore, following the same reasoning as before, the 1-5 scale would be: 5 – [AAA; AA]; 4 – [A; BBB]; 3 – [BB]; 2 – [B]; 1 – [CCC/C]. As one property may have more than one tenant, a weighted average of the failure score was conducted based on the property's value each tenant was occupying over the full value of a property occupied in that specific building.

Risk of Property Specificity

When a property lacks versatility, the likelihood of finding a tenant or even to sell may be negatively affected. As the CFA Institute (2018) mentions, specific properties are considered riskier, either based on its correlation with the business cycle, which is the case of hotels and their particular characteristics. This is the case of football stadiums, schools, among others. To capture this effect, we studied each building with the client to identify whether there was this property specificity risk or not. If the risk exists, then the liquidity score would drop by 1; otherwise, it will remain unchanged.

10.2.2 Results

Before analysing the liquidity score of all properties, it is crucial to consider some critical notes. Firstly, as mentioned before, each building segment was attributed based on the value per segment per building that was higher than half of the value of the whole property. Yet, there was one exception to be taken into account: *Edificio Península*, which was divided by 43% of the entire value in Retail, 23% in Offices, and 34% in Others (Parking), was considered in the Retail segment since it is the higher percentage and the client demanded so. Secondly, regarding the tenant risk, the building's failure score was calculated as a weighted average of the tenants' score based on the value of the fraction they were occupying over the value of the whole rented space in that property. However, the Informa D&B database does not provide information for all tenants. Thus, when the information was not available, the weights of all indicators were adjusted such that tenant risk would be dropped and the respective weight was distributed among the other variables.

If the score was between 4 and 5, then it is expected that the building could be sold within 6 to 10 months; if it was between 4-3, it is expected to be sold within 10 to 14 months. If between 3-2, the building is to be sold within 14 to 18 months, and if the score was lower than 2, then

the property is probable to be sold only after 18 months. We applied these timeframes based on the average time BPI GA takes to sell or buy a property.

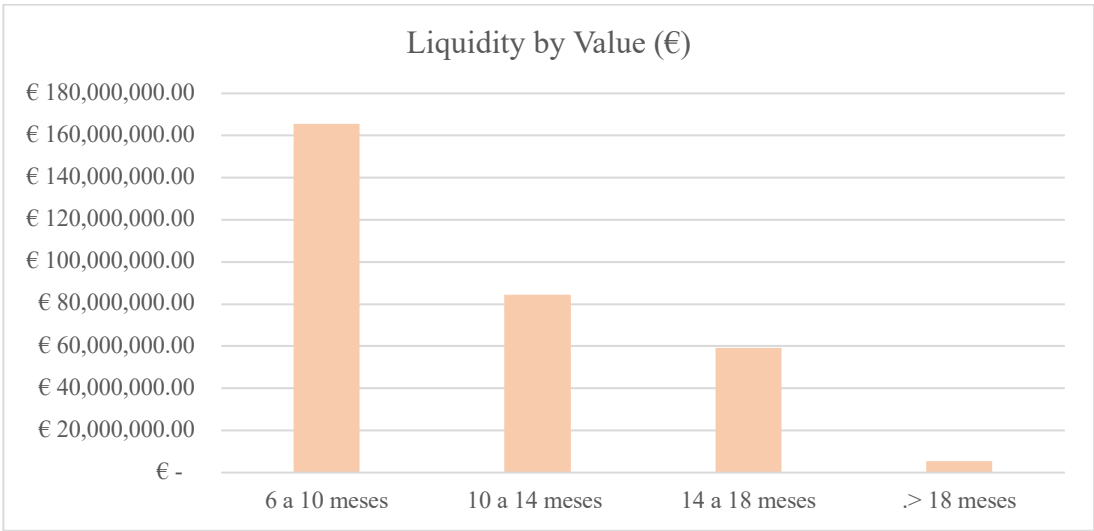


Figure 3 - Liquidity Score in terms of value.

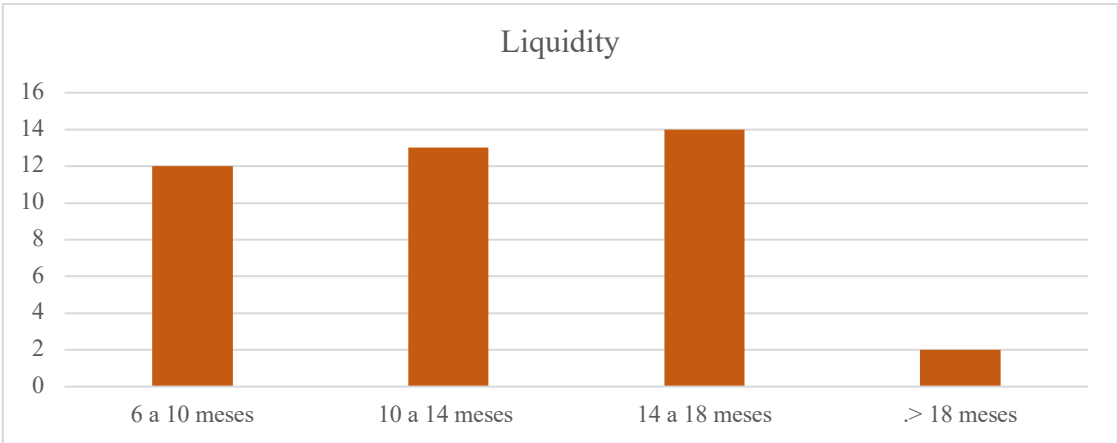


Figure 4 - Liquidity Score in terms of number of properties.

The results indicated that, in terms of value, BPI GA could receive around 52% (Figure 3) of the entire portfolio value within 6 to 10 months, yet, in terms of the number of properties, just 12 properties could be sold within that time on a total of 41 properties (Figure 4). Therefore, if liquidity stress and BPI is forced to sell properties, this model offers a proxy for which property could be sold faster without compromising the price. The portfolio overall is proven to be quite liquid within the Real Estate class. For instance, the top 10 properties – listed in Appendix 10.4

in terms of liquidity score represent 47% of the investment value in direct Real Estate, while the bottom 10 represent just 11% - listed in Appendix 10.5. This falls in line with the investment strategy of *Imofomento*, as it is a core fund with low volatility and the criteria to invest in direct Real Estate takes in consideration most if not all the factors used to compute the liquidity score.

10.2.3 Stress Tests

We believe the asset management team must stress specific scenarios to be prepared if one of those events happens. One of the most concerning scenarios is when a fund does not have enough liquidity to meet investors' redemptions (Association of the Luxembourg Fund Industry 2018). Notably, after the 2008 Global Financial Crisis, European regulators started to demand higher control on funds' liquidity side. As a result, we studied several situations based on the scenarios recommended by the Association of the Luxembourg Fund Industry (ALFI), the European Securities and Markets Authority (ESMA), and the Autorité des Marchés financiers (AMF), the French Financial Markets Regulator.

According to ESMA (2019), a liquidity shock could be either a redemption shock or the consequence of other types of shocks resulting from various scenarios. Nonetheless, in this analysis, we assume a simulation that focuses on a one-month horizon shock and consequent impact. The first approach is based on historical data of the fund. In other words, the scenarios considered are based on outflows observed in the past (ESMA, 2019). The Net flows in a percentage of NAV are defined by:

$$flows_t = \frac{Flows_t}{NAV_{t-1}} \quad (13)$$

Where $Flows_t$ represents the Net Flows at time t (equal to subscriptions minus redemptions) and NAV_{t-1} is the Net Asset Value at time $t-1$. We computed the historical Value at Risk (VaR) at 1% and at 5% using *Imofomento*'s data between January 2002 and September 2020. A potential pitfall of the VaR approach is that it discards any flows that are below the VaR. Hence,

we also computed the Expected Shortfall (ES) since it considers all the extreme events and weights them equally (ESMA, 2019). Also, we studied extreme cases alone, for instance, the worst loss in terms of Net Flow for 2005-2010; 2010-2015 and 2015-2020.

Then, we analysed redemption shocks based on different possible scenarios. Specifically, a fixed number of redemptions (ranging between 10% and 50%), redemption by the largest investor, and redemptions per investor type, which in the case of *Imofomento* are non-monetary financial institutions, resident individual investors, companies, and non-resident individual investors (AMF 2017) (ALFI 2018).

Moreover, we considered specific scenarios based on the asset side. The *Imofomento's* portfolio has a significant portion of properties exposed to seismic risk, mainly in Lisbon and Algarve. Therefore, we computed the loss incurred following an earthquake or tsunami in those areas. It is important to notice that most of the portfolio properties have insurance that protects from natural disasters. Yet, if a scenario with this magnitude happens, it is possible that the insurance company may not be able to meet its obligations entirely; thus, it was assumed *Imofomento* only recovers 60% of the value²⁶. Additionally, regarding the tenant risk and because *Imofomento's* portfolio is also highly dependent on its top 15 tenants' performance, we analysed the scenario in which the top 5 and top 10 tenants defaulted.

Given the information available for September 2020, Appendix 10.6 resents all these scenarios and the respective expected losses. In case the loss surpasses the liquidity available, the fund will be forced to sell its assets. To do so, it should use the liquidity score as a complementary tool to evaluate which building(s) to sell. Overall, the fund is extremely well-prepared for the scenarios considered. This is mostly due to the high percentage of liquidity which *Imofomento*

²⁶ The rate we assume was discussed and accepted by the client based on their insurance agreements.

has registered over the past five years, which, on the one hand negatively impacts the fund's returns, on the other hand, offers security and stability for possible shocks.

11 ESG Risk

According to the Task Force on Climate-related Financial Disclosures (TCFD), one of the most significant risks organisations face today is climate change, which is perhaps the most misunderstood. As organisations do not perceive the long-term effects of climate change accurately, the associated risk is not correctly priced, leading to a general misallocation of capital. A proper Environmental, Social and Governance (ESG) risk management is critical for real estate investors due to this asset class' high portfolio presence and accounting for a buildings' environmental impact.

Therefore, this section defines an ESG risk management strategy tailored to BPI's profile through a process that identifies the material ESG Key Risk Indicators (KRIs). The previous is an action plan for the investment process and outlines a strategy to maximise the United Nations Principles for Responsible Investment (UNPRI) Real Estate score. This approach stems from the literature review on ESG matters. The authors concluded that the ESG impact on performance depends upon the trade-off between short-term costs versus long term benefits, requiring an even longer materiality horizon for real estate investors. Moreover, we based the strategy on the indications and frameworks developed by several international organisations²⁷. Overall, the decisions that should be made today concerning sustainability and responsible investing tend to be postponed, as the lack of transparency in information makes investors unaware of market inefficiencies.

²⁷ This strategy follows the recommendations and standards of international organizations, namely the GRESB, SASB, GRI, Investor Network on Climate Risk (CERES – INCR), Institutional Investors Group on Climate Change (IIGCC), Investor Group on Climate Change (IGCC), Principles for Responsible Investment (PRI), Royal Institution of Chartered Surveyors (RICS), United Nations Environment Programme Finance Initiative (UNEP FI) and the UN Global Compact.

11.1 Material ESG KRIs for Commercial Real Estate

Environmental Factors

As mentioned in the literature, the environment is the most dominant ESG dimension and the easiest to be measured. Therefore, different KRIs related to infrastructure design and quality affects a building's ESG performance, such as the energy efficiency (that accounts for CO² emissions), the existence of a property certification label or scheme, and the percentage of renewable energy which are extracted from the energy certificates. Waste and water-efficient management are also important sources of risk exposure and their impact on biodiversity and land contamination. The geographical location of the building impacts its proximity to public transportations and affects the resilience to natural disasters, related to the risk of sea-level rise and floods, as well as earthquake. Finally, additional material environmental KRIs are light and noise pollution from the environmental impact of construction interventions.

Social Factors

The social component of ESG risk management ranges building features and stakeholders, namely tenants, buyers and sellers, and external providers²⁸. Entities should be analysed for connections with child labour, compliance with labour standards, compliance with human rights and involvement with controversial weapons. Moreover, the building safety standards will be taken into account, associated with infrastructure quality and safety procedures (such as personal security, first aid kits and protocols and equipment designed for earthquakes, floods and fires) to ensure the well-being of the different stakeholders. Similarly, features that adapt buildings for handicapped contribute positively to a lower ESG risk exposure.

²⁸ In this section, the providers of external services mostly concern the workers related to the building, namely the ones associated with construction activities (developments, improvements and renovations), cleaning services and security personnel.

Governance Factors

Governance factors depend mostly on the organisational level of the fund and its managers. Important KRIs to be considered are the existence of an overall Property Investment Policy and a Responsible Property Investment Policy (RPI Policy). Moreover, to tackle transparency and corruption, the KRIs measured are the possibility of conflicts of interests, the separation of powers and impartiality among the different lines of defence in risk management, as well as scandals related to bribery, money laundering and corruption. Moreover, Governance factors include integrating ESG clauses in contracts, supervision by the investment committee on ESG integration and commitment to proper due diligence. The previous also target the compliance with international standards, availability of budget to improve ESG performance, considering ESG in pricing and measuring its impact on financial performance. Establishing comparisons with past ESG performance and aligning strategy with the Sustainable Development Goals (SDGs) are also essential governance aspects. Lastly, considering ESG in construction interventions, measuring its ecological impact, using certified labelled materials and considering green building certifications are important material KRIs.

11.2 The Approach to ESG Risk Management

According to the Principles for Responsible Investment (PRI), responsible investment implies incorporating ESG factors in investment decisions and active ownership. Hence, the ESG risk management's approach is an action plan – based on the CDC Group's framework²⁹ – that allows for integration through the investment cycle. It is a SMART plan – specific on the ESG risks/opportunities materially identified; measurable through scorings, benchmarks and

²⁹ The plan will be based on the guidelines provided by the CDC Group and in the international framework for implementing the Paris Agreement for real estate sustainable investments.

performance improvement; achievable and realistic; and time-delimited for different target dates – aiming to address long-term value-generating opportunities for real estate investors.

ESG risk management is an integral component of decision-making and monitoring ESG. It covers the four stages of the investment process (PRI 2020) – deal sourcing, investment decision, ownership and sale – associated with the three phases of the real estate life cycle – development, use and recovery (UN Global Compact & RICS 2018). The ESG risk management approach identifies the specific KRIs for each stage, uses pre-defined metrics to obtain ESG risk scores, compares them with internal targets much associated with past performance, attests SDG alignment, and delineates the mitigation strategies for ESG performance improvement. The previous is developed from an organisational perspective (mostly concerning governance practices) and from the point of view of the portfolio holdings.

Risk Management at the Organizational Level

The organisational ESG risk exposure depends on the previously identified material governance KRIs. We attributed ESG scores based on a set of pre-defined metrics, as shown in Appendix 11.1 – with a higher ESG score representing a lower risk exposure, and vice versa. The previous requires constant monitoring, targeted to the real estate team and the associated investment committee. For the KRIs with a non-positive score³⁰, the organisation should define mitigation strategies that allow for a lower exposure to material real estate governance risks, when effectively applied. To illustrate, the preliminary step for risk mitigation at the organisational level implies the development of a Responsible Real Estate Investment Policy that delineates the entire approach to ESG risk management. We developed a draft of the Responsible Investment Policy for the real estate asset class for BPI GA, as well as its complementary manual of procedures (Appendix 11.2).

³⁰ Each KRI is assessed through a “Yes” or “No” answer, corresponding to one or zero points, respectively.

Risk Management at the Portfolio Level

Pre-Investment Action Plan – Screening and Due Diligence

The pre-investment section ranges the first two stages of the investment process – deal-sourcing and investment decision. In the deal sourcing, the material KRIs for the specific property are measured through informative E, S and G screens, based upon a thorough process of due diligence³¹. The previous implies that managers complete the deal sourcing scoreboard presented in Appendixes 11.3 and 11.4 for each new investment opportunity, obtaining its final ESG score that should weight for the final investment decision. For the previous judgment, the client should recognise that a higher risk exposure impacts the property's financial performance negatively, thus having a higher probability of requiring the implementation of active ownership strategies or execution of interventions and renovations. The decision is then communicated to the investment committees responsible for its approval.

Post-Investment Action Plan – Monitoring and Mitigation

The post-investment action plan focuses on the last two stages of the investment process – ownership and sale – linked to the life-cycle phases of usage, development and recovery. To manage the exposure to ESG risk factors, we divided the action plan into monitoring and mitigation. While the former is conveyed through ESG scores and an SDG alignment strategy, mitigation is employed through developments, renovations and improvements, as well as voting and engagement, aiming to improve ESG performance. Finally, it is worth mentioning that the investment process ends with the asset sale, where the property's price should reflect the ESG risk exposure – the lowest corresponding to a price premium.

³¹ Following the PRI's indications, information may include raw data (utility bills, building management system, existing environmental management system, engagement with tenants), third-party reports (energy audit reports, certification reports, surveyors' reports) and independent databases (geospatial databases, flood records).

Risk Monitoring – ESG Scores

Analogous to the pre-investment strategy, the action plan for monitoring the post-investment phase depends on assessing ESG scores. As shown in Appendixes 11.3 and 11.4, while the property level ESG KRIs are identical to the deal sourcing ones, we added new informative screens that assess the current tenant and the providers of external services. These final scores should be evaluated regularly and compared to previous ones, to determine the historical ESG performance of the asset being monitored. To improve a particular ESG score, it is necessary to employ the risk mitigation strategies explained next.

Risk Monitoring – SDG Alignment Strategy

The 2030 Agenda for Sustainable Development was established in 2015 by the UN among world leaders, comprehending 17 goals and 169 targets to "*to end poverty, fight inequality and tackle climate change*". As these goals are not independent of the finance industry and acknowledging that global frameworks depend heavily on scalability, the real estate industry can significantly contribute to meeting the 2030 agenda. Thus, this responsible investment strategy aims to set short- to medium-term SDG targets for the real estate asset class at BPI GA, aligning the company with this international framework. The approach³² implies re-thinking material ESG risks and opportunities under the scope of business activities – in this case, Real Estate investments – to the extent of meeting the chosen SDG outcomes (Appendix 11.5 presents the targets SDGs, targets and indicators). The strategy to meet the priority SDG targets is shown in Appendix 11.6, divided between three implementation periods – until the end of 2020, 2023 or 2026 – and its progress should be monitored continuously.

³² The SDG alignment strategy is based on the PRI's five-part framework for investing with SDG outcomes (PRI 2020), as well as on the strategy defined by the GRESB for SDG integration, answering the four main questions for the Real Estate Industry – What, Where, Why and How.

Overall, the timeframe until 2020 targets corruption practices at the organisational level, child labour scandals, and compliance with labour, health and safety standards, from the perspective of tenants and external services' providers. Until 2023, the SDG alignment strategy focuses on increasing recycling patterns among tenants and reducing water pollution caused by constructions, by not dumping hazardous chemicals. Lastly, until 2026 the management company should increase the portfolio's proportion of renewable and decrease CO² emissions, prioritising the acquisition and development of greener buildings, improving the current portfolio's assets and monitoring tenant's activities, mitigating this exposure through engagements when necessary. Moreover, the decrease in deaths caused by natural disasters is also a 2026's target, through the excellent quality of construction and materials, as well as by having the correct procedures and equipment in place.

Risk Mitigation - Developments, Renovations and Improvements

For buildings to become more sustainable, the planning and execution of developments, improvements and renovations should account for ESG factors. Nonetheless, it is essential to highlight that brownfield investments should be preferred to greenfield developments, as mentioned in the literature. Improving older buildings has a lower environmental impact than acquiring or developing new high-performance green buildings, even though being usually more complicated and sometimes more expensive.

Therefore, we developed a scoreboard to evaluate the ESG level of a specific construction intervention (shown in Appendix 11.7). The previous considers the impact of the intervention itself by assessing incidents with ecological impacts, light and noise pollution, waste management, health and safety of the workers, and the choice of materials with certified labels. Moreover, the score also accounts for the ESG outcome of the intervention, thus considering improvements in water management, for instance through automotive taps and new rainwater

harvesting features, as well as the installation of renewable energy technologies and the achievement of green building certifications.

Risk Mitigation - Voting and Engagement

The active ownership strategies of engagement (dialogue) and voting are vital for a successful sustainable management process of real estate portfolios, aiming to tackle different stakeholders. Consequently, their implementation contributes to building stronger long-term relationships and improving investment performance – both sustainable and financial. Tenants are crucial stakeholders to consider when addressing active ownership strategies, which tend to improve satisfaction, increase retention rates, reduce vacancy and void periods, and attract other quality tenants. Additionally, engagements can as well target the providers of external services.

This active ownership strategy aims to define and integrate a standard process for engagements in the real estate department's organisational governance at BPI GA – built upon GRESB guidelines (2015) – which implies identifying the source of ESG risk, planning, mobilising resources and capacity, implementing and monitoring. Then, following the PRI's recommendations, the management company can engage with tenants through regular meetings to address possible ESG concerns, implementing a system for tenants to share ESG data, develop a tenant newsletter that informs them about the latest ESG trends, distribute tenant satisfaction surveys, as well as implementing green leases or adding green clauses in the current contracts.

11.3 ESG Reporting – UNPRI Maximization Strategy

According to international standards, the disclosure of sustainability-related practices increases transparency and improves the assessment and pricing of ESG risks. The TCFD stresses the importance of disclosing clear, comparable and consistent information about the risks and opportunities presented by climate change. Therefore, this section details a strategy for BPI GA

to disclose ESG-related information for real estate investments according to the UNPRI framework. The approach to maximise the associated score started with analysing the requirements and assessing its grade as of September 2020 – estimated to be around 20%.

The ESG risk management strategy is tailored to the UNPRI, integrating its requirements into the various action plans. Therefore, we developed the score maximisation tactic by defining targets for each question, as well as the strategies to meet them, aiming to be implemented along three time periods – December 2020, 2023 and 2026³³ – as shown in Appendixes 11.8 and 11.9. A successful implementation of the maximisation strategy allows for the real estate asset class at BPI GA to obtain the UNPRI scores of 55%, 88% and 97%, for the reporting years of 2021, 2023 and 2026, respectively.

³³ The activities of a certain reporting year are only reported in March of the following year, based on the UNPRI guidelines. This means, for instance, that the measures implemented until December 2023 will be reported in March 2024.

12 Valuation – Explicit Capitalization Rates Model

The valuation of a property is an estimation process of the market value of a Real Estate asset. As mentioned in the literature, property investors are exposed to several risks when appraisal experts perform valuations (or appraisals). To incorporate those risks into the valuation process, it is relevant to reflect again upon the variables that have the most significant impact in estimating the final value, which for the income approach are the income, operating expenses and capitalization rate.

Therefore, this section specifies a valuation model that aims to determine the investment value of a property by determining the explicit cap rates while fixing the income and operating expenses variables. The word “explicit” describes the process of disaggregating the cap rate into its different components, instead of considering it to be equivalent to the rate of return of investments made on similar properties. The model intends to be an internal practical tool that allows BPI GA to determine the worth of its properties in advance, therefore supporting the investment decisions of buy, sell or hold. The model also contributes to lower exposure to the uncertainty derived from experts' valuations performed on BPI GA's Real Estate assets.

12.1 Valuation in *Imofomento's* Portfolio

The valuation model is tailor-made for *Imofomento's* portfolio, which assets are appraised by Portuguese appraisal experts under the Portuguese law³⁴. *Imofomento's* properties should be appraised bi-annually³⁵ by two valuers, requiring a third one when the results from the previous two differ by more than 20%. We performed a study to analyse the valuer more often requested

³⁴ A valuer respects the requirements expressed in article 2º of DL nº 153/2015 of 14th September. Besides the qualification requirements, the valuer needs to act with integrity, independence and objectivity. Incompatibilities are specified in article 19º of DL nº 153/2015 of 14th September.

³⁵ The frequency of property appraisals is specified in the article 144º of the *Regime Geral dos Organismos de Investimento Coletivo*, which states that open-end funds should have a minimum frequency equal to the number of redemption periods.

in the last five years, which verified that *PVW*, *Urbanflow* and *Garen* were the three appraising expert firms with most fractions appraised (Appendix 12.1 shows the totality of *Imofomento's* appraisal experts). Besides, as *Garen* is the one with the highest presence in 2019 and 2020³⁶, we studied its valuation criteria and interviewed one of its experts to support the model's considerations. The income approach is the preferred appraising method at BPI GA, and according to the analysis of several valuation reports³⁷, the one most often used by appraisal experts.

12.2 The Model

The explicit capitalization rates valuation model aims to determine the investment value of a property based on the income capitalization approach. The model assumes that an asset's growth level is stable, therefore not requiring a forecasting period, and considering a terminal value – which is the basis of value when applying the income capitalization method. The investment value of property differs from its market value, the former implies a subjective assessment that reflects the owner's market perceptions, contrasting with the objective analysis performed by appraisal experts mentioned in the literature.

Thus, the model aims to find the explicit capitalization rate by disaggregating its formula into different components – nominal risk-free rate, risk premium and growth – as described in the literature. Among the previous three, the most challenging element to be determined is the risk premium, while we assumed that the risk-free rate is equivalent to the 10-year Portuguese government bonds and growth is an implicit component of the risk premium. To determine the risk premium, it is necessary to address its different determinants, divided between systematic – macro/market – and unsystematic – micro/asset-specific. More precisely, the model

³⁶ Garen appraised 1033 fractions of *Imofomento's* portfolio in June 2020 (Appendix 12.2 shows the n° of fractions appraised by Garen since 2016).

³⁷ Valuation reports are developed in accordance with the requirements of article 20° of DL n° 153/2015 of 14th September.

incorporates the macroeconomic risk component, the sector and location components, and the asset-specific ones – tenant, vacancy and building (Baum and Crosby 2008). We applied the model to a total of 33 *Imofomento's* properties in 2020 and will compare the results with the actual cap rates. The term “actual cap rates” describes the capitalization rate that measures the investment's true value based on supply and demand free market forces. We derived the actual cap rates by dividing the Net Operating Income (NOI) of each property by its market value – assuming that all properties are fully rent and that the market value is the average of the two appraisal experts' opinion of value.

Macroeconomic Component

The macroeconomic component of the risk premium considers the statistically significant variables found in Chapter 6 – Macroeconomic Risk – Systematic Factors –, which include real GDP growth, inflation, real interest rate, and money supply. We created a score that attributes a certain risk premium to each macroeconomic variable. The findings presented in Chapter 6 are the base for the weight attributed to each macro variable, with real GDP having the higher weight, resulting on an average risk premium for the Real Estate market produced by macroeconomic factors of 1.30% in September 2019 and of 2.15% in September 2020.

Sector and Location Components

The model assumes the sector and location components as the ones with the most significant influence on the risk premium. We aligned this consideration with *Garen's* practices, which attributes an average risk premium of around 1.5% for the sector and of 1.3% for the location when appraising office buildings inserted in prime locations. Then, we scored the two risk factors based on the methodology constructed in Chapter 10 – Liquidity Risk – with premiums attributed to each level of risk exposure. The results obtained through the actual cap rate analysis of *Imofomento's* properties highlight that locations and sectors with higher liquidity

levels benefit from lower risk premiums. Yet, we found an exception for the Tourism properties that have an income source dependent on both fixed and variable components, with the variable part being almost null in 2020 due to the pandemic situation. Thus, leading to an actual cap rate much lower than expected based on the asset's liquidity. Altogether, taking into account the Liquidity Score and the importance given by appraisal experts over location and sector, we assumed, on average a location and sector risk premiums of 1.60% and 1.64%, respectively.

Tenant, Vacancy and Building Components

The influence of the tenant, vacancy and building factors in the risk premium considers the liquidity score built in Chapter 10 that defines high liquid properties as being low in vacancy levels, with strong tenants and few years of construction. Among the previous three asset-specific components, the literature points towards a more substantial influence on cap rates from tenant covenants, while building risk is the least significant. Furthermore, it is possible to verify the direction of the relationship between each micro/asset-specific risk and the actual cap rates by plotting the properties by the micro risk score related to their level of liquidity determined in Chapter 10 – Liquidity Risk – against the correspondent actual cap rate. Based on the previous two considerations, the average risk premium assumed for tenant risk, vacancy risk, and building risk was of 0.74%, 0.64% and 0.3%, respectively.

Concerning vacancy risk, as portrayed in Appendix 12.3, lower vacancy levels – which imply lower vacancy risk – correspond on average to lower actual cap rates. As a matter of fact, for vacancy levels higher than 30.01% (liquidity risk score level 1, which is the riskiest, representing the lowest liquidity level), the average actual cap rate is of 7.19%, while vacancy levels between 0% and 4% (risk score level 5, which is the least risky) verify an average actual capitalization rate of 5.88%.

Moreover, the tenant score reflects the risk of having a tenant with low credibility, implying that low tenant scores – more tenant risk involved, therefore less liquidity – verify higher risk premiums and result in higher capitalization rates. Tenants' scores are based on the failure score of *Informa D&B* and capture the most severe scenarios of default. The trendline is slightly negative for the properties studied if we exclude the tourism sector since this sector faces a low liquidity tenant score and low actual cap rates. The relation between tenant risk and actual cap rates is presented in Appendix 12.4, exposing that the average cap rate of properties with a high probability of default – most risky, with a level 1 score – is 6.42%, while for low default probabilities – liquidity risk score level 5 – cap rates are on average 6.04%.

Furthermore, the building risk – mostly influenced by the age factor – was found to affect cap rates, with the lower risk being associated with lower yields, as plotted in Appendix 12.5. The previous relation was only verified when disregarding the tourism sub-sector and the properties located in Lisbon and Porto's city centres. In fact, the results demonstrate that the age factor is less significant when properties' location is in the city centre, which is a location where many buildings have a high historical value and most often suffered reconstructions or renovations, not bearing the same negative impact of age in their actual cap rates as buildings outside the city centre.

12.3 Conclusions

The approach suggested for managing valuation risk at BPI GA comprises a model that defines each property's explicit capitalization rates, thus determining its investment value. The explicit cap rates were constructed in accordance with literature findings, by summing up the risk-free rate, the systematic risk of the Real Estate market, and all the unsystematic risks attributed to every single property under study – with different levels of risk exposure and scores representing the liquidity of the investment, resulting on different premiums charged. Appendix 12.6 shows

the model's final results, allowing for a comparison between average explicit cap rates and average actual cap rates in September 2020. To allow for relevant conclusions, we grouped properties by sector, as well as by their location within each sector, with the results indicating an average explicit cap rate of 6.49%, while the average actual cap rate is of 6.31%. Furthermore, the same model was applied to September 2019, considering 30 properties, as shown in Appendix 12.7. The results present an overall average explicit cap rate of 5.71%, while the average actual cap rate is 6.02%.

The model results point towards a close approximation between the explicit and actual cap rate values for most properties, emphasising that the different components considered in the model – macroeconomic, sector, location, tenant, vacancy and building – are accurate drivers for the cap rates. However, we found an exception for properties inserted in the tourism segment mostly driven by their rent structure and the particular situation faced during 2020, implying that this sector requires a more in-depth analysis. Moreover, it is worth stressing that a slight change in cap rates correspond to a significant inverse variation in property values estimations. Therefore, the investment value obtained from the explicit capitalization rate might vary substantially from the market value obtained from actual cap rates.

To conclude, when using this model one cannot forget that actual valuations always imply a certain subjectivity level since valuers assess a property's value based on their beliefs and experience. Therefore, the explicit cap rates model aims to determine an investment value which is the most similar to the experts' results, based upon the different conclusions reached throughout the thesis, and adding *Garen's* valuation criteria to further improve results. However, when developing the model, we found that there are some risks not yet fully priced in the market, such as ESG and asset concentration risks. In fact, Commercial Real Estate markets are gradually adapting to a range of issues encompassing ESG factors, which include some environmental hazards such as seismic and flooding risk, energy efficiency, climate and

matters of legislation, management and fiscal considerations. According to the RICS (2019), valuers should reflect markets and be aware of sustainability features, and their implications on property values in the short and long-term, which implies a continuously seek to enhance their knowledge as markets change. Therefore, when being aware of its limitations, this valuation model can be a useful tool for investors, by signalling a valuable purchase or sale before the market prices the property's corresponding risk exposure.

13 REITs

13.1 Direct and Indirect Real Estate Investments

Both direct Real Estate and REITs investments involve buildings and land that produce cash flows. Hence, one would believe that the returns of the two approaches are highly correlated. Indeed, direct and indirect physical holdings of Real Estate must be affected by similar fundamentals; thus, returns should follow the same pattern. To evaluate this issue, we considered different scenarios when computing the correlation between the *STOXX Europe 600* (equities), *FTSE EPRA NAREIT Developed Europe Index* (European REITs index), and the *Commercial Real Estate Index* (provided by the ECB).

We used price variations from the beginning of 2000 until the second quarter of 2020 at a quarterly frequency for this analysis. The following table shows the correlation between direct Real Estate, REITs, and equities. Considering one quarter as the holding period (HP), the correlation between REITs and equities' price variations is exceptionally high, at 78%, while the correlation between REITs and direct Real Estate is low, at 9.5%. Hence, REITs resemble equities more than they resemble direct Real Estate. This conclusion falls in line with Ang's (2014) findings, who conducted the same analysis for the USA market. The author found that direct Real Estate was poorly correlated with REITs (15%), while REITs were highly correlated with equities (63%).

	<i>CRE Index</i>	<i>SXXP Index</i>	<i>EPRA Index</i>
<i>CRE Index</i>	1		
<i>SXXP Index</i>	0.117	1	
<i>EPRA Index</i>	0.095	0.781	1

Table 5 – Correlation between direct Real Estate, REITs and equities.

Nonetheless, the correlation between direct Real Estate and REITs increases as the holding period increases. This relation is represented in Appendix 13.1, which considers different horizons. For instance, after 12 quarters, the correlation rises to 34%, continuing an upward trend as the horizon increases. After 20 quarters, the correlation tappers around 42%, which is a very similar result to Ang (2014), who reported a correlation of 43% for the North American market. Furthermore, it is crucial to note that the correlation between REITs and equities is still substantial but decreases as the horizon increases. For example, after 20 quarters the correlations is 67%, lower than the 78% verified with the one-quarter horizon.

All in all, it is possible to conclude that REITs' prices move, in the long run, along with direct Real Estate prices. This is an exciting finding for BPI GA as the investment in REITs does not fall entirely outside the investment strategy of *Imofomento*, assuming that price variations work as a good proxy for the behaviour of returns. However, REITs are still much more liquid assets than direct Real Estate investments and usually more volatile. The following chapters explore the inclusion of REITs within the *Imofomento's* portfolio.

13.2 *Imofomento's* Portfolio with REITs

There are different reasons for suggesting the inclusion of REITs in *Imofomento's* portfolio. The fund invests only in the Portuguese market and, due to its investment profile, the portfolio is intentionally concentrated in Lisbon, as well as in the office segment – a location with attractive investment opportunities and a segment with an impressive risk-return trade-off. Furthermore, the fund's liquidity has been increasing in recent years, affecting returns negatively due to the negative European interest rates and the lack of suitable Real Estate investment opportunities in Portugal. Therefore, to tackle this issue, we explore four investment strategies with European REITs, based on the literature previously performed on this topic, which would expose *Imofomento* to other European markets, segments, and more attractive

returns, while still following its investment strategy. The four strategies are the 70:30, 70:25:5, *Hedge* and *No Hedge*, with the last two being sub-divided into variance minimisation and tangency portfolios.

The listed Real Estate (REITs) component of the portfolio we consider is the *BNP Paribas Easy FTSE EPRA/NAREIT Developed Europe UCITS ETF*, a proxy for the European REITs market. The ETF seeks to fully replicate the FTSE EPRA Nareit Developed Europe index's performance – designed to track the European listed Real Estate companies' performance – by investing in the same companies as the index with a maximum tracking error of 1%. The period we considered is between September 2015 and December 2019³⁸, using monthly data. During the period analysed the ETF reported an average annualised return of 52.6% and an annualised standard deviation of 35.98%, a result much influenced by a frequent dividend distribution.

Each strategy suggests different capital allocations, and the final recommendations are given by comparing the results obtained from such allocations with the ones verified by the fund while accounting for its specific investment characteristics. During this period, the annualised average return of *Imofomento* was 3.42%, with an annualised standard deviation of 2.37% and a sharpe ratio of 1.61 (considering the 3M EURIBOR as the risk-free rate). The returns calculated in this chapter do not incorporate potential fees.

³⁸ We considered this period because before 2015 the liquidity share of the overall *Imofomento*'s portfolio was not precisely accurate and sufficient to realistically use part of it to invest in other alternative classes - REITs. Liquidity (cash) availability is crucial for every Real Estate fund to cover unexpected withdrawals from investors, having in mind that Real Estate assets are not as liquid as it should be in order to protect from these situations. Also, we did not consider 2020 due to its particular and uncommon pandemic situation that consumed every single security's returns, which would incorrectly influence the results of this analysis.

13.2.1 Strategy 70:30

The National Association of Real Estate Investment Trusts (2011) proved that portfolios with a 70:30 capital allocation – 70% invested in private Real Estate and 30% in listed Real Estate – provide higher risk-adjusted returns than just considering direct Real Estate. When implementing these capital allocations within *Imofomento's* portfolio, we arrive at the same conclusion. The annualised return is 19.71% and the annualised standard deviation is 10.20%, resulting on a sharpe ratio of 1.97. As the volatility is much higher than what BPI GA Real Estate team is willing to accept, we do not recommend this strategy to the client, even though it proves to be extremely attractive.

13.2.2 Strategy 70:25:5

Moss and Farrelly (2014) present a slightly different capital allocation than the previous strategy, suggesting one must split the portfolio following a 70:25:5 capital allocation. This means investing 70% in unlisted direct Real Estate, 25% in listed Real Estate (REITs) and 5% cash. We expect that including cash in the portfolio will decrease the volatility compared to the previous strategy. The results indicate that the risk-adjusted returns indeed improve, with an annualised return of 17.07% and an annualised standard deviation of 8.48%, indicating a sharpe ratio of 2.06. This also meets Lee's (2014) conclusions that including REITs in a blended portfolio would improve risk-adjusted returns. However, 5% invested in cash does not satisfy the client's requirements to securely meet investors' redemptions.

13.2.3 No Hedge Strategies – Minimum Variance and Maximum Sharpe

The stock market and REITs are positively correlated, and the listed Real Estate securities performance is deeply affected by equities' behaviour. The strategy's name is based on the fact that these portfolios are not hedged against the stock market. We constructed two portfolios:

the minimum variance – applying the Markowitz Mean-Variance Portfolio Theory (Marling and Emanuelsson 2012) – and the tangency portfolio - maximising the sharpe ratio. Nonetheless, while developing these portfolios, we also considered some restrictions imposed for Portuguese non-listed open-ended Real Estate funds, which are presented in Appendix 13.2, and assumed no short-selling was possible. The goal is to find the optimal capital allocation for direct Real Estate (using data from *Imofomento*), cash, and REITs (*BNP Paribas Easy FTSE EPRA/NAREIT Developed Europe UCITS ETF*).

To minimise the portfolio variance, we applied the following formula:

$$\sigma_{portfolio}^2 = w_A^2 \sigma_A^2 + w_B^2 \sigma_B^2 + w_C^2 \sigma_C^2 + 2w_A w_B \rho_{AB} \sigma_A \sigma_B + 2w_A w_C \rho_{AC} \sigma_A \sigma_C + 2w_B w_C \rho_{BC} \sigma_B \sigma_C \quad (14)$$

Where w_i is the weight of asset i , the σ_i^2 is the variance of asset i , and the ρ_{ij} is the correlation coefficient between assets i and j . We conclude that the optimal capital allocation is investing 64% in direct Real Estate, 33.33% in cash and 2.67% in REITs (Appendix 13.3). Consequently, the annualised return and standard deviation are 4.9% and 2.29%, respectively, resulting on a sharpe ratio of 2.31. This investment strategy is much more appropriate to *Imofomento*.

On the other hand, we also studied the tangency portfolio's case (maximum sharpe ratio). By following this strategy, we expected to obtain a higher standard deviation as well as a higher return compared to the previous strategy. Under these conditions, the optimal capital allocation is to invest 60.60% in direct Real Estate, 33.33% in cash and 6.07% in listed Real Estate (Appendix 13.3). The return increases to 6.50%, yet the standard deviation rises less than expected (2.61%). This results on a sharpe ratio of 2.64, higher than the minimum the variance strategy.

While the minimum variance approach presents a lower annualised volatility, the tangency portfolio approach presents a slightly higher annualised volatility. Yet, in both cases, the level

of volatility is similar to the current risk profile of *Imofomento* (Level 2, according to CMVM). All in all, both portfolios are very attractive and the choice between the two depends solely on the client's risk-return preferences.

13.2.4 Hedge Strategies – Minimum Variance and Maximum Sharpe

This strategy analyses the potential diversification opportunities arising from investments in Real Estate hedged indexes. REITs are highly exposed to the stock market due to its daily trading feature, which ends up exposing this asset class to a higher level of risk. Hence, we applied Stevenson's (2000) framework to construct a hedged index based on the STOXX Europe 600. The main goal is to eliminate the effect of the stock market from the listed Real Estate security, and consequently, get closer to the actual returns of direct Real Estate. Therefore, we adjusted the original indirect security for the influence of their respective equity markets through the following regression:

$$r_t^p = \alpha + \beta r_t^e + \mu_t \quad (15)$$

Where r_t^p is the unhedged index – *BNP Paribas Easy FTSE EPRA/NAREIT Developed Europe UCITS ETF* – total return, the r_t^e is the respective equity index – *STOXX Europe 600* – total return, α is the intercept and β is the estimated beta coefficient. We then retrieved the hedged Real Estate index as:

$$r_t^{hp} = r_t^p - \beta r_t^e \quad (16)$$

Where r_t^{hp} is the hedged index. Since the relationship between indirect Real Estate securities and the stock market may not be stable throughout time, we applied the strategy defined by Stevenson (2000), computing a forty-eight-month rolling beta³⁹.

Following the same approach as the No Hedge, we constructed the same two portfolios – minimum variance and tangency portfolio – based on the same constraints. However, the securities included in this strategy are direct Real Estate, cash, and the Real Estate hedged index. Because this approach implies selling the STOXX Europe 600, we assumed transaction costs of 0.4%, which is the value indicated by Morning Star (2020) for this security.

By minimising the portfolio's variance strategies, the optimal capital allocation is investing 63.36% in direct Real Estate, 33.33% in cash and 3.31% in the hedged index (Appendix 13.4). As a result, the annualised return is 4.96%, and the annualised standard deviation is 2.20%, which implies a sharpe ratio of 2.44. Furthermore, by computing the tangency portfolio, the optimal capital allocation is to invest 61.01% in direct Real Estate, 33.33% in cash and 5.66% in the hedged index (Appendix 13.4). The respective annualised return is 5.90%, annualised standard deviation of 2.54%, and a sharpe ratio of 2.48.

It is worth noticing that both strategies face a slightly lower variance than in the *No Hedge* strategy. This was already expected since hedging the REITs index against its implicit volatility derived from the stock market. Therefore, the client should consider both options, as they allow for a better risk-return trade-off.

³⁹ We computed 51 betas, through an OLS regression for each 48-month period. Overall, we achieved an average beta of 83.89% for the period analysed, which clearly demonstrates the positive correlation between REITs and the stock market.

13.3 Testing the *Hedge* and *No Hedge* Strategies

In order to further inform the client on the two recommended strategies – the *No Hedge* and the *Hedge* – we performed a new analysis, aiming to understand what would have been the performance of *Imofomento* if the asset management team had invested in REITs since 2015. Thus, given the strategies described before, we assumed the capital invested in REITs equal to the capital allocation computed on each optimal portfolio. That percentage invested in REITs would be discounted from the fund's liquidity and the percentage invested in direct Real Estate would remain the actual value verified for the period between 2015 and 2019. We show the results in Appendix 13.5.

For instance, when considering the *No Hedge* strategy tangency portfolio, if the asset management team had invested 6.07% in *BNP Paribas Easy FTSE EPRA/NAREIT Developed Europe UCITS ETF*, the fund's annualised return and info sharpe would have been of 6.64% and 2.52, respectively – both substantially better than the actual results of 3.42% and 1.45. In fact, all these strategies would have produced higher returns and better risk-return levels than the ones they did and are highly recommended to be analysed by the client.

To conclude, there is clear evidence that including REITs in *Imofomento's* portfolio will lead to a better overall performance. This diversification solution will be useful to deliver more attractive returns to investors. Still, it will also decrease the portfolio's exposure to some specific risks that were already mentioned, such as liquidity and asset concentration risk.

14 The Knowledge Initiative

This thesis addresses the fundamental drivers of Real Estate returns, from a risk management perspective, determined based on the literature. We adapted the academic support to the Portuguese market and the client itself. Moreover, the literature pointed towards risks that are not yet fully priced in the market, such as ESG risk. Therefore, there was a further need to confirm whether different stakeholders understood the ESG factors involved in Commercial Real Estate investments and included them in valuations. To address the previous needs, we developed three surveys targeting three main stakeholders: (1) Real Estate department, (2) tenants and (3) appraisers. This chapter summarises the main results.

Appraisers' Survey

The goal of this survey was to understand the appraisal process in Portugal further, and the main drivers considered by the experts. From a sample of twenty appraisers, there was a 50% adherence. We divided the survey into three main sections, that tackled the most commonly used appraisal methods, the macroeconomic variables considered to be the most relevant, and the level of knowledge and integration on ESG matters. We found that the majority (80%) of the appraisers use the yield method (the income capitalisation method), as shown in Appendix 14.1.

Moreover, the macroeconomic variables worth highlighting are the economic cycles and the long-term interest rates considered by all appraisers – and the unemployment rate, real GDP growth, inflation rate, monetary policy by the central banks – even though with a lower representativity. Concerning ESG, half of the appraisers recognise that the topic has been impacting valuations more substantially in recent years. A major 90% of appraisers that answered the survey considered these topics when performing an appraisal, such as energy efficiency (obtained from the energy certificates) or even going deeper in other ESG issues, as

shown in Appendix 14.2. In fact, 70% of the appraisers stated they included a premium for green buildings, and 80% said the same for smart buildings (Appendixes 14.3 and 14.4, respectively)

Tenants' Survey

Commercial Real Estate investments' success depends on quality tenants, stressing the need to understand the considerations that drive the demand side, emphasising ESG awareness and integration. There was only a 10% response ratio for this survey, yet the results we got are relevant. Firstly, the top three ESG factors considered by tenants when choosing a renting property were the building's energetic efficiency (e.g. the use of LED lamps), the good conditions and safety of workers, and lastly the proximity to public transports.

It was also reported a 61,1% rate of property exclusions in the selection process due to poor ESG character (Appendix 14.5), and that 44% of tenants are willing to have a lease agreement that tackles social or government environmental characteristics as this conclusion reflects in Appendix 14.6. Surprisingly, 61,1% disclosed that they had little knowledge or were not familiar with the ESG topic (Appendix 14.7), yet considering ESG factors in their decisions, such as installing LEDs and improving workers' conditions. The previous answers indicate that tenant's value ESG factors, yet not possessing a wide knowledge on this topic. Lastly, 61,1% of the respondents were willing to pay a rental premium for buildings with better ESG characteristics or a more sustainable location, as shown in Appendix 14.8.

Real Estate and Risk Department's Survey

The survey targeted the Real Estate and Risk departments to assess the current practices and knowledge on Real Estate risk management, again focused on ESG factors, and obtained 60% response ratio. Firstly, 83,3% affirmative answers for considering that the current investment procedures for decision-making and monitoring follow an appropriate framework, as

demonstrated in Appendix 14.9. Moreover, when assessing the important factors for risk management, all respondents consider vacancy risk as a crucial one, but tenant, valuation and liquidity were also considered.

Focusing on the ESG topic, 83,3% responded either being vaguely familiar or extremely familiar (Appendix 14.10), yet not using this information in the investment process meaning. Also, 66,6% answered that they did not assess material ESG risks and opportunities when making investment decisions (Appendix 14.11), and the majority answered not tracking the information concerning the ESG impact in the company's financial performance and ESG performance for Real Estate assets.

However, it is worth noticing that even though not considering including ESG factors in investment decisions, it was possible to conclude that many employees do so unconsciously. They consider aspects that are pro-ESG, yet without realising that the previous is the effect of ESG factors. Concerning the UNPRI reporting framework, 66,6% said they were unaware of these requirements, while no one had seen its last update released in November 2020, as shown in Appendix 14.12.

This survey was composed of two other sections, that tackle BPI's alignment with its tenants and appraisers. Regarding, tenants BPI's employees believe that tenants account for ESG factors such as energy efficiency, good and safe conditions for workers and proximity to transports – coincident with the tenants' answers. Moreover, 33,3% of the team members that answered the survey thought tenants were willing to pay a premium for more ESG-friendly buildings or to have their location updated to a more sustainable one. Simultaneously, the remaining did not believe this was something valued by the tenants – which contrasts with the tenant's survey that verified a much higher percentage of affirmative answers. Concerning the alignment with appraisers, BPI's team believed GDP growth, economic cycles, interest rates and inflation were

the macroeconomic factors mostly considered in valuations, as well as that ESG impacts appraisal – which goes in line with the appraisers.

Conclusions

Overall, the surveys allowed us to extract some important conclusions that support, in addition to the literature, the choice of the fundamental drivers for Commercial Real Estate and the approach to risk management. Concerning the appraisers, a preference for the yield method is verified, as well as for certain macroeconomic and ESG factors. Tenants also considered the previous as relevant, with the possibility of excluding properties based on their poor ESG characteristics, added to the option of paying a premium for buildings more ESG-friendly. Lastly, the Real Estate and risk teams believe they have the appropriate systems for risk management in place, yet not being familiar nor considering ESG factors when assessing their investments, added to a poor understanding of the UNPRI requirements for this asset class. Nonetheless, it is critical to notice that the company has several interests aligned with tenants and appraisers – two significant Commercial Real Estate industry stakeholders.

15 Conclusions

This paper seeks to investigate Commercial Real Estate drivers while developing a risk management approach that integrates macro and micro factors, tailored to BPI GA's *Imofomento* Real Estate fund. The main goal was to deliver a robust assessment of the portfolio's materially relevant risks and to develop measurement and monitoring tools to manage them. Furthermore, a client's central requirement was the maximisation of the UNPRI's Real Estate score. Therefore, we developed an action plan that tackles ESG risk management aligned with the previous requirements.

Regarding the macro risk components, we found that real GDP growth, inflation, money supply growth and the 10-year interest rates growth were significant factors in explaining Commercial Real Estate price variations. Nonetheless, the models' R squared indicates that these factors do not entirely explain Commercial Real Estate performance. Through an extensive literature review, market research and survey assessment, we identified several material micro risk factors and incorporated them on the risk assessment framework. The micro risks found relevant are tenant, vacancy, liquidity, asset concentration and ESG.

By performing an in-depth analysis of both macro and micro drivers, we built a concise valuation model that predicts the near future capitalization rates. The model aims to minimise the real appraisers' valuation process's subjectivity and offer a more material perspective of risk premiums. Nonetheless, we recommend further research on this topic, to define holistic weights for each risk premium and measure the non-currently priced risk attributes, namely seismic, flood and ESG risks. Furthermore, we developed a dashboard on Power BI and a database on Access that allows the client for a more interactive and descriptive tool to monitor the material risks identified (described in Appendix 15.1 and Appendix 15.2, respectively).

Many researchers have analysed whether adding listed Real Estate increases risk-adjusted returns on a direct Real Estate portfolio. This paper also explores the inclusion of Real Estate Investment Trusts (REITs) within *Imofomento's* portfolio, finding an optimal mix between liquidity, publicly-traded Real Estate securities and direct Real Estate for different investment strategies. Results indicate that, for the period considered, REITs improve risk-adjusted returns. The capital allocated to those assets is relatively low as listed Real Estate securities tend to be very volatile. Lastly, Commercial Real Estate transactions occur in private and illiquid markets – with low transparency and data availability. However, the sector's fast growth implies that more transparent channels of information must be made available to develop a better and more universal understanding of its underlying risks.

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17 Appendix

Appendix Chapter 2: Asset Class Characterization

Appendix 2.1 – Debt Real Estate Exposure.

There are private and public markets for debt-based investments in Real Estate, namely through construction lending and mortgages. Debt funds play a significant role in the industry by lending large sums to buyers and entrepreneurs. Furthermore, public debt can be represented by the securitization of commercial or residential mortgages - mortgage-backed securities (MBS) which are bond-like investments formed by a package of a diversified portfolio of mortgages.

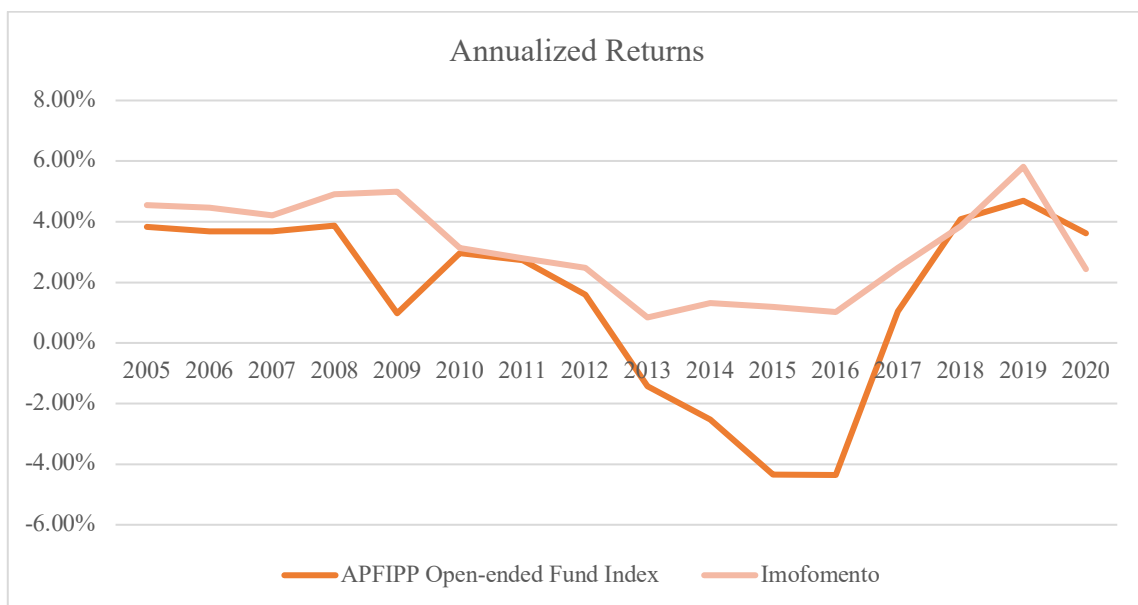
Appendix 2.2 – Real Estate funds: value-added and opportunistic.

The value-added strategy frequently seeks assets that aim to maximize their cash flow over time, through both changes and repositioning of the land. This strategy may include making physical modifications to the asset, thus seeking higher rents and increasing attempts to lease vacant space to quality tenants, enhancing land maintenance and customer loyalty, or minimizing operational expenses when feasible. When the property's net operating revenues increase, the aim is to sell the asset and gain market growth earnings. Efficient value-added strategies usually produce better financial returns for investors than core ventures due to asset inflation. These developments are more costly in terms of risk since properties do not run on maximum capacity at the acquisition time. It is not entirely rented, rented at lower market rents, and has not been adequately managed and properly maintained.

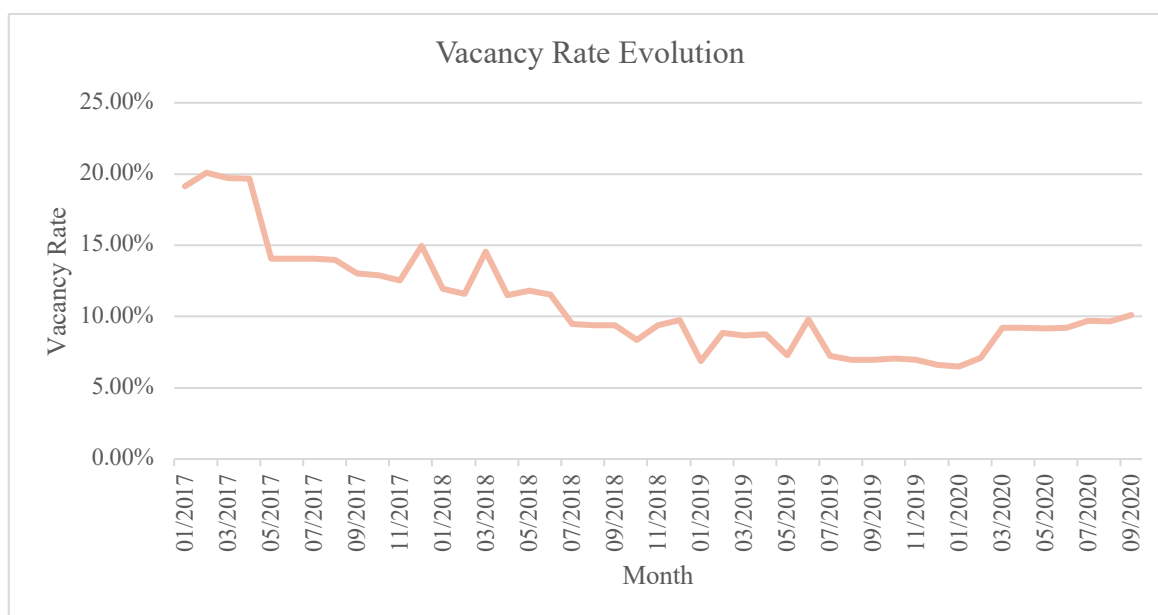
The opportunistic strategy follows the value-added approach, yet further extending the risk spectrum, entering the world of development and of niche markets that are riskier and tend to require essential rehabilitation, yet having the potential for high returns. When the investment strategy is successful, these ventures will deliver the highest returns but will face the most risk derived from their complicated management plans. Moreover, these assets have little to no cash flow in place at the time of acquisition or during the several development years, while being highly leveraged and exposed to market trends that might move against the investors.

Appendix Chapter 3: Company Overview

Appendix 3.1 – Annualized returns of the APFIIP open-end fund index and the *Imofomento* fund, between 2005 and 2020.



Appendix 3.2 – Evolution of *Imofomento*'s vacancy rate, between 2017 and 2020.

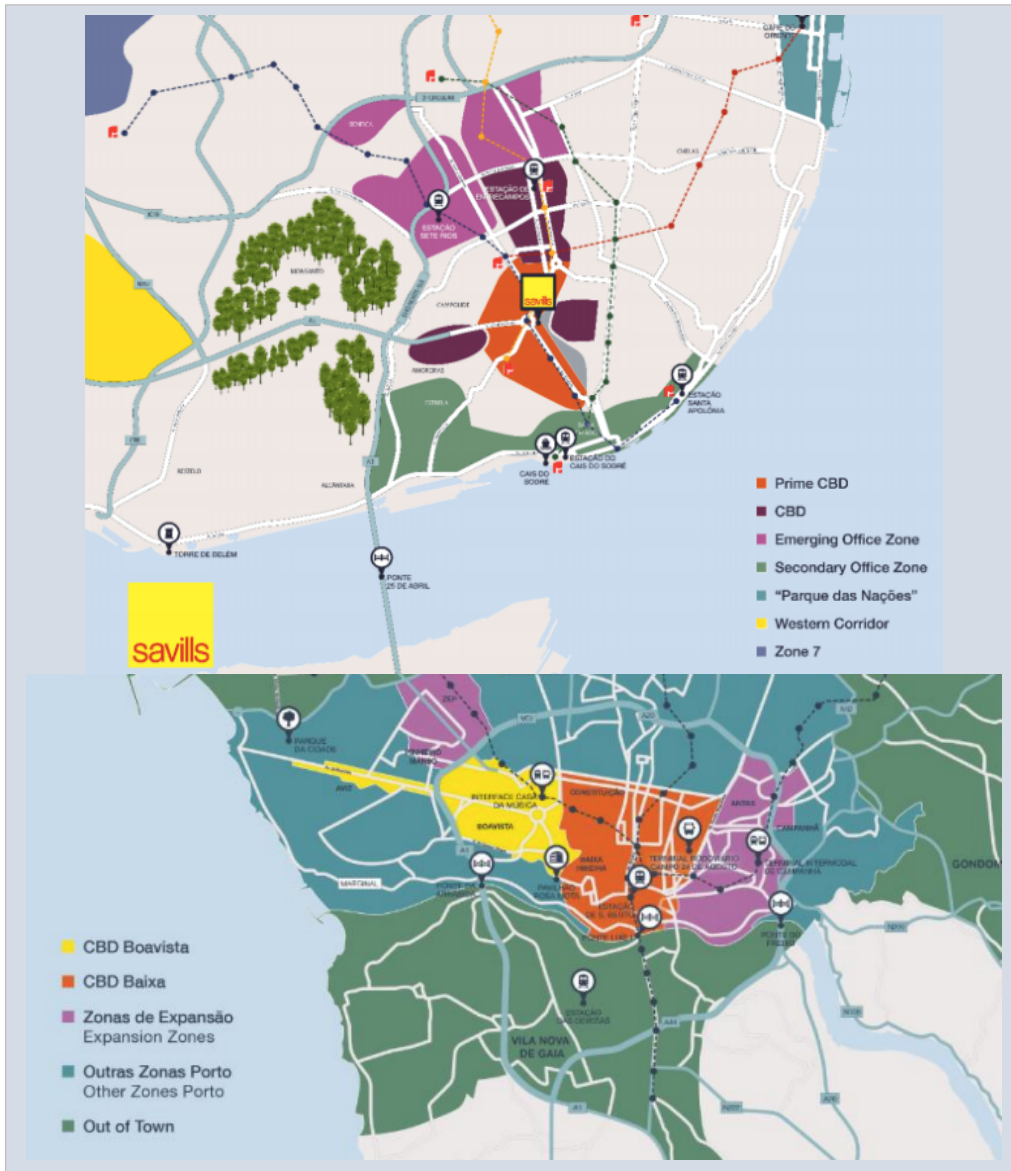


Appendix Chapter 4: Market and Industry Overview

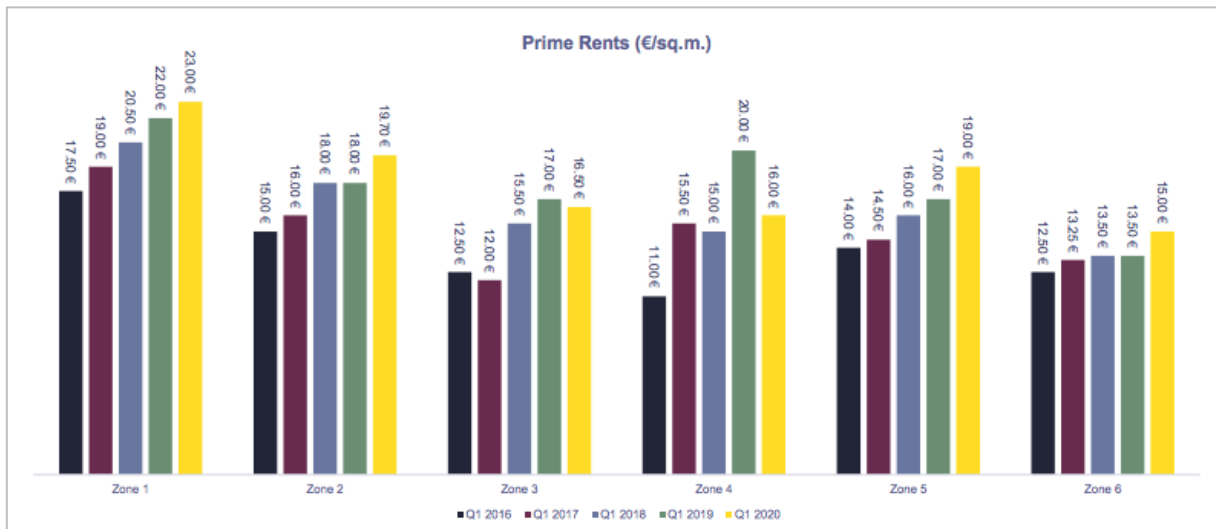
Appendix 4.1 – Prime yields for the different segments of CRE. Source: Savills, Q1 2020.

PRIME YIELD (%)	2016	2017	2018	2019	Q1 2020
Offices (Gross)	5.00	4.75	4.50	4.00	4.00
Shopping Centres (Net)	5.50	5.00	5.00	4.75	4.75
Retail Parks (Net)	7.25	6.75	6.75	6.50	6.50
High Street (Gross)	5.00	4.50	4.25	3.75	3.75
Industrial & Logistics (Gross)	7.00	7.00	6.50	6.25	6.25

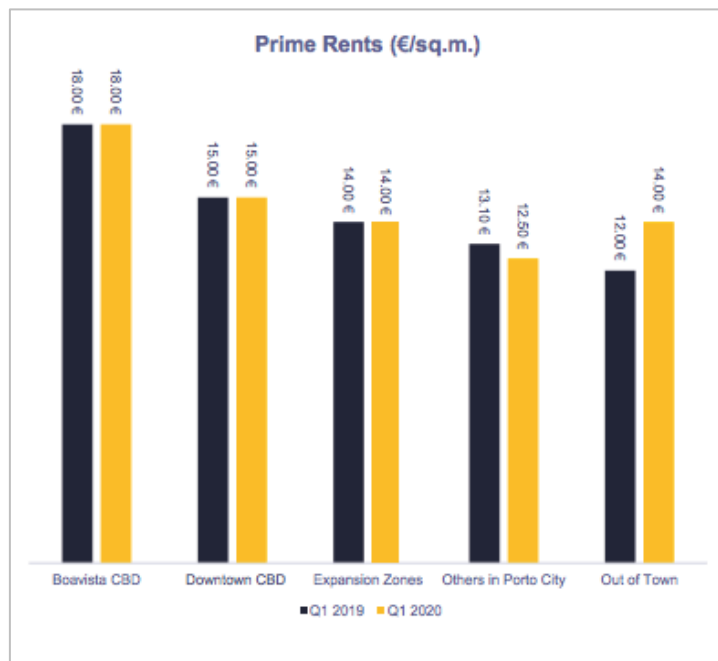
Appendix 4.2 – The different areas in Lisbon and Porto. Source: Savills, Q1 2020.



Appendix 4.3 – Prime rents in the Lisbon office market. Source: Savills, Q1 2020.



Appendix 4.4 – Prime rents in the Porto office market. Source: Savills, Q1 2020.



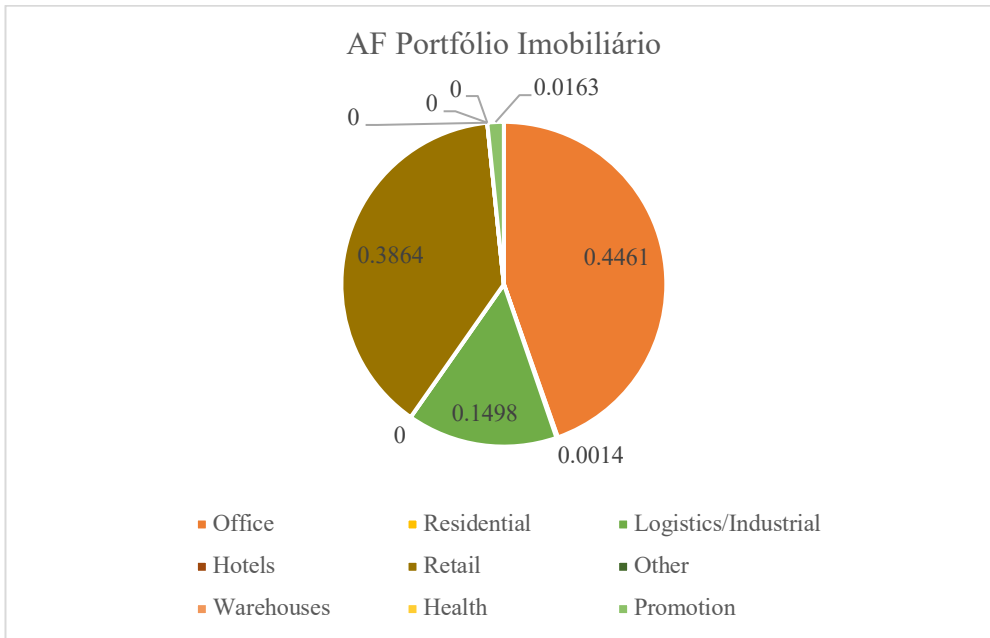
Appendix 4.5 – Summary of the major Portuguese players in the CRE non-listed open-end fund’s market. The market data was retrieved from Fund’s People (2019 market data) and the information from each fund and corresponding asset manager was obtained through their websites.

Management Firm	Market Share	Top Real Estate Fund
Interfundos	13.20%	AF Portfólio Imobiliário
Square Asset Management	10.40%	CA Património
Fundger	5.20%	Fundimo
BPI GA	5.00%	Imofomento
Silvip	4.40%	Vip

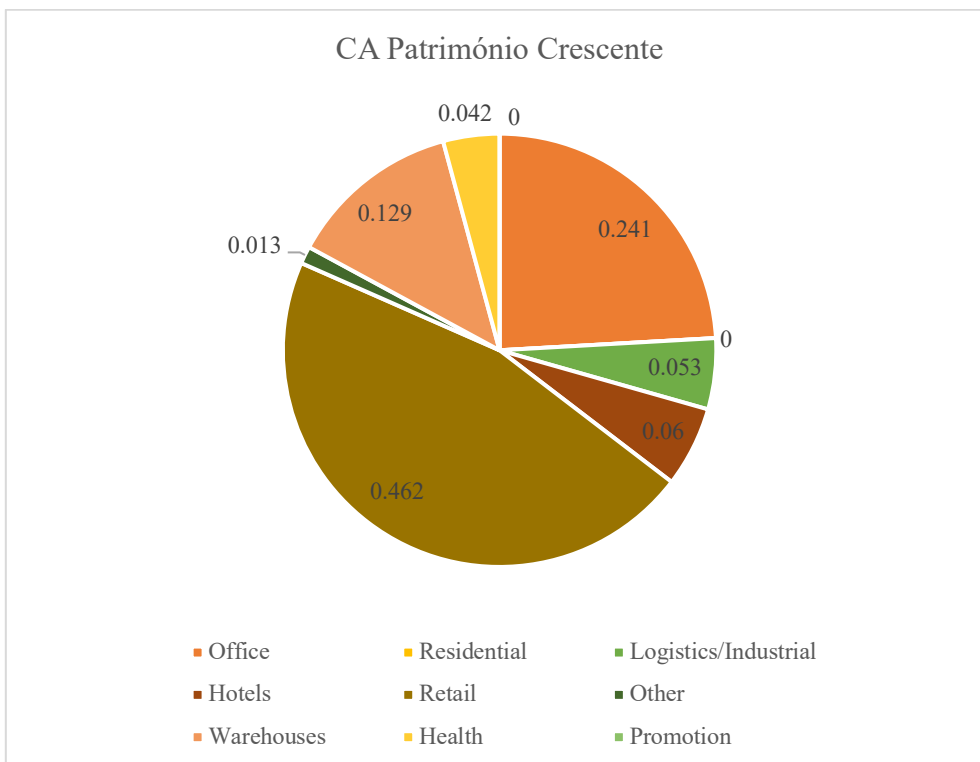
Appendix 4.6 – Summary of the top CRE non-listed open-end funds. The market data was retrieved from Fund’s People (2019 market data) and the information from each fund and corresponding asset manager was obtained through their websites.

Real Estate Fund	AuM (million €)	Returns	UP Price	Volatility	Sharpe Ratio	Investment Type
AF Portfólio Imobiliário	261.72	3.43%	10.61 €	1.38%	3.09	Core/ Value added
CA Património	817.83	4,07%	18.14 €	0.61%	7.59	Core
Fundimo	608.60	6,03%	7.90 €	2.01%	1.99	Core
Imofomento	512.95	2.37%	5.92 €	1.35%	2.47	Core
Vip	308.84	3.85%	9.66 €	0.52%	7	Core/ Value added

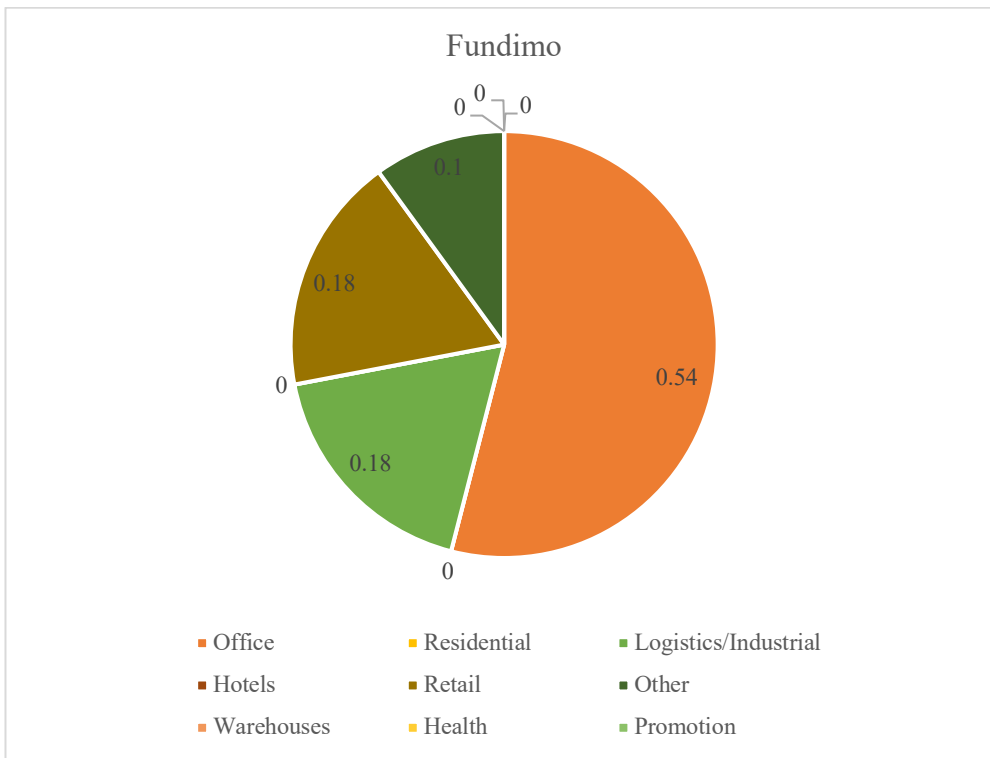
Appendix 4.7 – Segment distribution of *AF Portfólio Imobiliário*.



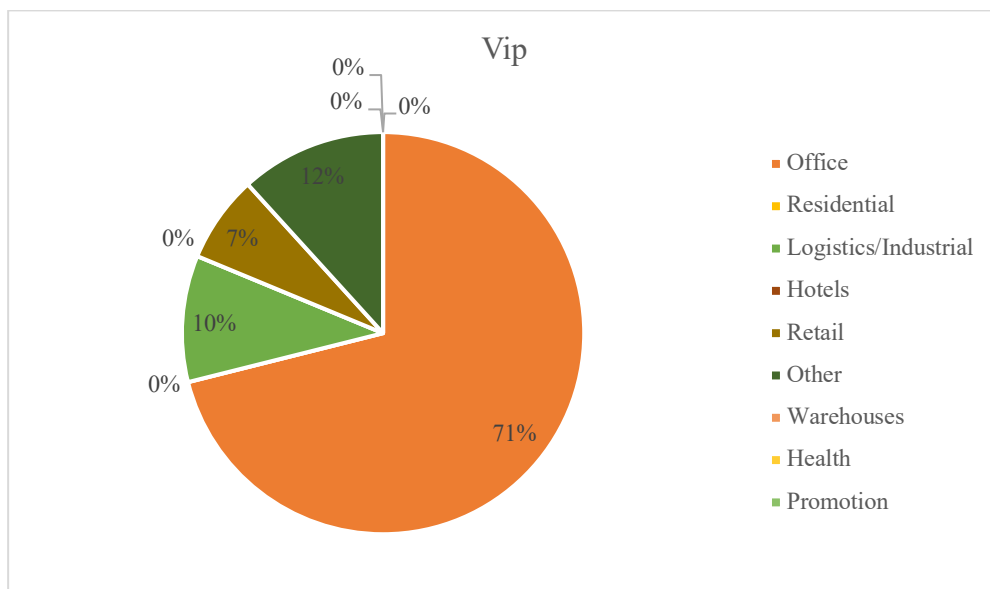
Appendix 4.8 – Segment distribution of *CA Património Crescente*.



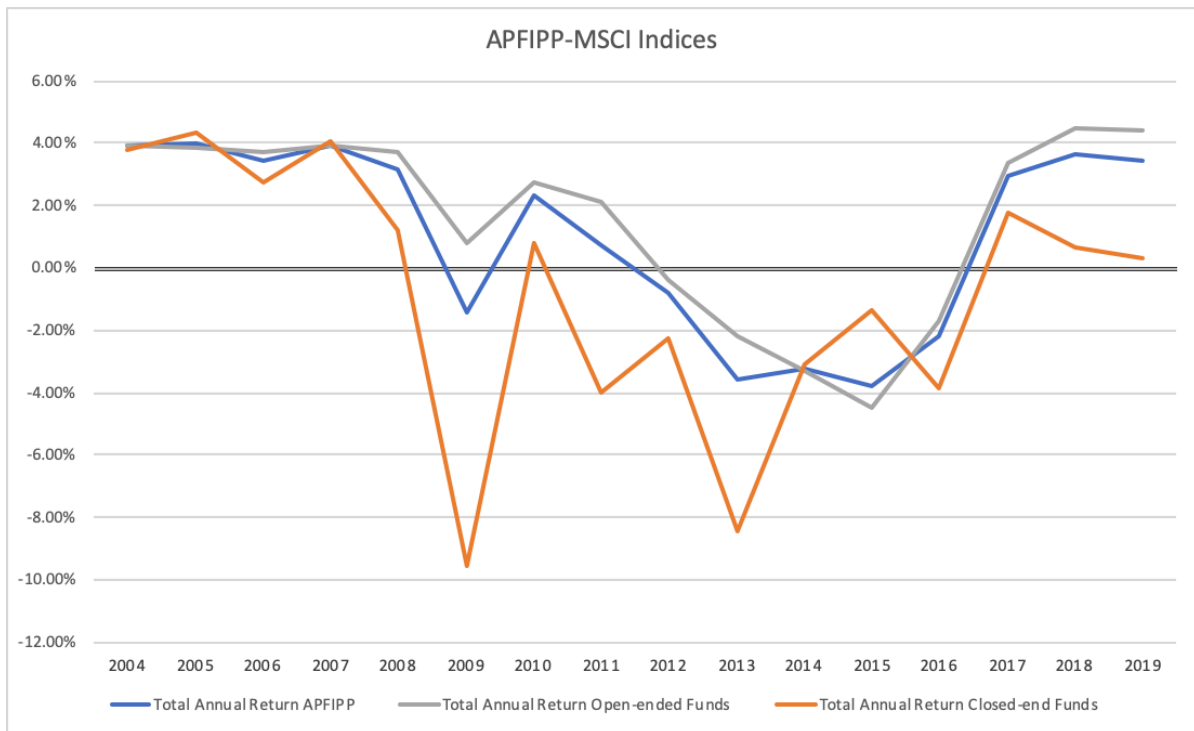
Appendix 4.9 – Segment distribution of Fundimo.



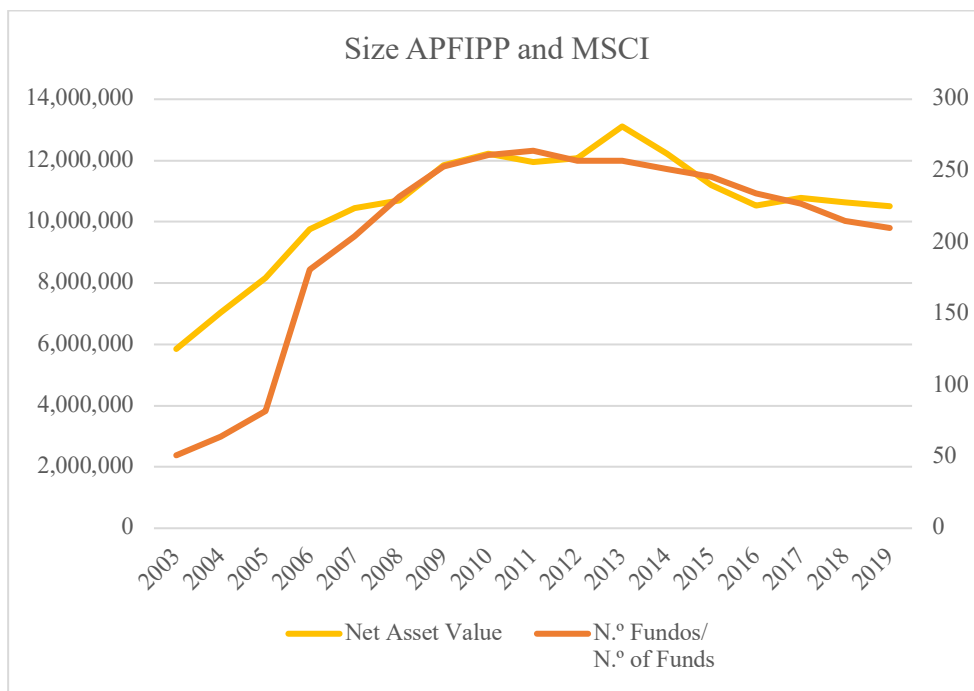
Appendix 4.10 – Segment distribution of Vip.

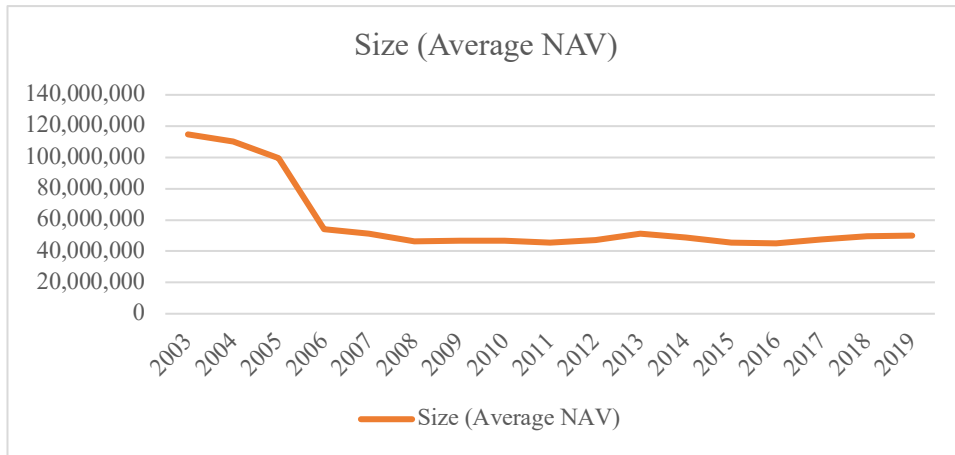


Appendix 4.11 – Graphical Representation of the performance of the APFIPP indexes.

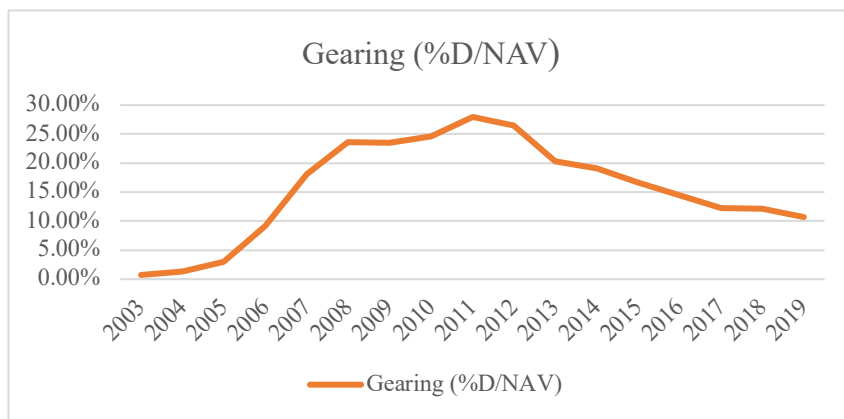


Appendix 4.12 – Graphical Representation of the historical average fund size of the APFIPP index, NAV and number of funds. The graph does not discriminate between closed-end, open-end and other fund types.

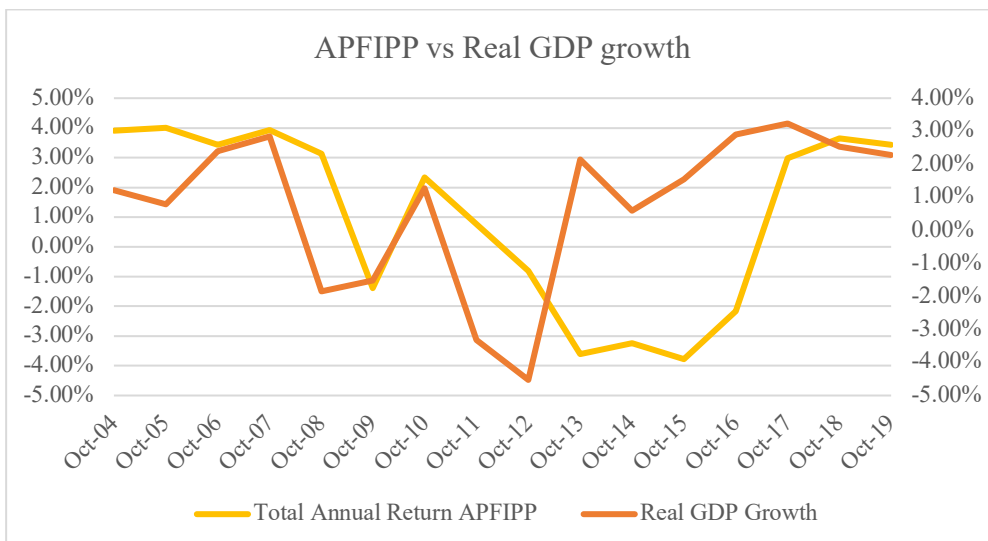




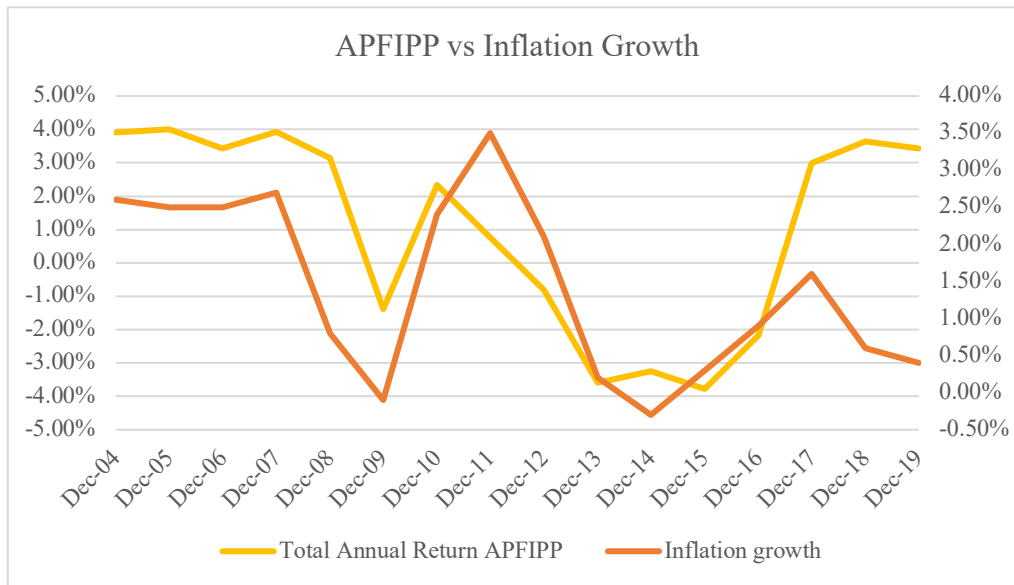
Appendix 4.13 – Graphical Representation of the Gearing of the APFIPP index.



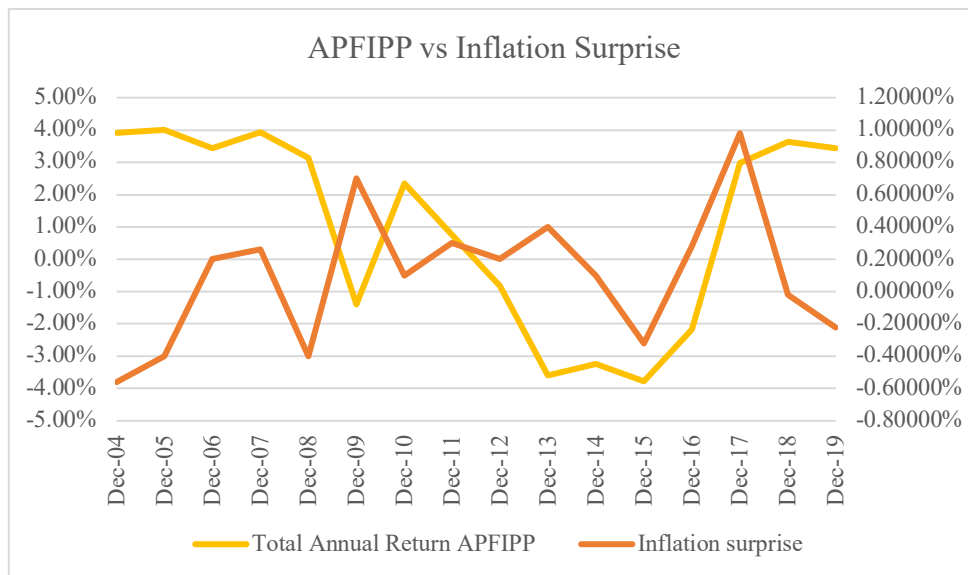
Appendix 4.14 – Graphical representation of GDP growth against the returns of non-listed Portuguese funds (APFIPP index).



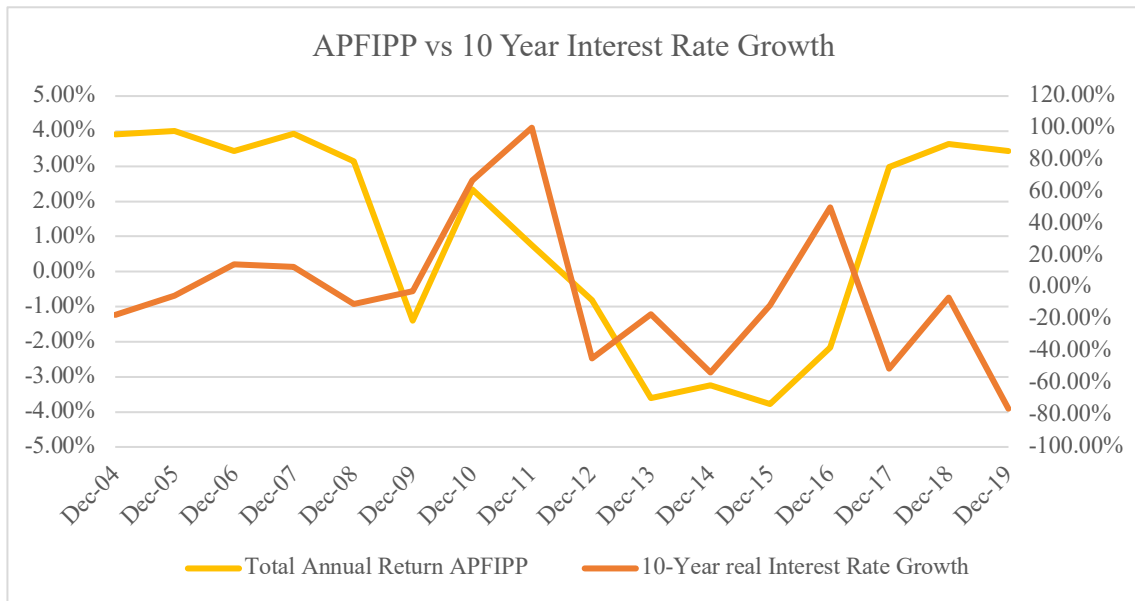
Appendix 4.15 – Graphical representation of inflation growth against the returns of non-listed Portuguese funds (APFIPP index).



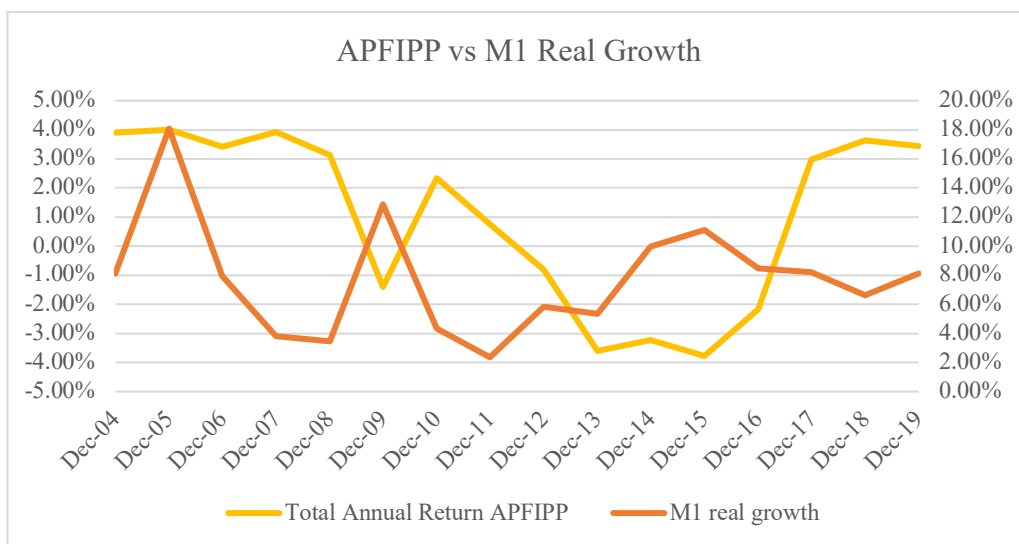
Appendix 4.16 – Graphical representation of inflation surprise against the returns of non-listed Portuguese funds (APFIPP index).



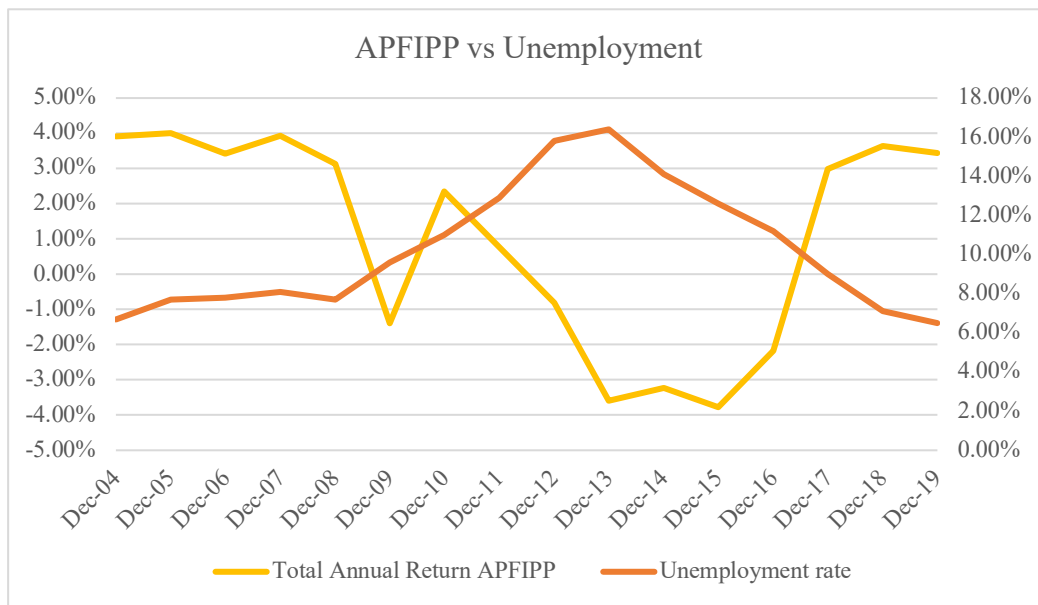
Appendix 4.17 – Graphical representation of interest rate growth against the returns of non-listed Portuguese funds (APFIPP index).



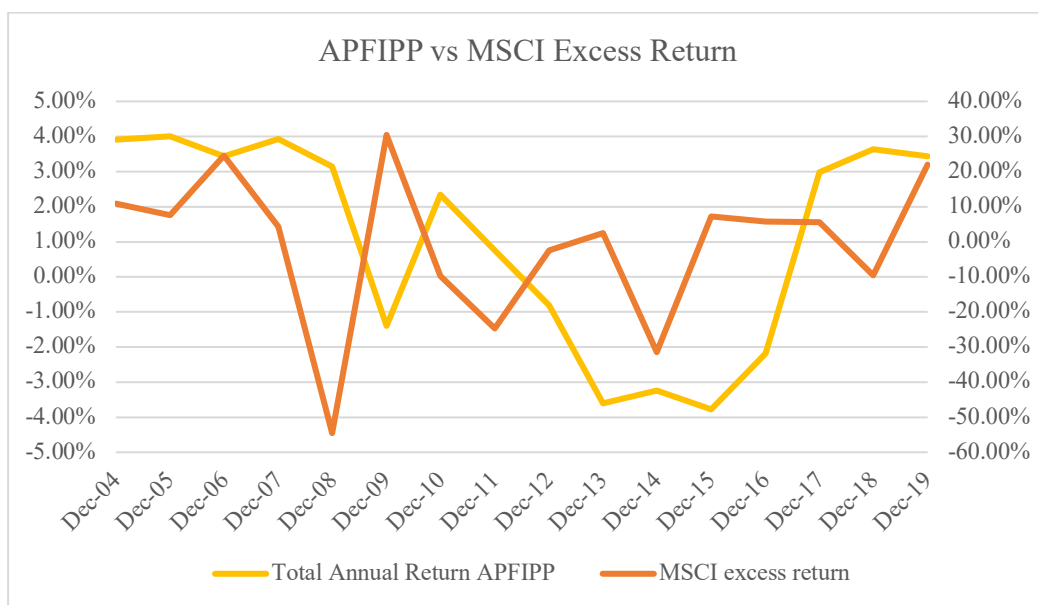
Appendix 4.18 – Graphical representation of money supply against the returns of non-listed Portuguese funds (APFIPP index).



Appendix 4.19 – Graphical representation of unemployment rate against the returns of non-listed Portuguese funds (APFIPP index).



Appendix 4.20 – Graphical representation of the excess return of the MSCI Portugal index against the returns of non-listed Portuguese funds (APFIPP index).





Appendix 4.21 – Porter’s 5 Forces crossing the CRE Industry with the CRE Private Fund’s Industry.

Porter’s Force	Level and Analysis
Threat of New Entrants	<p><i>Moderately Low – CRE Fund’s Industry</i></p> <p>Due to high entry costs and high transaction costs. Buying a property requires a substantial initial investment, especially when compared to investments in the stock and bond markets. Yet, the rise in REITS is changing this landscape.</p>
Bargaining Power of Suppliers	<p><i>Moderately High – CRE Industry</i></p> <p>This force is not significant in terms of the suppliers of external services. However, suppliers of existing buildings have a moderately high bargaining power. BPI GA’s Real Estate funds target the regions of Lisbon and Porto, where there are few offers that meet the fund’s target goals, namely with an adequate risk-return profile and mostly compromising big buildings (currently the most important ones ranging from €8 million to €53 million). The two regions have seen a decrease in construction permits in recent years (INE, 2019), added to a business trend around these two major Portuguese cities which boosts the demand for an already saturated market.</p>
Bargaining Power of Buyers	<p><i>Moderately Low – CRE Industry</i></p> <p>Following the same reasoning behind the high bargaining power of suppliers, the bargaining power of buyers – in this case the tenants and actual buyers of CRE assets – will be low, due the high demand and the low supply verified.</p>
Threat of Substitutes	<p><i>Moderate – CRE Fund’s Industry</i></p> <p>Threat of substitutes may be an increasing one, with COVID changing the status-quo of CRE. Investors may forecast a shrinkage in the CRE market caused by a decrease in office demand, but such could be offset by an increase in the logistics sub-sector. Moreover, alternative solutions which allow investors to get exposure to the CRE market are</p>

	increasing and becoming more relevant, such as REITs and derivatives.
Rivalry from Existing Players	<i>High – CRE Fund’s Industry</i> The rivalry between existing major competitors is fierce, since the market is fragmented and composed by different major players with similar market shares.

Appendix Chapter 5: Literature Review

Appendix 5.1 – Crosby et al. (2016) conceptual model for a Real Estate pricing.

Spatial Scale of Influence		Returns to Reflect	Drivers	Variables
Macro   Micro	Investment and Capital Markets	RFR	Expected inflation, time preference	National level measures such as Treasury Bill rates, Gross Redemption Yields on government bonds, and actual and expected inflation rates.
	Real Estate Market	Risk and growth expectations	Performance and volatility of real estate relative to other assets	Macro-economic and industry estimates of income and capital returns and key drivers in asset markets at national, local and submarket levels.
	Sector		Market specific factors, economic/ catchment profile	
	Location			
	Stock/Asset		Tenant	Credit worthiness
			Lease	Multi/single-let, Review/user clause, Period to expiry/review
			Location	Micro location/ accessibility
Building	Sustainability rating, Obsolescence			

Appendix 5.2 – The data collected on the CoStar building quality rating for the central London office market, in the empirical analysis performed by Crosby et al. (2016).

Building Rating	Definition	Percentage in Sample
1 Star	A very poor quality building with no tenant and little prospect of attracting a tenant because it is in very poor condition with substantial physical and structural defects and does not offer viable accommodation.	0.0%
2 Star	An older building, typically more than 20 years old, with the majority of the accommodation cellular. Poor quality reception areas with no lifts or old, poorly maintained lifts and generally poor maintenance with physical or structural defects. Rents will be substantially lower than for 3 Star buildings and close to the lowest levels achieved locally.	1.2%
3 Star	This is an older building that offers basic open plan accommodation and has been partly renovated but the interior has not been completely refurbished. Plant and other servicing likely to be outdated and inferior with some functional limitations although still reasonably well maintained.	39.2%
4 Star	A modern building, completed or renovated in the last 10 years, which offers good quality modern open plan space which is well maintained and managed. Externally less architecturally impressive than a 5 Star building. Offers good quality open plan office accommodation with raised floors, some form of air cooling system and adequate passenger lifts but is of a more basic design than a five star building.	47.6%
5 Star	A landmark building, either new built or extensively renovated within the last 5 years; to provide top specification accommodation and typically have a BREEAM rating of VERY GOOD, EXCELLENT or OUTSTANDING. If the building is older then the interior will be completely reconstructed with only the historical façade or structural frame remaining, and maintained and managed to the highest standard. Commands rents at or close to the top achievable rents in the local market.	12.0%

Source: CoStar (2013)

Appendix Chapter 6: Systematic Risk – Macroeconomic

Appendix 6.1 – Descriptive statistics on the econometric model.

	Mean (%)	St. Dev (%)	Min (%)	1st Qu. (%)	Median (%)	3rd Qu. (%)	Max (%)
% Change CRE Prices							
<i>USA</i>	3.414	12.271	-29.725	1.598	6.591	12.351	15.685
<i>Australia</i>	0.065	0.123	-0.190	0.030	0.055	0.123	0.280
<i>Brazil</i>	7.927	4.034	-1.701	5.667	8.193	10.838	13.982
<i>Denmark</i>	4.363	16.252	-22.006	-10.073	1.967	15.340	40.768
<i>Euro Area</i>	1.278	4.813	-8.502	-1.050	1.601	2.670	9.778
USA							
<i>Real GDP growth</i>	1.590	1.847	-3.924	1.385	1.952	2.624	4.148
<i>M3 growth</i>	6.335	1.952	1.945	5.572	6.126	7.153	10.176
<i>Inflation</i>	1.967	1.496	-1.623	1.265	1.836	2.935	5.303
<i>Stock excess return</i>	5.041	19.022	-38.736	-3.134	8.377	16.627	39.930
<i>10-Year IR growth</i>	-3.852	25.266	-46.183	-19.017	-8.462	9.418	71.407
Australia							
<i>Real GDP growth</i>	2.771	0.879	1.418	2.116	2.645	3.212	4.941
<i>M3 growth</i>	2.446	11.590	-10.960	-6.317	1.429	6.666	35.766
<i>Inflation</i>	2.640	0.941	1.200	1.950	2.600	3.150	5.000
<i>Stock excess return</i>	-0.103	24.675	-56.828	-13.970	-0.038	11.763	71.995
<i>10-Year IR growth</i>	-4.868	18.406	-40.318	-21.298	-2.762	6.955	30.623
Brazil							
<i>Real GDP growth</i>	2.840	3.463	-5.476	0.222	3.302	5.364	9.270
<i>M3 growth</i>	15.674	4.038	7.717	12.409	16.693	17.721	22.973
<i>Inflation</i>	5.703	1.556	2.988	4.625	5.687	6.424	10.361
<i>Stock excess return</i>	-4.758	42.623	-66.621	-33.597	-15.069	14.357	128.517
<i>10-Year IR growth</i>	10.301	32.298	-32.803	-9.116	0.852	20.268	108.973
Denmark							
<i>Real GDP growth</i>	0.780	2.506	-6.168	-0.112	1.139	2.293	4.732
<i>M3 growth</i>	7.168	9.506	-17.752	1.869	9.713	13.315	19.770
<i>Inflation</i>	1.762	0.985	0.268	0.797	1.892	2.493	4.183
<i>Stock excess return</i>	10.872	25.488	-51.519	-1.004	18.409	27.463	64.398
<i>10-Year IR growth</i>	-9.288	31.575	-82.424	-30.596	-5.695	12.436	72.470
Euro Area							
<i>Real GDP growth</i>	0.832	2.330	-5.644	-0.408	1.532	2.324	3.799
<i>M3 growth</i>	4.539	4.124	-2.125	1.569	2.967	8.525	11.405
<i>Inflation</i>	1.685	1.114	-0.359	0.621	1.877	2.481	3.911
<i>Stock excess return</i>	-0.296	19.701	-47.738	-10.705	4.452	12.659	38.395
<i>10-Year IR growth</i>	-12.534	26.052	-83.306	-25.582	-7.252	9.570	30.655

Appendix 6.2 – Equity indexes used as a proxy for the stock market variable.

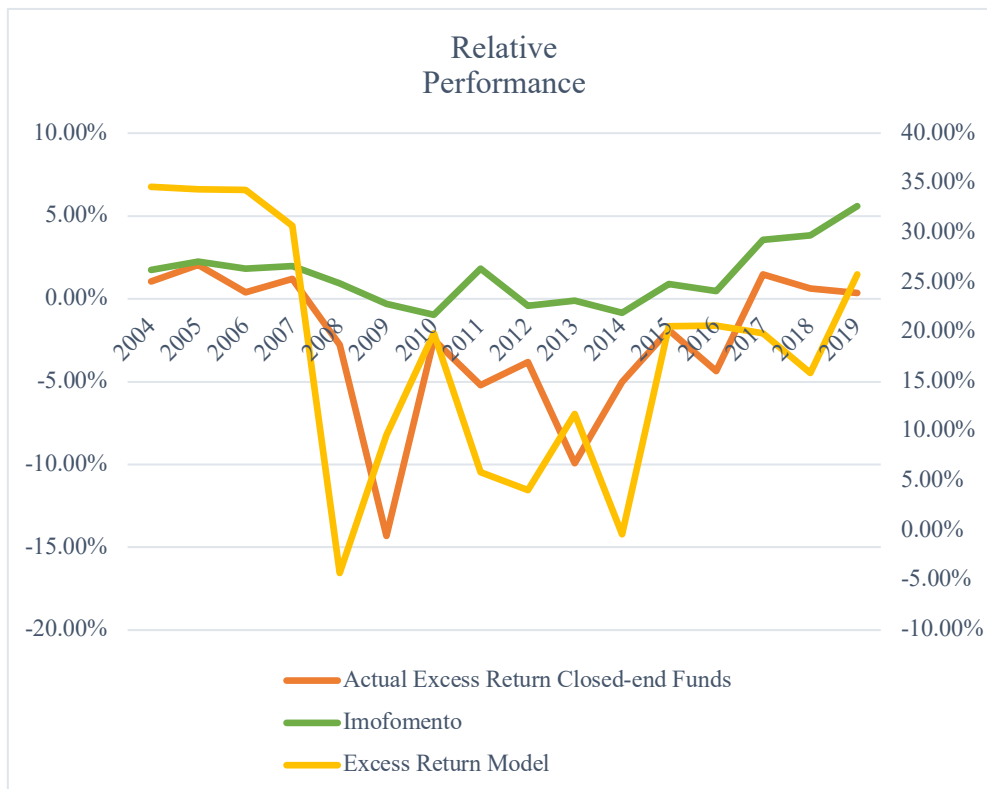
Equity Index	
<i>USA</i>	S&P 500
<i>Australia</i>	S&P/ASX 200
<i>Brazil</i>	Bovespa
<i>Denmark</i>	OMX Copenhagen 20
<i>Euro Area</i>	STOXX Europe 600

Appendix 6.3 – A detailed approach to the categorical variables when applying Delfim and Hoesli’s study (2016) to the Portuguese market.

Categorical Variable (Delfim and Hoesli’s study (2016) reference level)	Considerations in the Fitted-Values Model (dummy variables)
Vehicle structure of non-listed funds (Closed-end funds)	Has a dummy for open-end funds, which will be applied during the subprime crisis period.
Country (United Kingdom)	UK is the reference, thus a dummy for Italy will be used due to the fact that it is the country most similar to Portugal (Southern Europe Region).
Subperiod (Pre-subprime crisis)	Faces a dummy for the subprime crisis.
Sector (Retail)	The reference level is retail, and from Delfim and Hoesli’s research no significance was found across sectors for non-listed funds, so there was no need for adjustments to be made.
Investment style (Core)	No adjustments were made since the Core Style is the reference, and the majority of Portuguese funds, including <i>Imofomento</i> , are characterized by having a core investment style.

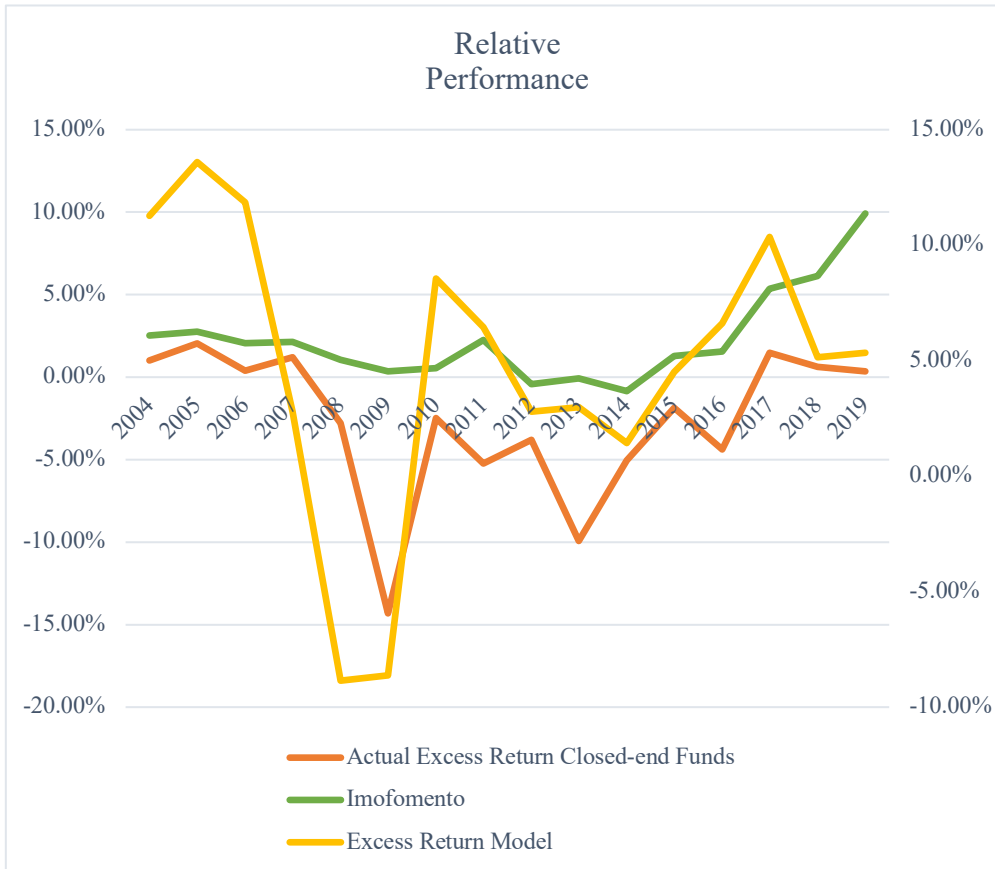
Appendix 6.4 – Results of the 1st Model concerning Real Estate non-listed Fund’s returns. It shows the model results obtained from the engine constructed with all the input data (Portuguese macroeconomic variables, fund characteristics variables and the coefficients of Delfim and Hoesli (2016) research). The Fitted-Values Model named “Return D&H” is the excess total return, which is compared to the returns given by APFIPP discounted by the risk-free rate given by the Euribor 12 month.

CORREL Imofomento vs Fitted-Value Model	0.4432
CORREL APFIPP vs Fitted-Value Model	0.5881
CORREL BPI Pension Fund vs Fitted-Value Model	0.4870



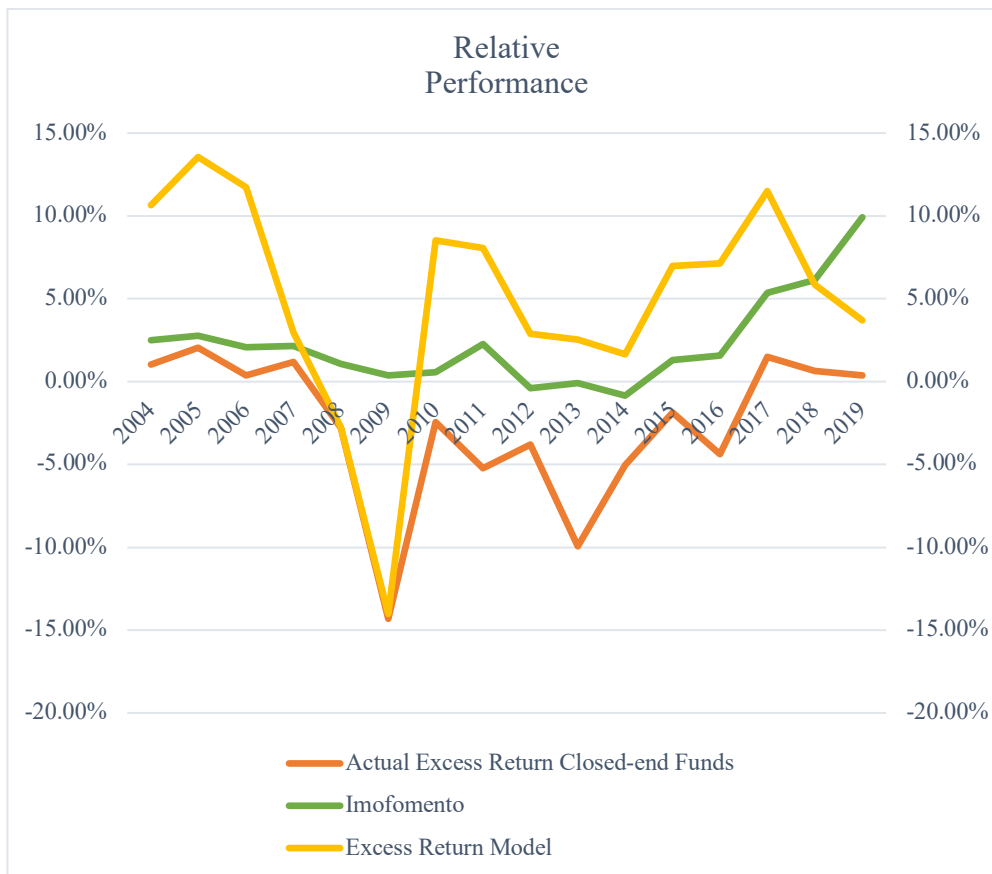
Appendix 6.5 – Results for the first model concerning Direct Real Estate Exposure.

CORREL Imofomento vs Fitted-Value Model	0.3098
CORREL APFIPP vs Fitted-Value Model	0.6507
CORREL BPI Pension Fund vs Fitted-Value Model	0.4207



Appendix 6.6 – Results of the 2nd Model concerning Direct Real Estate exposure. It shows the model results obtained from the engine constructed with all relevant macroeconomic data with the necessary lags and the coefficients of Delfim and Hoesli (2016) research. The Fitted-Values Model named “Return D&H” is the excess total return, which is compared to the returns given by APFIPP discounted by the risk-free rate given by the Euribor 12 month.

CORREL Imofomento vs Fitted-Value Model	0.2728
CORREL APFIPP vs Fitted-Value Model	0.7554
CORREL Pension Fund vs Fitted-Value Model	0.5512



Appendix Chapter 7 – Tenant Risk

Appendix 7.1 – Imofomento 's top 15 tenants regarding rents, ranked from highest to lowest rental prices.

Top 15	Tenant	Rent/month	Rent/year	% of Total Rents	Property
1	EDP DISTRIBUIÇÃO - ENERGIA SA	€ 338,059.54	€ 4,056,714.48	24.47%	Rua Camilo Castelo Branco 43
2	Modelo Continente Hipermercados SA	€ 249,969.50	€ 2,999,634.00	18.09%	Vasco da Gama
3	LOGIC LOGISTICA INTEGRADA S.A.	€ 72,500.00	€ 870,000.00	5.25%	Quinta da Arrovela
4	O Parque Ensino de Crianças S.A.	€ 68,474.09	€ 821,689.08	4.96%	O Parque (Restelo)
5	VILA AVENIDA HOTEL S.A.	€ 56,867.79	€ 682,413.48	4.12%	Av. Liberdade, 160
6	HP Health Clubs Portugal S.A	€ 41,088.50	€ 493,062.00	2.97%	Estádio Bessa
7	Servier Portugal-Especialid. Farmacêut.	€ 39,295.00	€ 471,540.00	2.84%	Ant. Aug. Aguiar
8	Saba Portugal - Parques de Estacionamento SA	€ 35,416.67	€ 425,000.04	2.56%	Picoas Plaza
9	Banco BPI SA	€ 35,391.96	€ 424,703.52	2.56%	Rua da Saudade
10	DHL EXPRESS PORTUGAL LDA	€ 34,390.50	€ 412,686.00	2.49%	Edifício Stern
11	Entreposto VM - SGPS, S.A.	€ 33,333.33	€ 399,999.96	2.41%	Entreposto Feijó
12	TELEPERFORMANCE PORTUGAL, S.A.	€ 31,364.73	€ 376,376.76	2.27%	Edifício Niña
13	DHL EXEL Supply Chain Portugal	€ 30,841.35	€ 370,096.20	2.23%	Armazém Vialonga
14	Pingo Doce Distribuição Alimentar S.A.	€ 29,892.91	€ 358,714.92	2.16%	Vale de Lobo
15	Perfumes & Companhia S.A.	€ 27,384.46	€ 328,613.52	1.98%	Mouzinho Silveira 11,15 e 19
TOTAL		€ 1,124,270.33	€ 13,491,243.96	81.38%	

Appendix 7.2 – Relation between the Failure Score provided by Informa D&B and the rating from S&P.

Min	Max	Rating
95.0	100	AAA
90.0	95.0	AA
80.0	90.0	A
70.0	80.0	BBB
55.0	70.0	BB
40.0	55.0	B
0.0	40.0	CCC/C

Appendix 7.3 – One-Year Square Transition Matrix. Source: S&P.

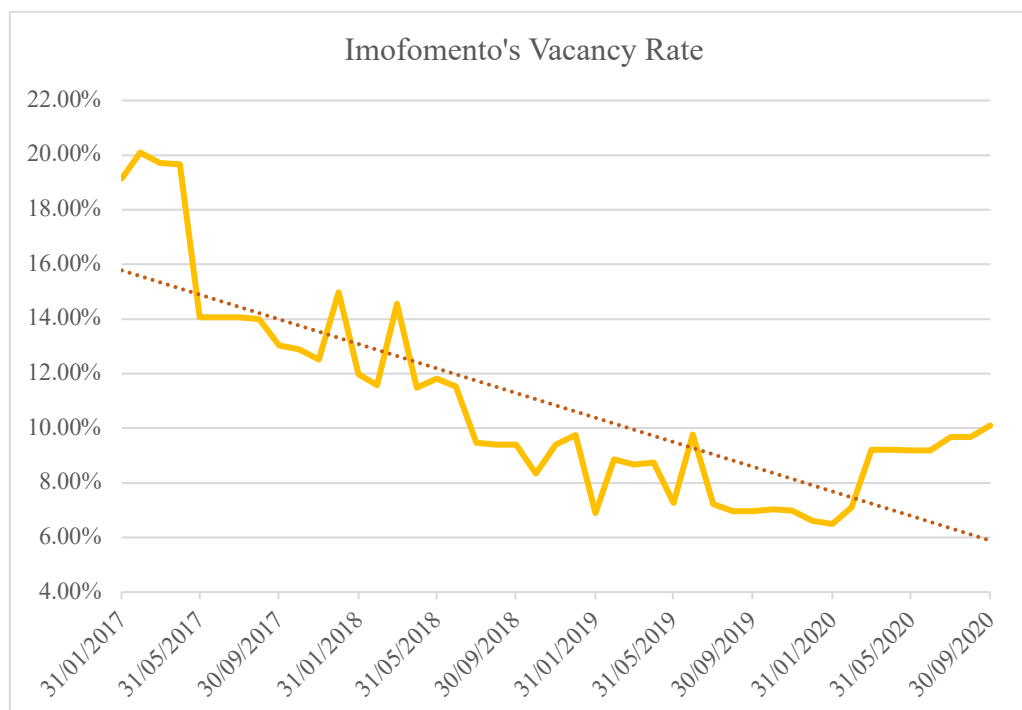
T = 1		AAA	AA	A	BBB	BB	B	CCC/C	D
From/to	AAA	89.82%	9.42%	0.55%	0.05%	0.08%	0.03%	0.05%	0.00%
AAA	AA	0.52%	90.64%	8.17%	0.51%	0.05%	0.06%	0.02%	0.02%
AA	A	0.03%	1.77%	92.29%	5.40%	0.30%	0.13%	0.02%	0.06%
A	BBB	0.01%	0.10%	3.66%	91.56%	3.88%	0.49%	0.12%	0.18%
BBB	BB	0.01%	0.03%	0.15%	5.35%	85.77%	7.36%	0.61%	0.72%
BB	B	0.00%	0.02%	0.09%	0.19%	5.63%	85.09%	5.05%	3.93%
B	CCC/C	0.00%	0.00%	0.13%	0.24%	0.70%	15.63%	51.49%	31.82%
CCC/C	D	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	100.00%
D									

Appendix 7.4 – Failure Score, Rating and PD of the top 15 tenants on *Imofomento*'s portfolio.

Top 15	Tenant	Failure Score	Rating	Probability of Default
1	EDP DISTRIBUIÇÃO - ENERGIA SA	78	A	0.06%
2	Modelo Continente Hipermercados SA	78	A	0.06%
3	LOGIC LOGISTICA INTEGRADA S.A.	18	CCC/C	31.82%
4	O Parque Ensino de Crianças S.A.	98	AAA	0.00%
5	VILA AVENIDA HOTEL S.A.	-	-	-
6	HP Health Clubs Portugal S.A	78	A	0.06%
7	Servier Portugal-Especialid. Farmacêut.	100	AAA	0.00%
8	Saba Portugal - Parques de Estacionamento SA	100	AAA	0.00%
9	Banco BPI SA	-	-	-
10	DHL EXPRESS PORTUGAL LDA	78	A	0.06%
11	Entrepasto VM - SGPS, S.A.	-	-	-
12	TELEPERFORMANCE PORTUGAL , S.A.	100	AAA	0.00%
13	DHL EXEL Supply Chain Portugal	86	AA	0.02%
14	Pingo Doce Distribuição Alimantar S.A.	78	A	0.06%
15	Perfumes & Companhia S.A.	100	AAA	0.00%

Appendix Chapter 8 – Vacancy Risk

Appendix 8.1 – Evolution of the overall *Imofomento*'s vacancy rate (2017-2020).



Appendix 8.2 – Top 5 *Imofomento*'s buildings in terms of vacancy rate, excluding the building totally vacant (2019).

Rank	Building	Vacancy Rate (%)
1	Edifício Monsanto	77.3%
2	Edifício Sagres	74.0%
3	Ed. Parque Oceano	67.7%
4	Edif. Eça de Queiroz	65.3%
5	Edifício Stern	58.2%

Appendix 8.3 – Ascending ranking of rental yields from the Top 5 *Imofomento*'s buildings with highest vacancy rates, excluding the ones totally vacant (2019).

Rank	Building	Yield (%)
1	Edifício Monsanto	1.70%
2	Ed. Parque Oceano	2.41%
3	Edifício Sagres	2.55%
4	Edif. Eça de Queiroz	2.76%
5	Edifício Stern	3.63%

Appendix 8.4 – Rental payments under different scenarios (15 years of rental contract)

Year	<u>1</u>	<u>2</u>	<u>3</u>	...	<u>7</u>	<u>8</u>
Scenario 1	x	x	x		x	x
Scenario 2	-	y + Premium	y + Premium		y + Premium	y + Premium
Scenario 3	-	y - Premium	y - Premium		y - Premium	y - Premium

Appendix 8.5 – User’s inputs to the real option’s vacancy model.

<i>Inputs</i>	<i>Description</i>
Risk Free	10 Year Portuguese Government Bond Yield.
Inflation	Expected annual inflation rate of the respective economy for the next 8 years. An accurate proxy for such variable might be the average annual inflation rate for the last 8 years within that same economy.
Probability	Fund's managers confidence that, in 1 year, they are able to find a new tenant that pays the requested rental premium (ranges from 0% to 100%).
Premium targeted	Rental premium targeted by the fund over the existing tenant's annual rent established in its lease contract. This new rental amount is the one which, in the perfect scenario (<i>Scenario 2</i>), the new tenant will pay (ranges from 0% to 100%).
Monthly Rent under the existing contract	Monthly rental amount that was initially agreed with the current tenant to be paid every month. This refers to the amount established on the rental contract, not the actual delayed rental amount received from the existing tenant.
Annual Rent under the existing contract	Monthly rent under the existing contract times twelve months.
N° of monthly rental payments delayed	Average number of months that the existing tenant is delayed in term of rental payments.

Appendix 8.6 – The Gentleman Square’s inputs to use in the real option’s tool (one of the tenants from *Edificio Peninsula*).

Risk Free	1.05%
Inflation	4.53%
Probability	50%
Premium targeted	20%
Monthly Rent under the contract	€ 1,500.00
Annual Rent under the contract	€ 18,000.00
N° of rental payments delayed	3

Appendix 8.7 – Real Option tool’s output (value of the option).

Year	0	1
NPV No Option (Scenario 0)	€ 120,686.80	
NPV (Scenario 1)		€ 173,526.42
NPV (Scenario 2)		€ 115,684.28
NPV with Option (Scenario 1 and 2)	€ 143,102.77	
Value of the Option	€ 22,415.97	

Appendix 8.8 – Sensitivity Analysis (n° of monthly rental payments delayed = 3)

€	Probability										
	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
22,415.97	€16,348	€16,955	€17,561	€18,168	€18,775	€19,382	€19,989	€20,596	€21,202	€21,809	€22,416
0%	€8,106	€10,968	€13,830	€16,692	€19,554	€22,416	€25,278	€28,140	€31,002	€33,864	€36,726
10%	€951	€5,244	€9,537	€13,830	€18,123	€22,416	€26,709	€31,002	€35,295	€39,588	€43,881
15%	-€6,205	-€480	€5,244	€10,968	€16,692	€22,416	€28,140	€33,864	€39,588	€45,312	€51,037
20%	-€13,360	-€6,205	€951	€8,106	€15,261	€22,416	€29,571	€36,726	€43,881	€51,037	€58,192
25%	-€20,515	-€11,929	-€3,343	€5,244	€13,830	€22,416	€31,002	€39,588	€48,174	€56,761	€65,347
30%	-€27,670	-€17,653	-€7,636	€2,382	€12,399	€22,416	€32,433	€42,450	€52,468	€62,485	€72,502
35%	-€34,825	-€23,377	-€11,929	-€4,80	€10,968	€22,416	€33,864	€45,312	€56,761	€68,209	€79,657
40%	-€41,980	-€29,101	-€16,222	-€3,343	€9,537	€22,416	€35,295	€48,174	€61,054	€73,933	€86,812
45%	-€49,135	-€34,825	-€20,515	-€6,205	€8,106	€22,416	€36,726	€51,037	€65,347	€79,657	€93,967

Targeted Premium

Appendix 8.9 – Sensitivity Analysis (n° of monthly rental payments delayed = 1)

€	Probability										
	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
4,403.32	-€10,471	-€9,865	-€9,258	-€8,651	-€8,044	-€7,437	-€6,831	-€6,224	-€5,617	-€5,010	-€4,403
0%	-€18,714	-€15,852	-€12,989	-€10,127	-€7,265	-€4,403	-€1,541	€1,321	€4,183	€7,045	€9,907
10%	-€25,869	-€21,576	-€17,283	-€12,989	-€8,696	-€4,403	-€110	€4,183	€8,476	€12,769	€17,062
15%	-€33,024	-€27,300	-€21,576	-€15,852	-€10,127	-€4,403	€1,321	€7,045	€12,769	€18,493	€24,217
20%	-€40,179	-€33,024	-€25,869	-€18,714	-€11,558	-€4,403	€2,752	€9,907	€17,062	€24,217	€31,372
25%	-€47,334	-€38,748	-€30,162	-€21,576	-€12,989	-€4,403	€4,183	€12,769	€21,355	€29,941	€38,528
30%	-€54,489	-€44,472	-€34,455	-€24,438	-€14,421	-€4,403	€5,614	€15,631	€25,648	€35,665	€45,683
35%	-€61,644	-€50,196	-€38,748	-€27,300	-€15,852	-€4,403	€7,045	€18,493	€29,941	€41,390	€52,838
40%	-€68,800	-€55,920	-€43,041	-€30,162	-€17,283	-€4,403	€8,476	€21,355	€34,234	€47,114	€59,993
45%	-€75,955	-€61,644	-€47,334	-€33,024	-€18,714	-€4,403	€9,907	€24,217	€38,528	€52,838	€67,148

Targeted Premium

Appendix Chapter 9 – Asset Concentration Risk

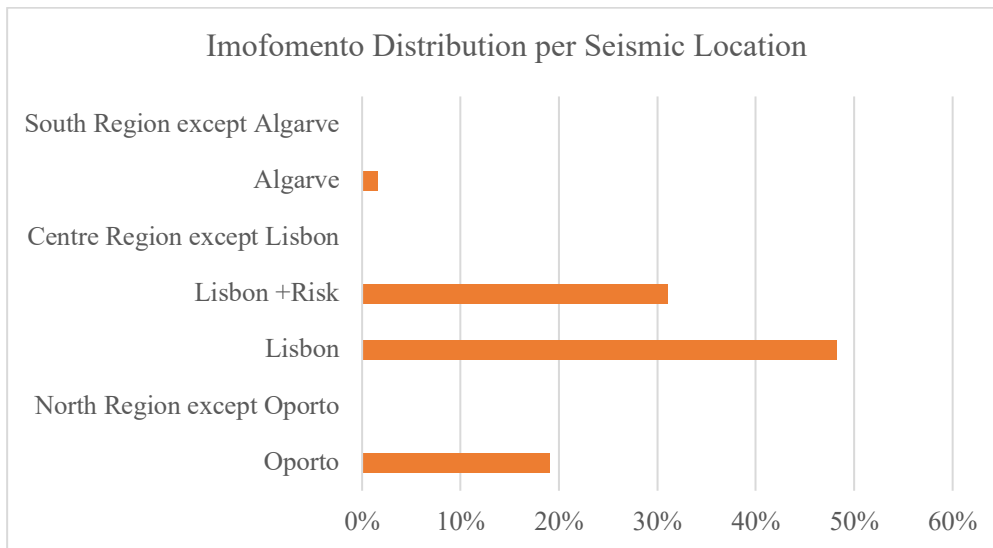
Appendix 9.1 – List of Imofomento’s properties where the fund is more concentrated in terms of value, ranked from highest to lowest.

Rank	Property
1	Vasco da Gama
2	Rua Camilo Castelo Branco 43
3	CCB 45
4	Edifício Península
5	Picoas Plaza

Appendix 9.2 – Seismic locations and respective levels of earthquake risk. The scores range between the levels 0 and 3, with 3 being the highest score that reflects a large seismic risk, translated into a high probability of seismic occurrences. The “Lisbon +Risk” location contains some specific sub-locations that were considered to be the ones with higher risk of earthquake, therefore not being considered in the location “Lisbon”, namely *Avenida da Liberdade*, *Avenida de Ceuta*, *Almirante Reis*, *Vale de Alcântara*, *Vale de Chelas*, *Área do Hospital de São José* (Agência Portuguesa do Ambiente 2014).

Location	Seismic Score
1. North Region except Porto	Level 0
2. Centre Region except Lisbon	Level 0
3. Porto	Level 1
4. Lisbon	Level 2
5. South Region except Algarve	Level 2
6. Lisbon + Risk	Level 3
7. Algarve	Level 3

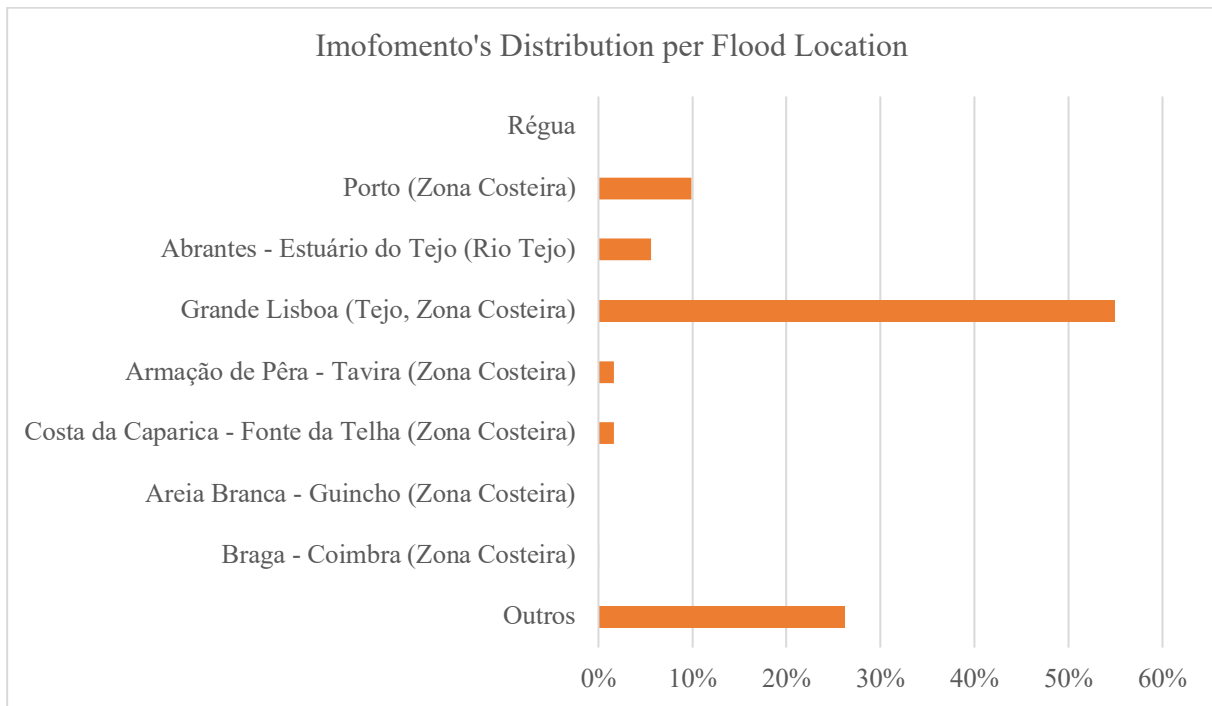
Appendix 9.3 – Weight of each seismic location in the overall portfolio.



Appendix 9.4 – Flood locations and respective levels of earthquake risk. The scores range between the levels 0 and 2, with 2 being the highest score reflecting the highest flood risk.

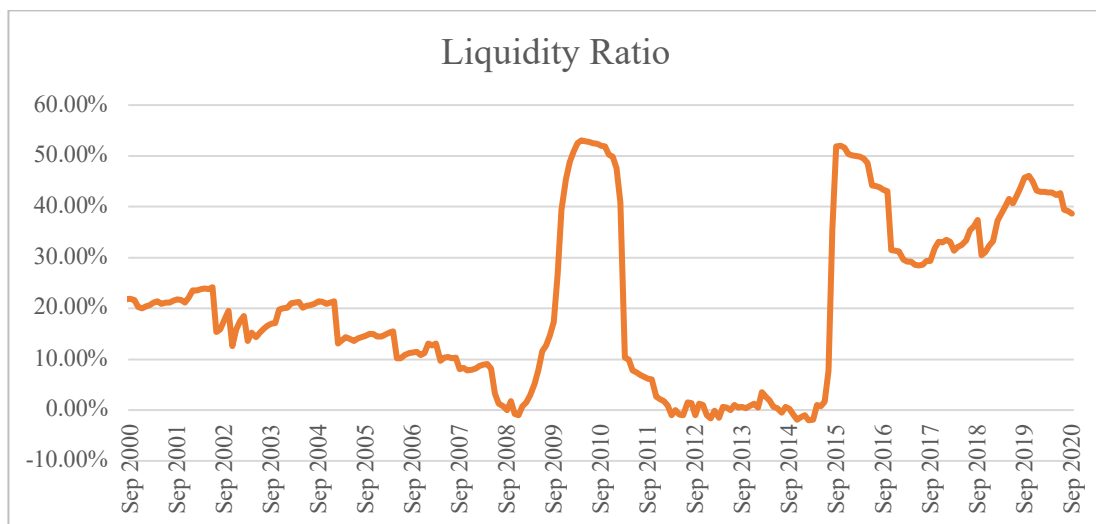
Location	Seismic Score
1. Régua	Level 2
2. Porto (Coast*)	Level 2
3. Abrantes to Estuário do Tejo	Level 2
4. Grande Lisboa (Tejo Coast)	Level 2
5. Armação de Pêra to Tavira (Coast)	Level 1
6. Costa da Caparica to Fonte da Telha (Coast)	Level 1
7. Areia Branca to Guincho (Coast)	Level 1
8. Braga to Coimbra (Coast)	Level 1
9. Others	Level 1

Appendix 9.5 – Weight of each flood risk location in the overall portfolio.



Appendix Chapter 10 – Liquidity Risk

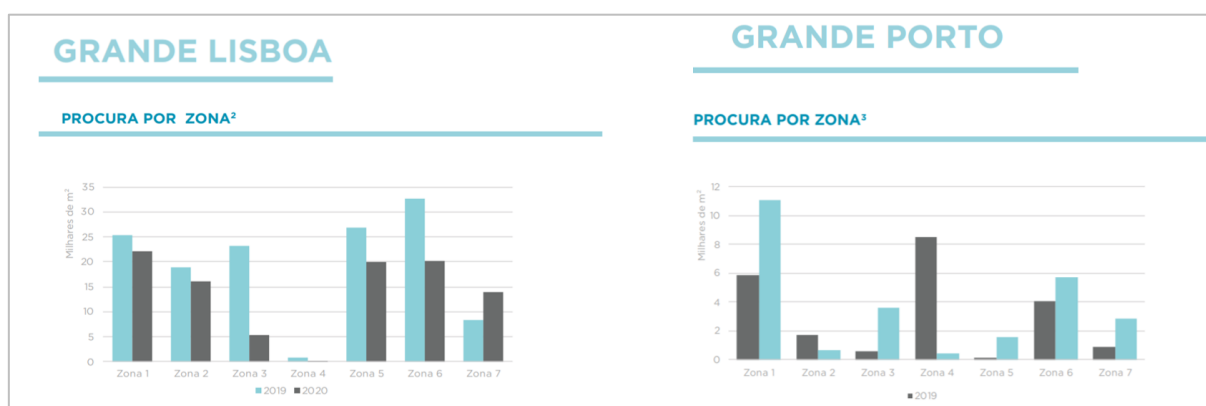
Appendix 10.1 – Imofomento's liquidity ratio between 2000 and 2020.



Appendix 10.2 – Summary of the zones used in the liquidity score, with the respective location and rents.

Number	Zone	City	Name	Rent (€/m ² /month)
1	Zone 1	Lisbon	Prime CBD	€19-23/m ² /month
2	Zone 5	Lisbon	Parque das Nações	€18.5-19/m ² /month
3	Zone 2	Lisbon	CBD	€17-18/m ² /month
4	Zone 3	Lisbon	New Office Zone	€16.5 – 17.5/m ² /month
5	Zone 4	Lisbon	Historic and Riverside Zone	€16-17/m ² /month
6	Zone 1	Porto	Porto Boavista	€15.5-18/m ² /month
7	Zone 2	Porto	Downtown	€14-17/m ² /month
8	Zone 6	Lisbon	Western Corridor	€13.5-16/m ² /month
9	Zone 6	Porto	Matosinhos	€12.5-14/m ² /month

Appendix 10.3 – Demand per location zone in Lisbon and Porto, in 2019 and 2020. Source: Cushman and Wakefield.



Appendix 10.4 – 10 properties listed in terms of its liquidity score.

TOP	Score	Building	Value	
1	4.90	Vasco da Gama	€	53,162,099.00
2	4.50	Ant. Aug. Aguiar	€	8,335,528.00
3	4.44	Av. Liberdade, 160	€	9,256,485.50
4	4.44	Av. Liberdade, 160	€	9,256,485.50
5	4.40	Av. Liberdade, 245	€	1,313,200.00
6	4.35	CCB 45	€	27,201,250.00
7	4.35	CCB 45	€	27,201,250.00
8	4.35	Mouzinho Silveira 11,15 e 19	€	6,162,528.00
9	4.28	Rua Sao Jose 169 a 175	€	4,651,860.40
10	4.25	Telheiras	€	412,407.00
TOTAL			€	146,953,093.40

Appendix 10.5 – Bottom 10 properties listed in terms of its liquidity score.

BOTTOM	Score	Building	Value	
1	1.36	Coimbra	€	211,831.50
2	1.80	Entrepasto Feijó	€	5,247,745.00
3	2.25	Columbano Bordalo Pinheiro	€	4,142,466.50
4	2.35	Quinta do Lago	€	2,268,731.00
5	2.60	Vale de Lobo	€	2,817,751.00
6	2.60	Edificio DHL	€	4,616,875.00
7	2.65	O Parque (Restelo)	€	4,958,345.50
8	2.70	Estádio Bessa	€	7,616,883.50
9	2.78	Quinta Grande	€	216,200.00
10	2.80	Edif. Eça de Queiroz	€	2,365,922.50
TOTAL			€	34,462,751.50

Appendix 10.6 – Stress Tests, with the different scenarios for September 2020. The first table summarises *Imofomento*'s information from September 2020.

30.09.2020			
NAV (€)	Real Estate (€)	Liquidity (€)	Value Unit (€)
512,952,180.02	314,539,610.31	198,412,569.71	5.9024

Scenario	Flow %	Value of Redemptions (€)	Δ Liquidity (€)	Number of Units Redeemed
Liquidity Stress				
Fixed Percentage Redemptions				
10%	10%	51,295,218.00	147,117,351.71	8,690,569.60
20%	20%	102,590,436.00	95,822,133.71	17,381,139.20
30%	30%	153,885,654.01	44,526,915.70	26,071,708.80
40%	40%	205,180,872.01	-6,768,302.30	34,762,278.40
50%	50%	256,476,090.01	-58,063,520.30	43,452,848.00
Redemption Largest Investor	37%	189,646,066.24	8,766,503.47	32,130,331.09
Historical Redemptions				
Max Loss 2015-2020	20.36%	104,432,826.83	93,979,742.88	17,693,281.86
Max Loss 2010-2015	1.57%	8,064,394.57	190,348,175.14	1,366,290.76
Max Loss 2005-2010	3.35%	17,208,480.15	181,204,089.56	2,915,505.58
Expected Shortfall (ES)	1.40%	7,196,908.57	191,215,661.14	1,219,319.02
VaR 5%	0.15%	778,955.62	197,633,614.09	131,972.69
VaR 1%	0.47%	2,393,818.65	196,018,751.06	405,567.00
Redemptions per Investor Type				
Non-monetary financial institutions	75%	14,938,165.11	183,474,404.60	2,530,862.89
Resident individual-investors	65%	226,258,032.35	-27,845,462.64	38,333,225.87
Enterprises	25%	3,393,937.62	195,018,632.09	575,009.76
Non-resident individual-investors	40%	49,386,184.20	149,026,385.51	8,367,136.11
Scenario	Value Real Estate (€)		Total Loss (€)	
Assets				
Seismic Risk				
Properties Level 3 Risk – Lisboa	97,701,855.31	5,146,397.04	44,227,139.16	154,185,430.55
Properties Level 3 Risk – Algarve	5,086,482.00	358,714.92	2,393,307.72	196,019,261.99
Default				
Top 5 Tenants Default	-	9,430,451.04	9,430,451.04	188,982,118.67
Top 10 Tenants Default	-	11,657,442.60	11,657,442.60	186,755,127.11
Top 15 Tenants Default	-	13,491,243.96	13,491,243.96	184,921,325.75

Appendix Chapter 11 – ESG Risk

Appendix 11.1 – Organizational scoreboard.

Organizational Assessment

#	KRI	E,S,G	Metric
1	Property investment policy	G	The organization has a property investment policy defined.
2	Responsible property investment (RPI) policy	G	The organization has a responsible property investment policy defined.
3	Formal commitment on RPI	G	The organization mentions RPI aspects in the funds' prospects for Real Estate assets.
4	ESG in contracts	G	ESG topics are mentioned in contract clauses or green leases.
5	Investment committee's supervision	G	The investment committee supervises all ESG aspects.
6	International standards	G	International standards/ frameworks are considered for materiality analysis (TCFD, SASB, GRI, GRESB, etc.).
7	ESG risk in pricing	G	The level of ESG risk exposure affects pricing offered/paid (e.g. OPEX and CAPEX assumptions).
8	Due diligence commitment	G	The due diligence encompasses third-party consultants, site visits and interviews to personnel.
9	Comparison with past performance	G	The team monitors the ESG scores at a property level and assesses historical performance for risk management purposes.
10	SDG alignment	G	The team has an SDG alignment strategy in place.
11	Budget availability	G	There is sufficient budget available to ensure that the systems and procedures needed to achieve the target are put in place.
12	ESG impact on financial performance	G	The ESG impact on financial performance is assessed.

Real Estate Team/ Department

#	KRI	E,S,G	Metric
1	Conflicts of interests	G	Employees at BPI GA are not related, except professionally, with the purchase, sale and rental of the buildings the company owns.
2	Separation of powers	G	The first line of defence in risk management is separated from the second and third ones.
3	Bribery, money laundering and corruption	G	Whether cases of bribery, corruption and money laundering were identified over the last 3 years, regarding any member of BPI GA.

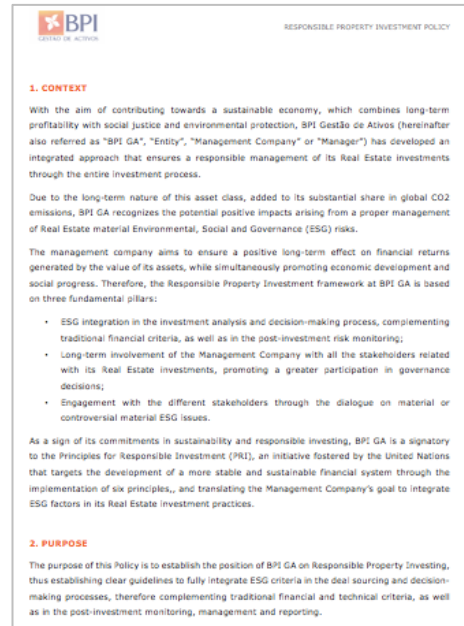
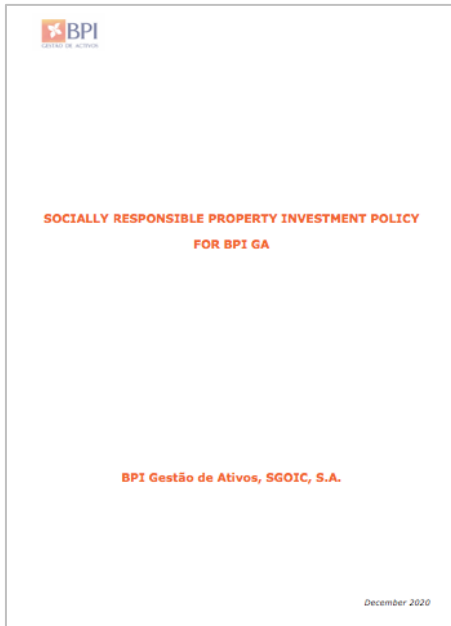
Active Ownership

#	KRI	E,S,G	Metric
1	Tenant engagements	G	Tenant engagements were made during the last year.
2	ESG in tenant engagements	G	Whether ESG factors are taken into account in tenant engagements.
3	Tenant exclusions	G	Tenants were excluded when necessary, namely when there was too much ESG risk exposure and engagements were made without efficacy.
4	Constructions	G	Constructions, developments or renovations were made when needed.

Appendix 11.2 – Socially Responsible Property Investment Policy and complementary manual of procedures.

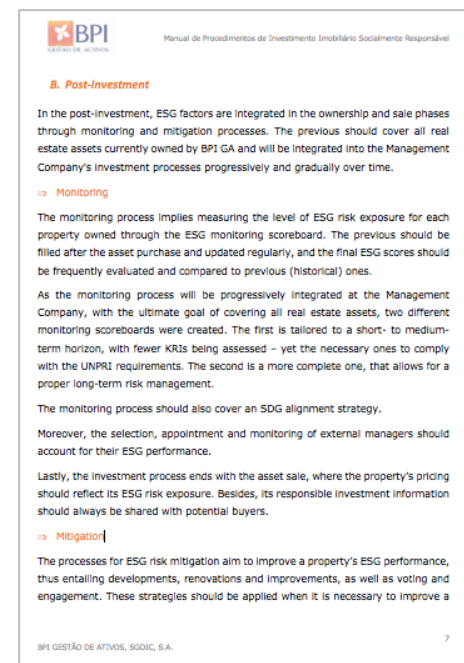
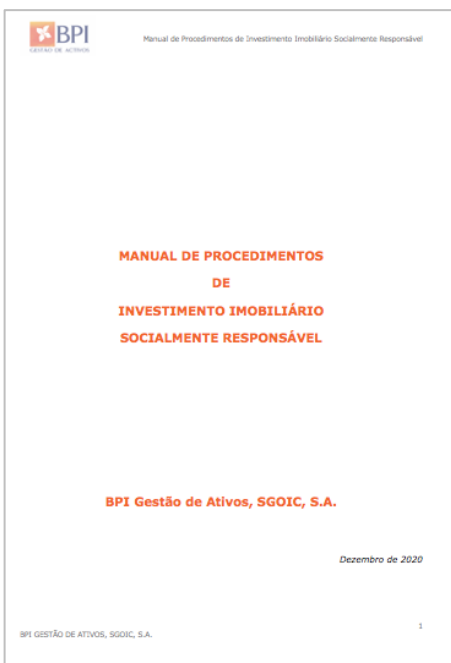
Socially Responsible Property Investment – Policy

We developed this Policy in collaboration with BPI GA's SRI and Real Estate Departments. It aims to establish the company's position on Responsible Property Investing, defining guidelines to integrate ESG criteria in the deal-sourcing and decision-making processes, as well as in the post-investment monitoring, management and reporting. The strategy complements traditional financial and technical criteria.



Socially Responsible Property Investment – *Manual of Procedures*

We developed a manual of procedures to complement the Policy. It describes the process followed by the company to incorporate ESG criteria in all the stages previously mentioned.



Appendix 11.3 – Property Assessment Scoreboard. Used in the deal sourcing (pre-investment) and in the monitoring phases (post-investment).

#	KRI	E,S,G	Metric
1	Energy efficiency	E	Energy efficiency represented by the energy class (from the energy certificate).
2	Percentage of renewable energy	E	Percentage of renewable energy from the total energy consumed (from the energy certificate).
3	Waste management	E	Existence of waste management procedures in place (e.g. recycling bins).
4	Water management	E	Existence of water management procedures in place (e.g. automatic taps).
5	Negative impact on biodiversity	E	No incidents with negative impacts on nearby biodiversity were verified in the last 5 years.
6	Contaminated land	E	No land contamination due to bad waste management or bad water management.
7	Resilience to natural disasters: Floods and sea level rise	E	Propensity of the property's location to the occurrence of floods and sea level rise (defined in the Asset Concentration section).
8	Resilience to natural disasters: earthquakes	E	Propensity of the property's location to the occurrence of earthquakes (defined in the Asset Concentration section).
9	Access to public transports	E	Building located in an area with access to the different types of public transports: metro, train, bus, boat, plane.
10	Infrastructure quality	S	No incidents due to the infrastructure/ materials were verified in the last 5 years.
11	Building safety: procedures and equipment	S	Existence of safety procedures/equipment in place (emergency exits, first aids kits, equipment and procedures for fires, earthquakes, floods).
12	Security	S	The building has a security team in place.
13	Adaptations for handicapped	S	The building has the necessary equipment/ infrastructure for handicapped people.
14	Property certification scheme/label	E	Building has a property rating/certification scheme (e.g. LEED, NAHB Green, BREEAM, CASBEE, HQE, DGNB)

Appendix 11.4 – Scoreboard for assessing tenants, sellers and providers of external services.

The score is measured for tenants in the deal sourcing (pre-investment) and in the monitoring phases (post-investment), for sellers in the deal sourcing phase. and for the providers of external services in the monitoring phase.

#	KRI	E,S,G	Metric
1	Human rights compliance	S	Compliance with the global human rights standards.
2	No child labour	S	Compliance with the global standards against child labour.
3	Labour standards compliance	S	Compliance with the global labour standards.
4	No connection with controversial weapons	S	No connection with controversial weapons and scandals, such as nuclear ones, in recent years.

Appendix 11.5 – Choice of SDGs: goals, targets and indicators being tracked.

Goal	Target	Indicator
Goal 6. Ensure availability and sustainable management of water and sanitation for all.	6.3 By 2030, improve water quality by reducing pollution, eliminating dumping and minimizing release of hazardous chemicals and materials, halving the proportion of untreated wastewater and substantially increasing recycling and safe reuse globally.	6.3.1 Proportion of wastewater safely treated.
Goal 7. Ensure access to affordable, reliable, sustainable and modern energy for all.	7.2 By 2030, increase substantially the share of renewable energy in the global energy mix.	7.2.1 Renewable energy share in the total final energy consumption.

<p>Goal 8. Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all.</p>	<p>8.7 Take immediate and effective measures to eradicate forced labour, end modern slavery and human trafficking and secure the prohibition and elimination of the worst forms of child labour, including recruitment and use of child soldiers, and by 2025 end child labour in all its forms.</p>	<p>8.7.1 Proportion and number of children aged 5-17 years engaged in child labour, by sex and age.</p>
	<p>8.8 Protect labour rights and promote safe and secure working environments for all workers, including migrant workers, in particular women migrants, and those in precarious employment.</p>	<p>8.8.1 Frequency rates of fatal and non-fatal occupational injuries, by sex and migrant status.</p>
<p>Goal 9. Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation.</p>	<p>9.4 By 2030, upgrade infrastructure and retrofit industries to make them sustainable, with increased resource-use efficiency and greater adoption of clean and environmentally sound technologies and industrial processes, with all countries taking action in accordance with their respective capabilities.</p>	<p>9.4.1 CO2 emission per unit of value added.</p>
<p>Goal 11. Make cities and human settlements inclusive, safe, resilient and sustainable.</p>	<p>11.5 By 2030, significantly reduce the number of deaths and the number of people affected and substantially decrease the direct economic losses relative to global gross domestic product caused by disasters, including water-related disasters, with a focus on protecting the poor and people in vulnerable situations.</p>	<p>11.5.1 Number of deaths, missing persons and persons affected by disaster per 100,000 people.</p>
<p>Goal 12. Ensure sustainable consumption and production patterns.</p>	<p>12.5 By 2030, substantially reduce waste generation through prevention, reduction, recycling and reuse.</p>	<p>12.5.1 National recycling rate, tons of material recycled.</p>
<p>Goal 16. Promote peaceful and inclusive societies for sustainable development, provide</p>	<p>16.5 Substantially reduce corruption and bribery in all their forms</p>	<p>16.5.2 Proportion of businesses that had at least one contact with a public official and that</p>

access to justice for all and build effective, accountable and inclusive institutions at all levels.		paid a bribe to a public official or were asked for a bribe by those public officials during the previous 12 months.
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Appendix 11.6 – SDG alignment strategy for BPI GA: SDG targets, target date, scope and strategies.

SDG	Target Date	Scope	Strategy
16.5.2	2021	Organizational level	Monitor that no corruption practices are verified in the management company. This should be measured through bribes paid to public officials.
8.7.1	2021	Tenants External services providers	Eliminate and/or do not incur in business with any current tenant or provider of external services which is related to child labour scandals.
8.8.1	2021	Tenants External services providers	Assure that current tenants and external services providers are in compliance with labour rights, as well as with health and safety standards, by addressing the number of incidents and fatal injuries occurred.
6.3.1	2023	Renovations, improvements and developments	Reduce water pollution caused by constructions, not dumping hazardous chemicals.
12.5.1	2023	Tenants Monitoring	Engage with the different tenants to increase recycling patterns across portfolio assets.

7.2.1	2026	Deal sourcing Renovations, improvements and developments Tenants	Increase the portfolio's proportion of renewable energy, from the total energy consumed. This means prioritizing the acquisition and developing buildings with greener features, improving the current assets in the portfolio which have a low percentage of renewable energy, and monitoring tenant's activities in this matter, mitigating through engagements when necessary.
9.4.1	2026	Deal sourcing Renovations, improvements and developments	Upgrade current infrastructure and give priority to new acquisitions that present greener features, thus decreasing the CO2 emissions of the overall portfolio and increasing the efficiency in resource usage.
11.5.1	2026	Deal sourcing Renovations, improvements and developments Monitoring	Decrease the number of deaths caused by natural disasters by ensuring that buildings are safe in their construction features and quality of materials, and by having the correct procedures and equipment in place for coping with these extreme events.

Appendix 11.7 – Scoreboard for construction interventions.

#	KRI	E,S,G	Metric
1	ESG in interventions	G	ESG matters were considered in renovations, improvements or developments.
2	Ecological impacts	G	Incidents that affected the environment and non-compliance with environmental permits, standards and regulations, were not verified during the last year.
3	Light pollution	E	Efficiency in the minimisation of light pollution to the surrounding community.
4	Noise pollution	E	Efficiency in the minimisation of noise pollution to the surrounding community.

5	Water management	E	Water conservation measures were employed.
6	Waste management	E	Management of waste by diverting construction and demolition materials from disposal was verified.
7	Health and safety	S	There was a constant monitoring of health and safety at the construction site.
8	Certified label for materials	G	There were requirements on the use of certified (or labelled) sustainable building materials.
9	Green building	G	Building achieved a green building certification.
10	Renewable energy	E	Renewable energy technologies were installed when feasible.

Appendix 11.8 – Targets for the UNPRI score maximization. This Appendix details the strategy for obtaining the highest possible score in each question, according to the client’s profile and business activities. Questions are divided according to the period when they are fully maximized, either 2020, 2023 or 2026. Note that the UNPRI has two open questions with no scoring, that will be answered considering the 2020 reporting year.

Questions with a maximum score obtained in December 2020
<p>RE 1) Create of a Responsible Investment Policy for the Real Estate asset class (RPI), covering the ESG approach to new constructions, major renovations, standing investments and tenants (excluding tenants if necessary). A complementary manual of procedures is advised as well.</p> <p>RE 2) Incorporate the responsible commitment in the prospectus, which can be considered the equivalent to formal LPAs in private equity.</p>

RE 3.1) Consider materiality data and recommendations from the SASB, GRI and TCFD throughout the entire ESG risk management strategy, by integrating them into the different action plans.

Questions with a maximum score obtained in December 2023

RE 9) Require, for development projects and major renovations, the management of waste by diverting construction and demolition materials from disposal, the minimisation of light and noise pollution to the surrounding community, the performance of an environmental site assessment, the protection of surface and ground water by controlling and retaining construction pollutants, as well as the constant monitoring of health and safety. The compliance with the previous requirements is done through the scoreboard for construction interventions.

RE 11) Collect the ESG performance of each building for electricity consumption, water consumption and waste production, through two monitoring scoreboards – one tailored to a short- to medium-term horizon with fewer KRIs being assessed, and a more complete one for a proper long-term ESG risk management.

RE 12) Determine targets for the KPIs being tracked considering both incremental improvements based on past performance, by comparing ESG internal scores obtained through time, and targeting global benchmarks, through the SDG alignment strategy.

RE 13) Support ESG targets in the monitoring phase through operational-level benchmarks to assess and analyse the performance of assets against sector performance, by ensuring budget availability, by hiring external verification services to audit performance, systems and procedures, as well as to develop minimum health and safety standards, which are in fact a law requirement in Portugal. The previous supporting measures can be monitored through the scoreboards.

RE 18) Share responsible investment information with potential buyers, namely the company's high-level commitment to responsible investment – such as being a PRI signatory – and the alignment with international standards and entities, as well as sharing the Responsible Property Investment Policy (or its key aspects) and the outcome of a latest ESG risk assessment.

RE 19) Report ESG matters to investors and beneficiaries, in aggregate, both formally and through public sustainability reports, as well as through digital or physical events or meetings. An ad hoc or informal reporting on serious ESG incidents is also performed.

Questions with a maximum (or almost maximum) score obtained in December 2026

RE 3) Assess materiality in the pre-investment phase at the asset level, for all Real Estate assets in the portfolio, which is achieved through the deal-sourcing scoreboard.

RE 4) The exposure to ESG risks, assessed through the due diligence, allowed the management company to identify risks and value creation opportunities, with the help of the deal sourcing ESG scoreboard (pre-investment), leading to the abandonment of new investments when necessary. The investment committee discusses all ESG factors, and this exposure affects the price paid/offered through CAPEX and/or OPEX assumptions.

RE 5) Conduct a proper due diligence by doing a high-level review for initial ESG red flags through the deal sourcing scoreboard, as well as through a technical due diligence on specific issues made by third party consultants, ESG questionnaires sent to target companies, site visits and in-depth interviews with management and personnel. Moreover, the actions based on the risks and opportunities identified are also considered in the post-investment plans – through the post-investment (monitoring) scoreboard – and the investment committee is the ultimate responsible for ensuring that all ESG due diligence is completed in the same manner as the other key due diligences, indicated in the RPI Policy.

RE 10) Require, aimed at construction interventions, green certifications for new buildings, the usage of certified sustainable building materials, the installation of renewable energies and water conservation measures, the health and well-being of occupants. Also, require for some interventions to become net-zero carbon emitters within five years of completion. The compliance with the previous requirements is done through the scoreboard for construction interventions.

RE 14) Create value by managing ESG risks and opportunities through property specific ESG action plans based on pre-investment research, due diligence and materiality findings, as well as adjusting them based on performance monitoring findings and hiring external advisors to provide support with specific ESG value creation opportunities.

RE 16) ESG/RI certification or label is attributed to the assets in the portfolio, provided by an independent ESG/sustainability initiative or labelling scheme.

RE 17) Engagements with tenants are defined through an appropriate engagement strategy, by organising events focused on increasing sustainability awareness and training, tackling energy and water consumption and/or waste production, as well as offering green leases and offering shared financial benefits from equipment upgrades.

Open questions with no score (to be answered in the 2020 reporting year)

RE 13.1) During 2020, two processes that support meeting ESG targets were implemented, namely the development of ESG scoreboards – that allow BPI GA to obtain final ESG scores based on the assessment of materiality KRIs at the organizational and portfolio levels – and the development of an SDG alignment strategy.

RE 15) A long-term ESG action plan allows for a stable and consistent increase in ESG performance, thus demanding the appropriate systems in order to manage potential issues on an ongoing basis and creating value while managing risks. The action plan for the management company is divided in three periods, obtaining a fully maximized grade for the

reporting year of 2026. Moreover, the scoreboards aim to create an historical database that allows for comparisons with past performance and inferences on materiality and mitigation strategies, that can be differentiated between different industries. The SDG alignment strategy also aims to be fully implemented until 2026. Therefore, the overall strategy for risk management aims to increasingly impact ESG performance and financial performance through time, creating value and decreasing the undesired ESG risk exposure.

Appendix 11.9 – Answers to the UNPRI for the three periods – until December 2020, 2023 and 2026. Questions with no score are not considered in this table.

Question	Sep 2020	Dec 2020	Dec 2023	Dec 2026
RE 1	(D)	(A)	(A)	(A)
RE 2	(D)	Minority: (A).	Majority: (A).	All: (A).
RE 3	(D)	(A); (B); (C).	(A); (B); (C).	(A); (B); (C).
RE 3.1	(D)	(A); (B); (C).	(A); (B); (C).	(A); (B); (C).
RE 4	Minority: (A).	Minority: (A); (B); (D); (E); (G).	All: (A); (B). Majority: (D); (E); (G); (H).	All: (A); (B); (D). Majority: (E); (G); (H).
RE 5	Majority: (C); (D).	Majority: (C); (D); (G). Minority: (A); (E).	All: (A); (B); (D); (G). Majority: (C); (E).	All: (A); (B); (C); (D); (E); (G).
RE 9	(E);(I).	(A); (C); (D); (E); (I).	(A); (C); (D); (E); (H); (I).	(A); (C); (D); (E); (H); (I).
RE 10	All: (G). Majority: (D). Minority: (F).	All: (G). Majority: (D). Minority: (F).	All: (G). Majority: (D); (F). Minority: (B); (C).	All: (G). Majority: (B); (C); (D); (F). Minority: (E).
RE 11	All: (A).	All: (A). Majority: (B); (C).	All: (A); (B); (C).	All: (A); (B); (C).

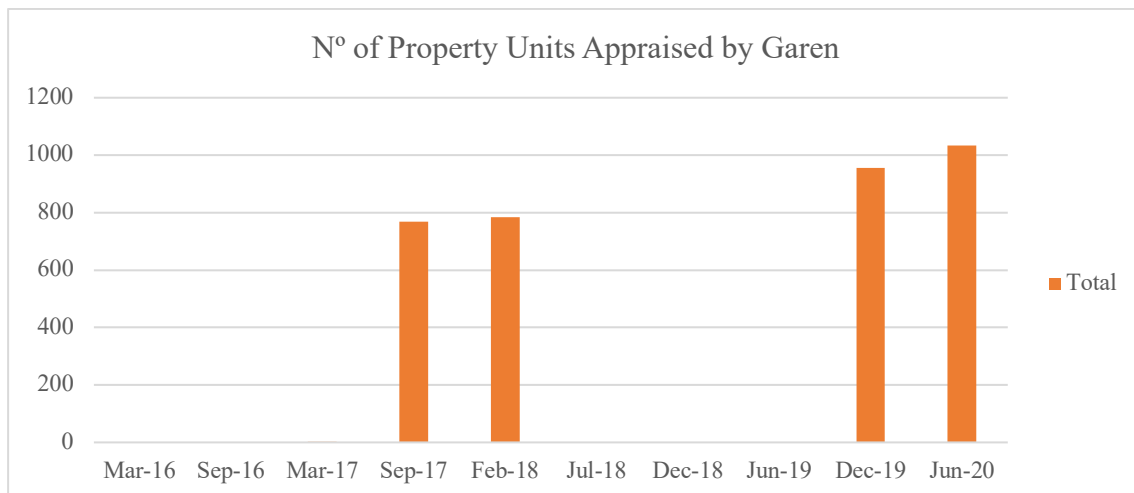
RE 12	(D).	(C).	(A); (C).	(A); (C).
RE 13	All: (F). Majority: (D).	All: (A); (F). Majority: (C); (D).	All: (A); (C); (D); (F).	All: (A); (C); (D); (F).
RE 14	(D).	Minority: (A); (B); (C).	All: (A); (B). Majority: (C).	All: (A); (B); (C).
RE 16	(D).	(C).	(B).	(A).
RE 17	Minority: (B).	Minority: (A); (B).	Majority: (A); (B). Minority: (C); (E).	Majority: (A); (B). Minority: (C); (E).
RE 18	Majority: (A).	All: (C). Majority: (A); (B). Minority: (E).	All: (A); (B); (C). Majority: (E).	All: (A); (B); (C); (E).
RE 19	(D).	(A); (B); (E).	(A); (B); (C); (E); (F).	(A); (B); (C); (E); (F).

Appendix Chapter 12 – Valuation

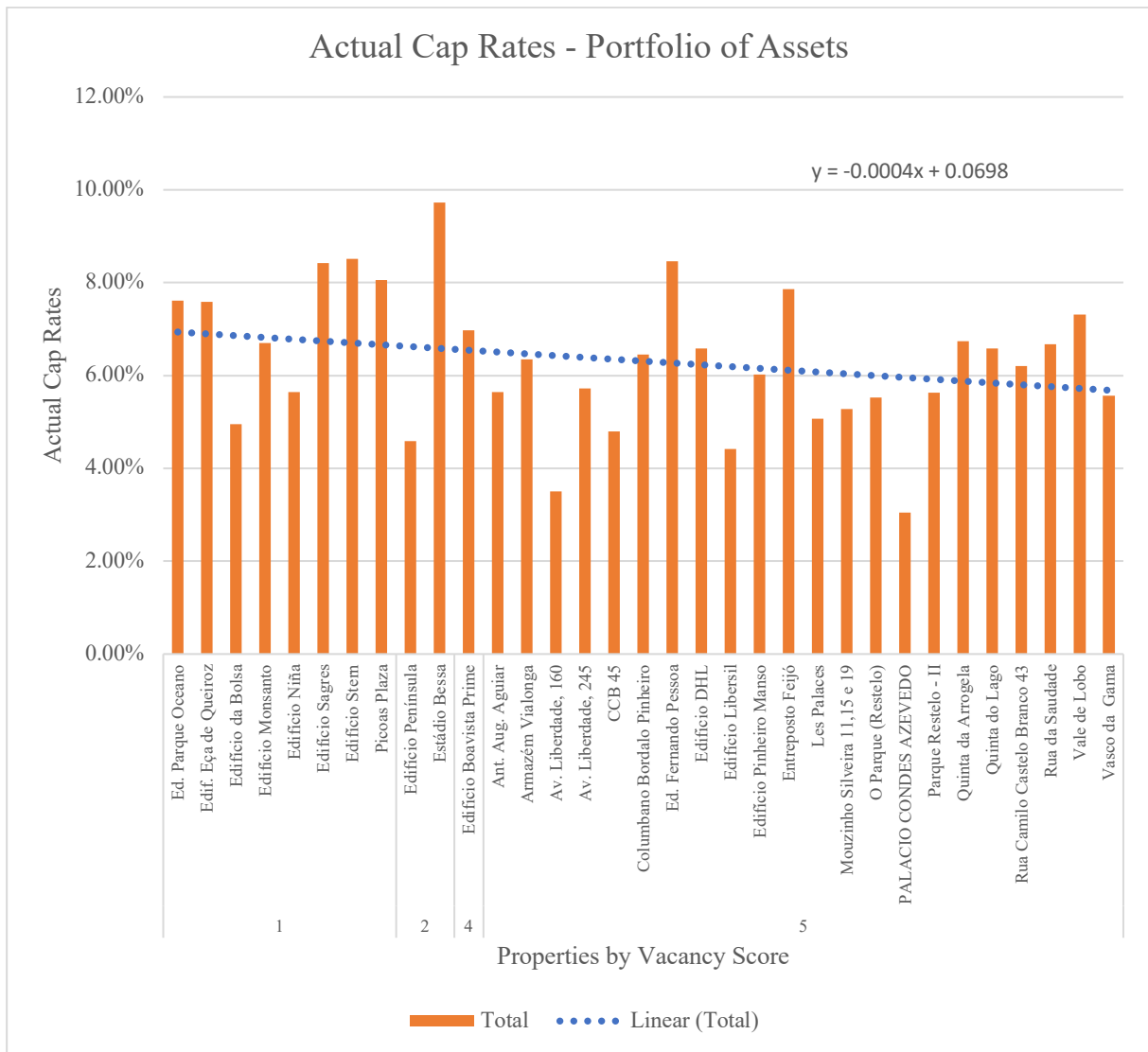
Appendix 12.1 – Imofomento’s appraisal experts, retrieved from Imofomento’s prospect.

6. Os Peritos Avaliadores de Imóveis
Os peritos avaliadores são:
Água Branca – Projectos de Engenharia,Lda.
AURA Real Estate Experts Portugal, Lda
Besturban – Avaliação e Gestão de Patrimónios Imobiliários, Lda.
BDOTPRIME – Mediação Imobiliária, Lda.
CBRE – Consultoria e Avaliação de Imóveis Unipessoal, Lda
CPU Consultores - Avaliação Imobiliária e Certificação Energética Lda
Cushman & Wakefield – Consultoria Imobiliária Unipessoal, Lda
Garen – Avaliação de Activos, Lda.
Gesvalt Premium, SA
JLL – Sociedade de Avaliações Imobiliárias Unipessoal, Lda.
Ktésios Appraisal – Consultoria e Avaliação de Imobiliário, Lda.
Leksi – Consulting Unipessoal,Lda.
Prime Yield – Consultadoria e Avaliação Imobiliária, Lda
PVW – Price, Value and Worth – Avaliações Imobiliárias, Lda.
Structure Value – Avaliações Imobiliárias, Lda.
Torres Mascarenhas, Lda.
Urbanflow – Engenharia e Consultoria, Lda.

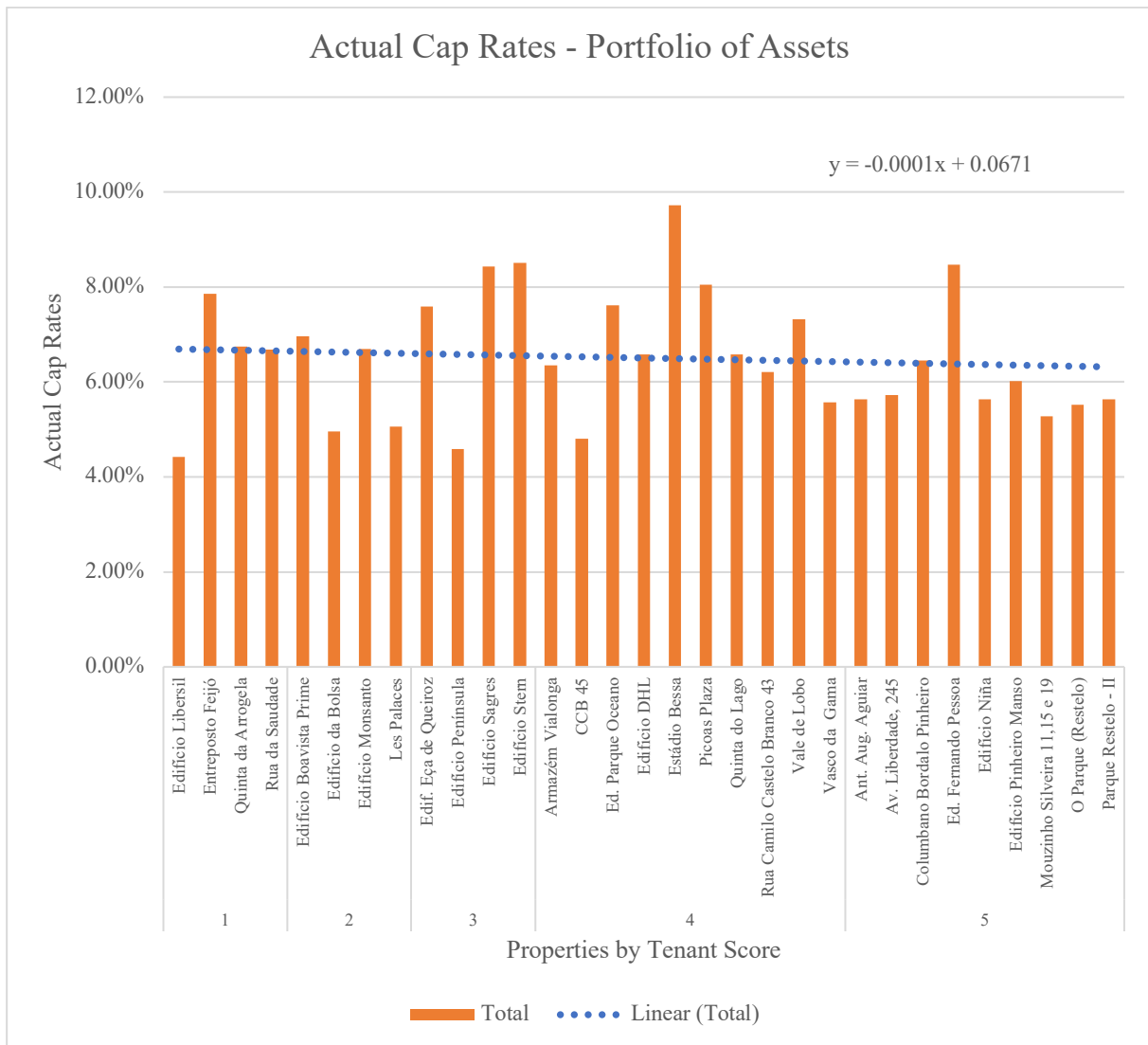
Appendix 12.2 – Number of property units (fractions) subject to valuation by the appraisal expert firm Garen - Avaliação de Activos, Lda.



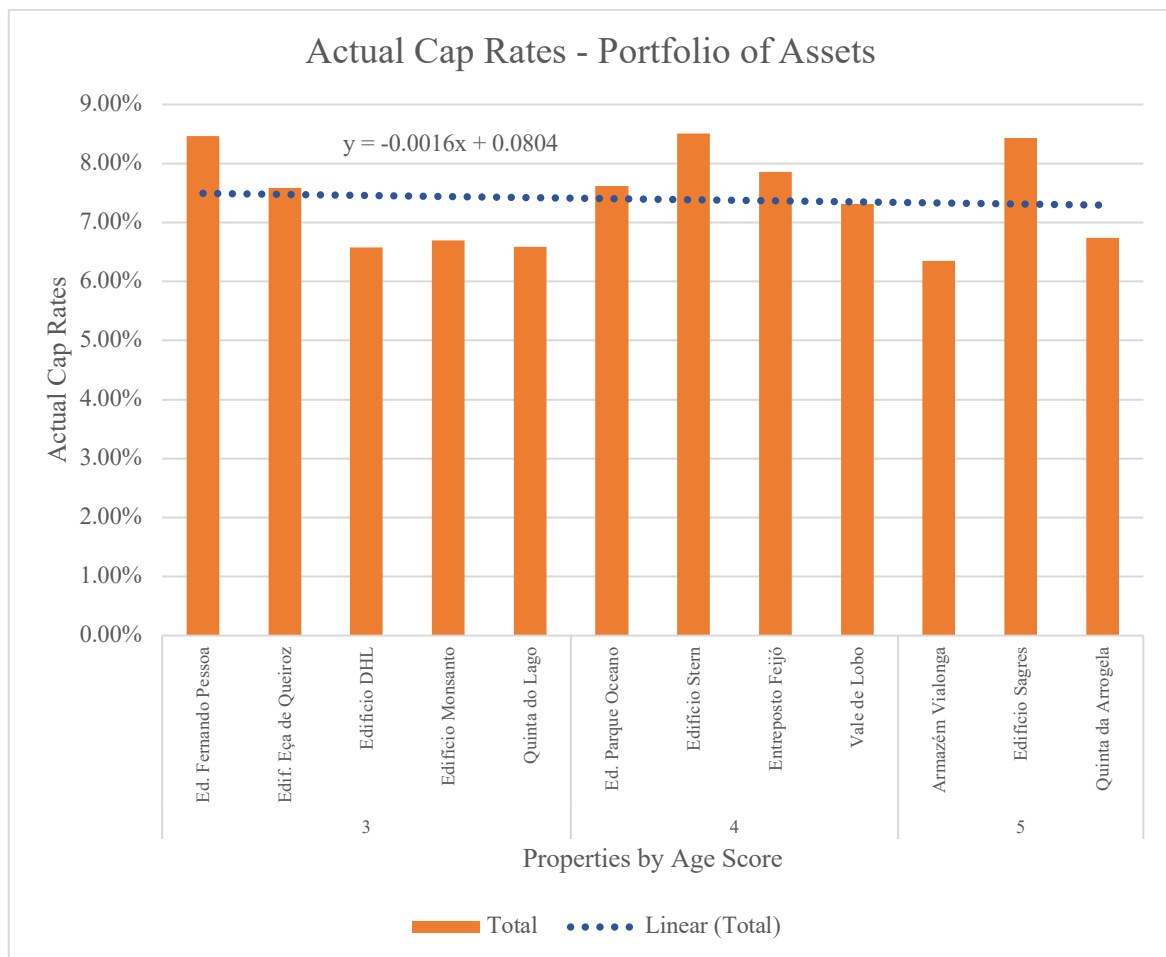
Appendix 12.3 – Vacancy scores plotted against the correspondent actual cap rates for each property. The vacancy score ranges from 1 to 5, with the level 1 corresponding to the highest vacancies (and highest vacancy risk), and the level 5 corresponding to the lowest vacancies. The plot shows that lower vacancy levels correspond to lower actual cap rates.



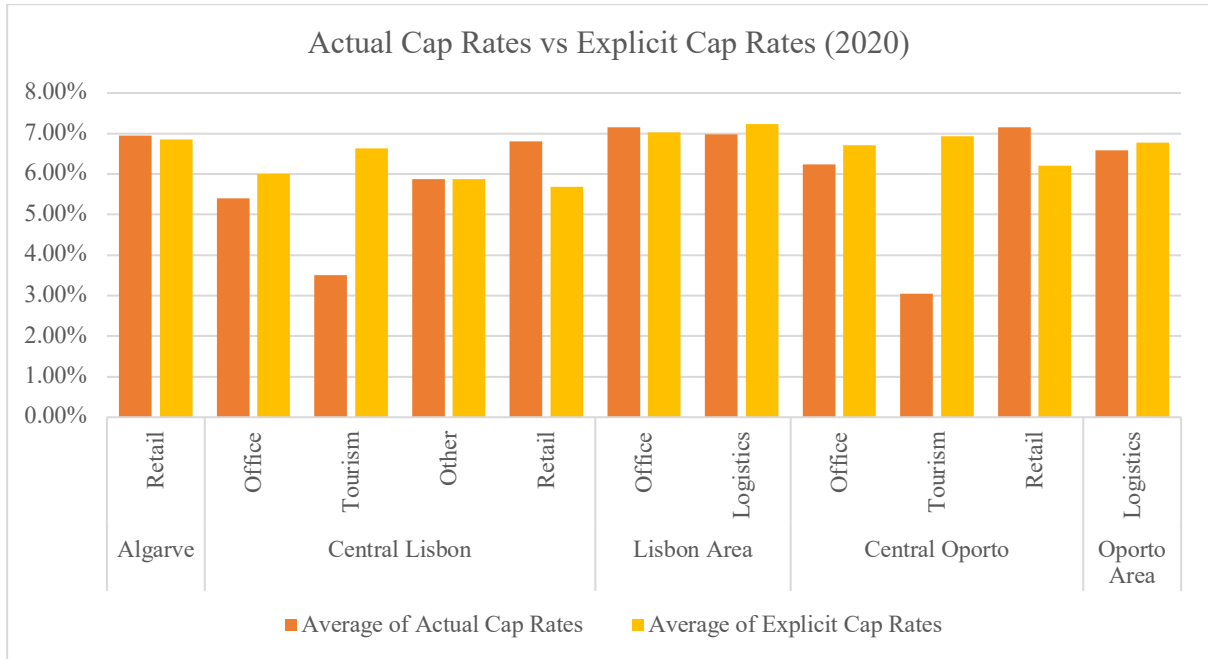
Appendix 12.4 – Tenant scores plotted against the correspondent actual cap rates for each property. The tenant score ranges from 1 to 5, with the level 1 corresponding to the riskiest tenants, and the level 5 corresponding to the best tenants. The plot shows that less risky tenants correspond to lower actual cap rates.



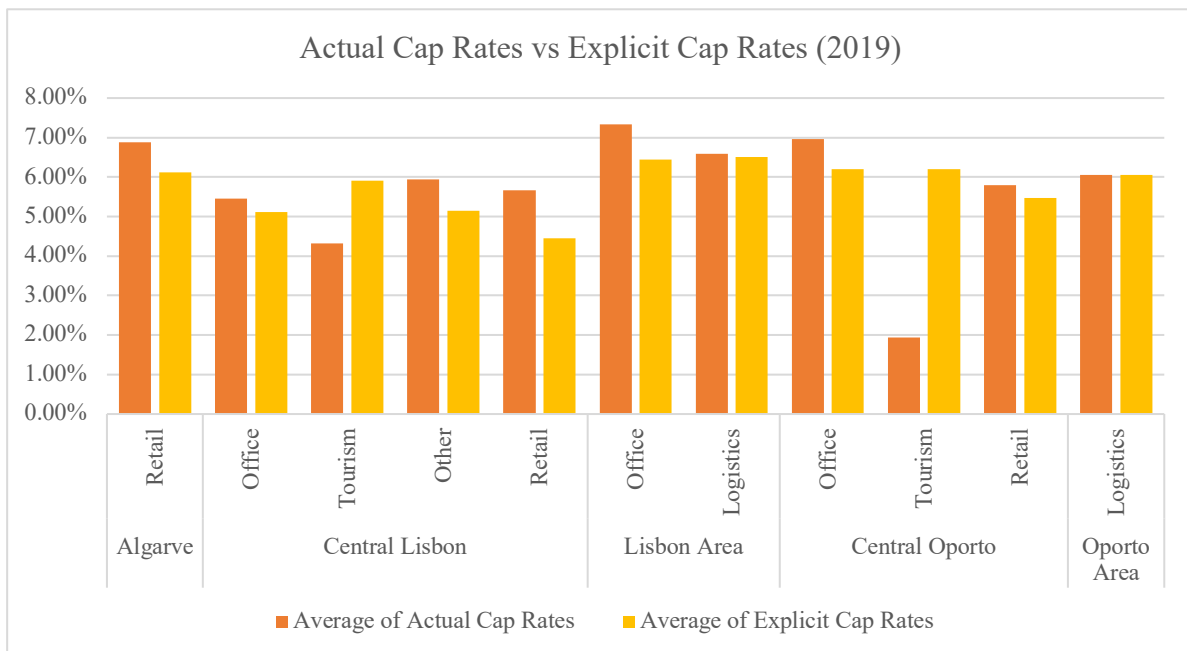
Appendix 12.5 – Building age scores plotted against the correspondent actual cap rates for each property. The age score ranges from 1 to 5, with the level 1 corresponding to the oldest buildings (and thus riskiest), and the level 5 corresponding to newest ones. The plot shows that less risky buildings in terms of the age factor correspond to lower actual cap rates.



Appendix 12.6 – Final results of the explicit capitalization rates model, plotted against the actual capitalization rates in 2020. The findings are grouped by sector within 5 different geographical areas – Algarve, Lisbon, Porto, Central Lisbon and Central Porto.

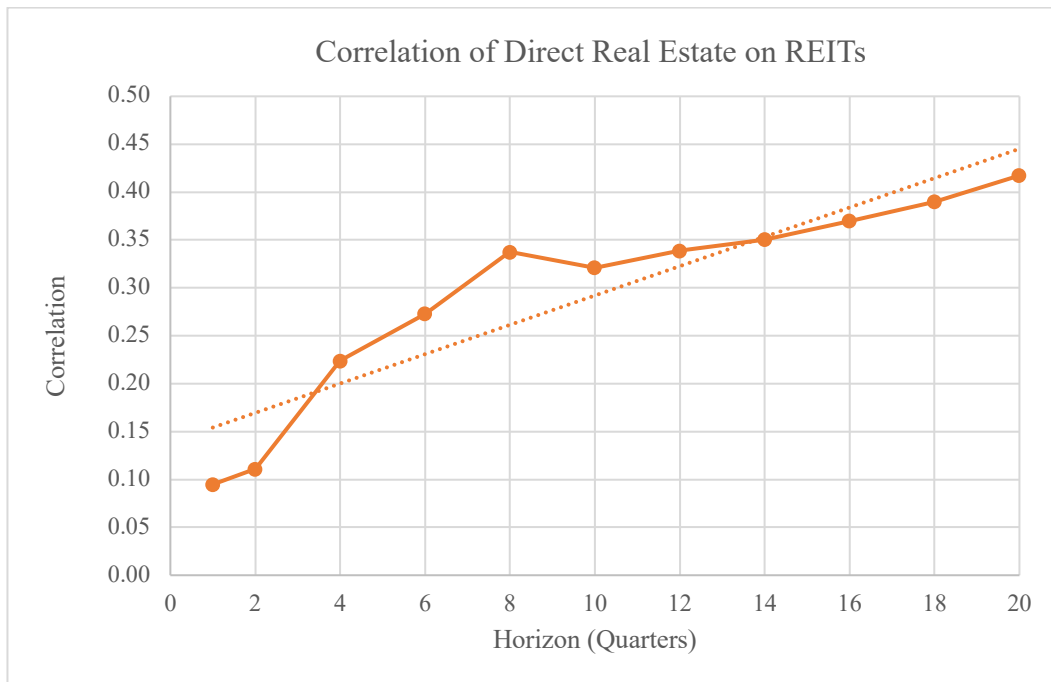


Appendix 12.7 – Final results of the explicit capitalization rates model, plotted against the actual capitalization rates in 2019.



Appendix Chapter 13 – REITs

Appendix 13.1 – Correlation between direct Real Estate and REITs.



Appendix 13.2 – Relevant investment legislation in Portugal for Real Estate funds, extracted from *Imofomento*'s official prospectus.

Limits to Investment
a) Real Estate assets must have a weight of 66.67% or higher of the overall portfolio's AuM.
b) Real Estate physical assets must have a weight of 33.33% or higher of the overall portfolio's AuM.
c) A single Real Estate asset must not have a weight higher than 20% of the overall portfolio's AuM.
d) The limit for the acquisition of participation units in external Real Estate funds (including REITs) is 25% of the overall portfolio's AuM.

Appendix 13.3 – Optimal portfolio for each strategy and current *Imofomento* portfolio's weights.

	Direct Real Estate	REIT	Hedged REIT's Index	Cash	
Imofomento	66.81%	-	-	33.19%	
70 / 30	70%	30%	-	-	
70 / 25 / 5	70%	25%	-	5%	
No Hedge	Min Var	64.00%	2.67%	-	33.33%
	Tangency Portfolio	60.60%	6.07%	-	33.33%
Hedge	Min Var	63.36%	-	3.31%	33.33%
	Tangency Portfolio	61.01%	-	5.66%	33.33%

Appendix 13.4 – Performance indicators for each strategy, including current *Imofomento*'s indicators.

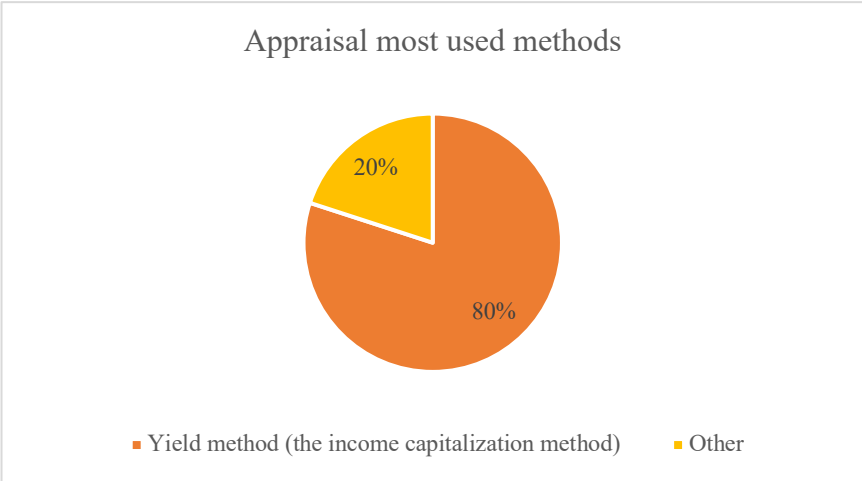
		Annualised Return	Annual Volatility	Info Sharp Ratio			
Imofomento		3.424%	2.37%	1.45			
70 / 30	↑	19.71%	●	10.20%	↑	1.93	
70 / 25 / 5	↑	17.07%	●	8.48%	↑	2.01	
No Hedge	Min Var	↑	4.90%	●	2.29%	↑	2.14
	Tangency Portfolio	↑	6.50%	●	2.61%	↑	2.49
Hedge	Min Var	↑	4.96%	●	2.20%	↑	2.26
	Tangency Portfolio	↑	5.90%	●	2.54%	↑	2.32

Appendix 13.5 – *Imofomento*'s historical performance (2015-2019) it had invested in REITs under each strategy.

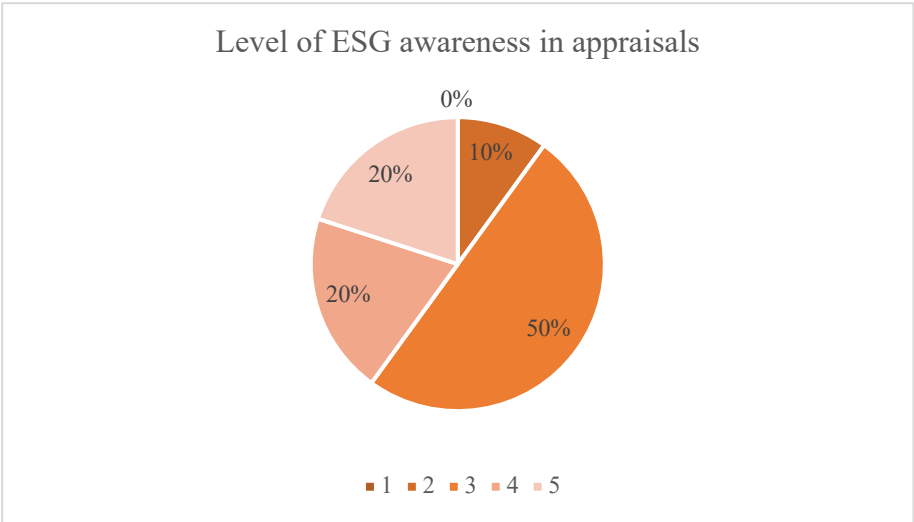
	REIT or Hedged REIT index	Annualised Return	Annual Volatility	Info Sharp Ratio
Imofomento	0%	3.424%	2.37%	1.45
No Hedge Min Var	2.67%	● 4.837%	● 2.24%	● 2.16
No Hedge Tangency Portfolio	6.07%	● 6.635%	● 2.63%	● 2.52
Hedge Min Var	3.31%	● 4.538%	● 2.17%	● 2.09
Hedge Tangency Portfolio	5.66%	● 5.613%	● 2.37%	● 2.37

Appendix Chapter 14 – Knowledge initiative

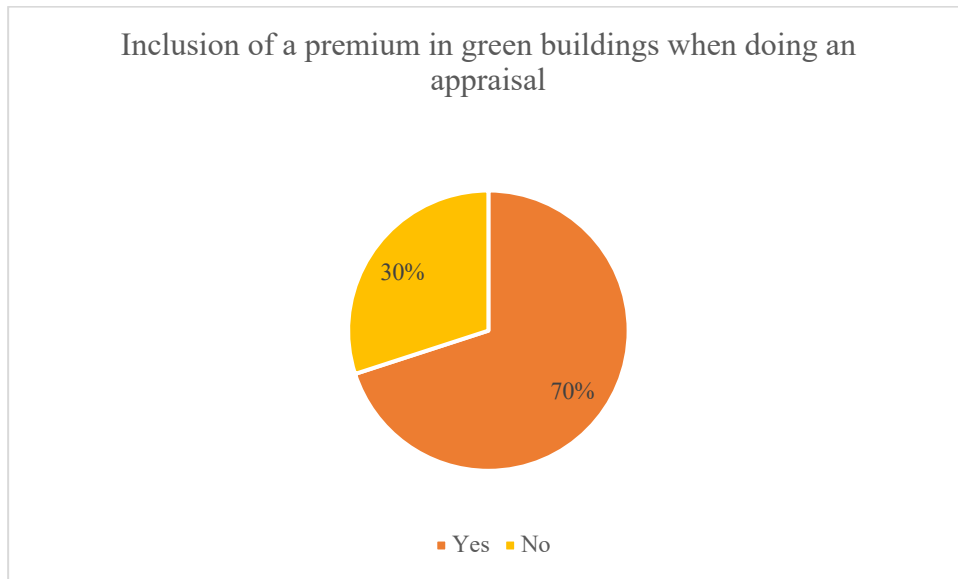
Appendix 14.1 – Appraisers’ answers to the most commonly used appraisal method.



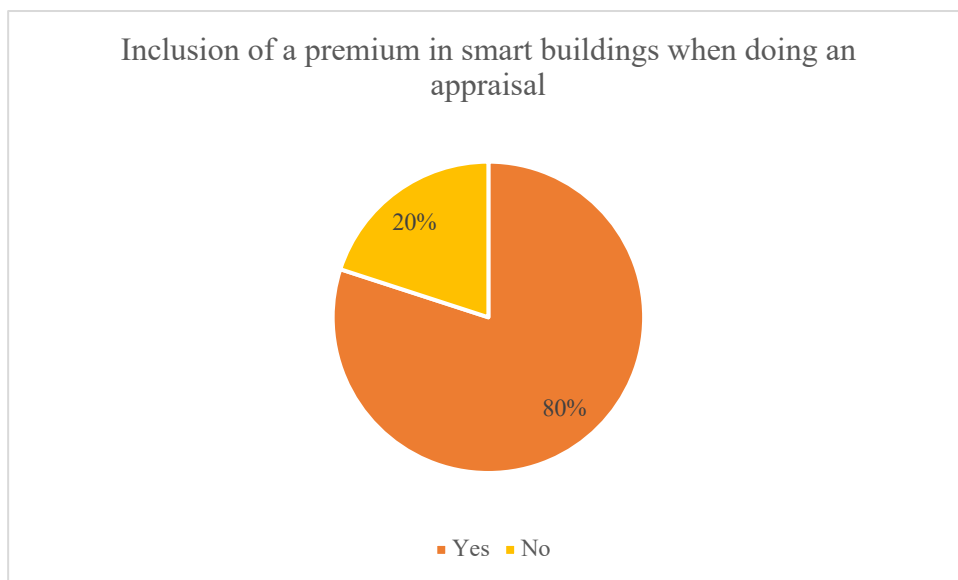
Appendix 14.2 – Appraisers’ answers related to the use of ESG-related information in appraisals. Legend: 1- We do not take ESG into consideration; 2- Yes, but we do not use this information when making appraisals; 3-We vaguely take energy certificates into account when making appraisals; 4- We observe in some detail the ESG aspects such as energy classification, CO2 emissions, among others, when making appraisals; 5- We integrate ESG aspects into evaluations



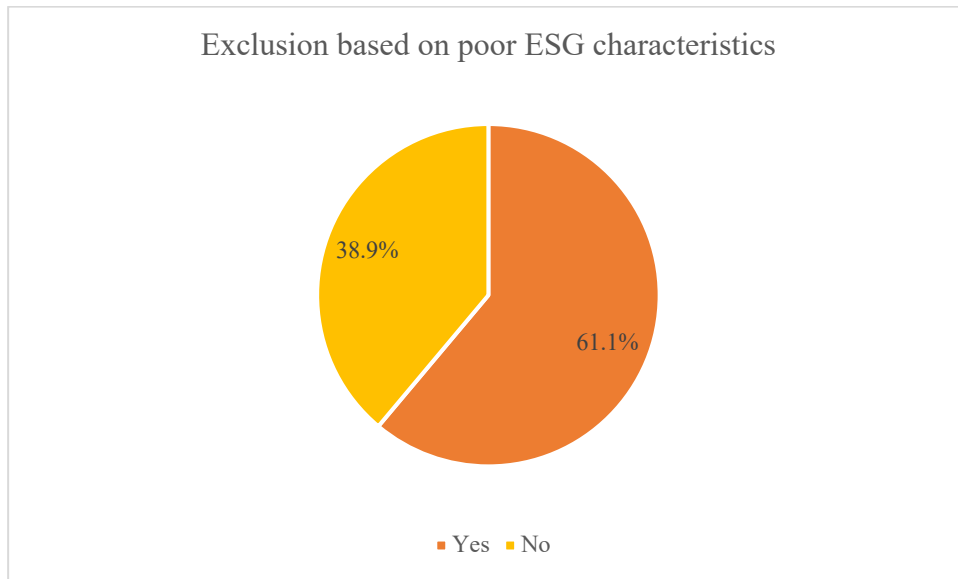
Appendix 14.3 – Appraisers’ answers concerning whether they include or not of a premium when appraising a green building.



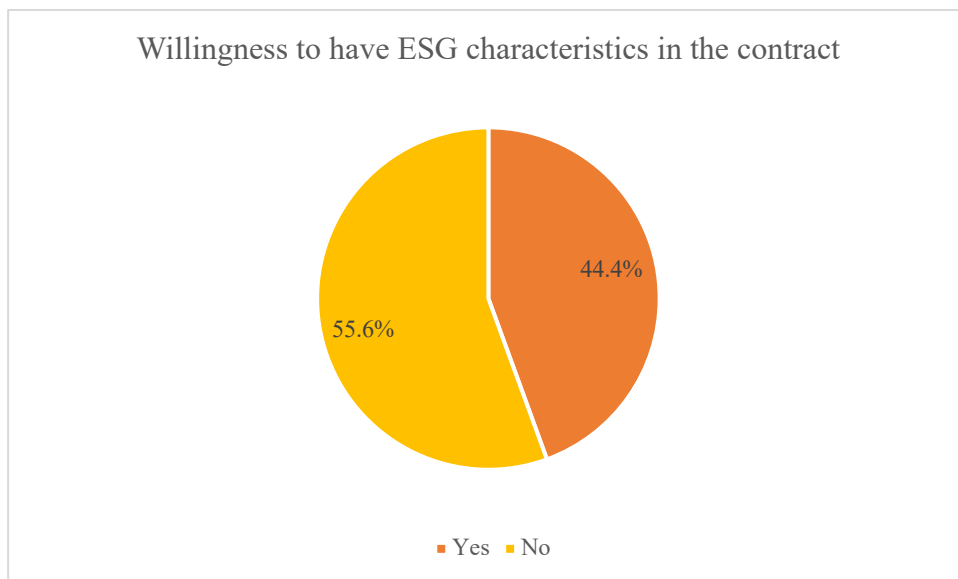
Appendix 14.4 – Appraisers’ answers to the inclusion or not of a premium when appraising a smart building.



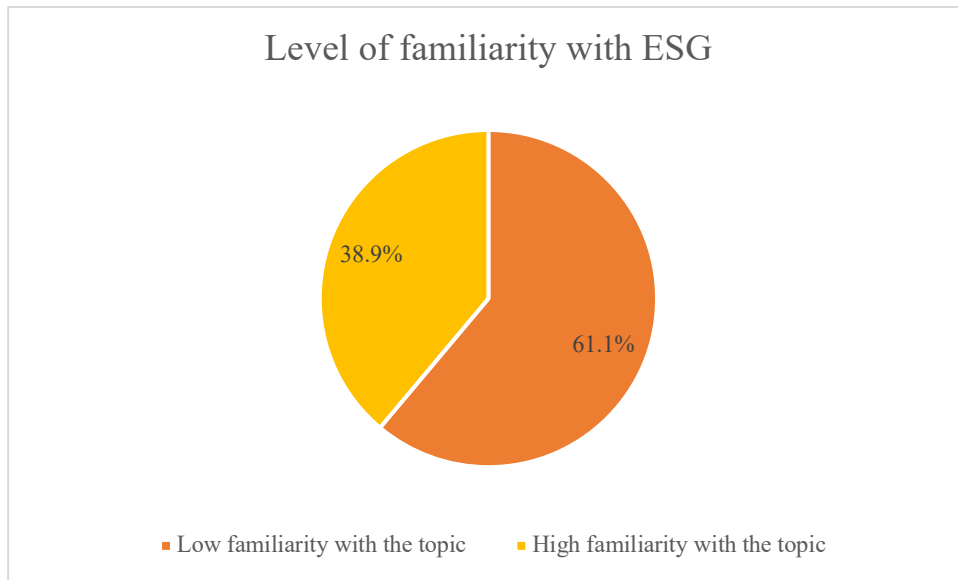
Appendix 14.5 – Tenants’ answers to the exclusion of properties based on poor ESG characteristics.



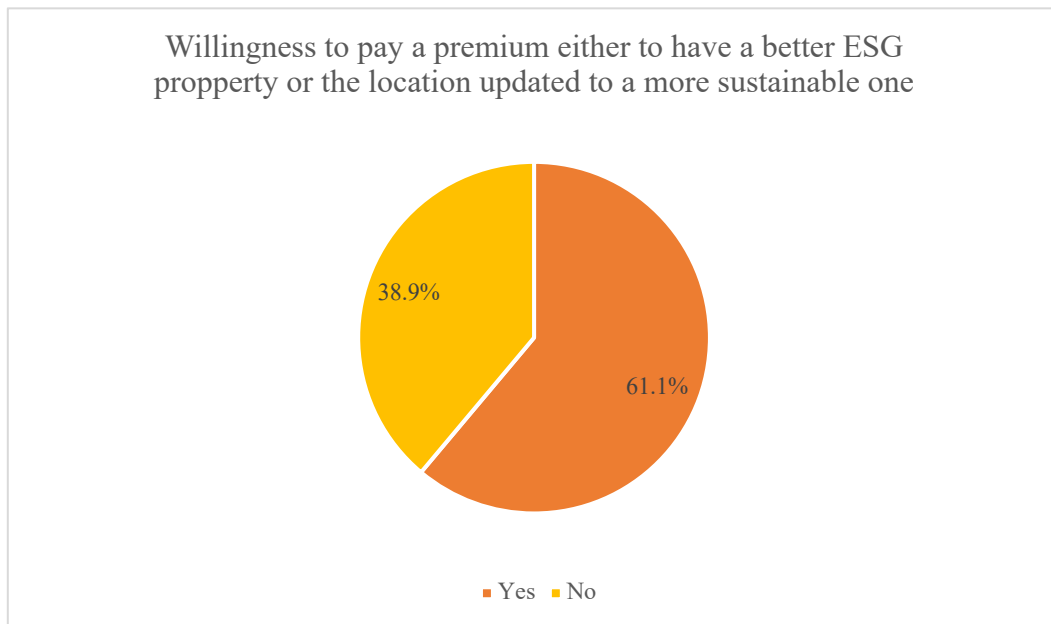
Appendix 14.6 – Tenants’ answers regarding the inclusion of ESG characteristics in the contracts.



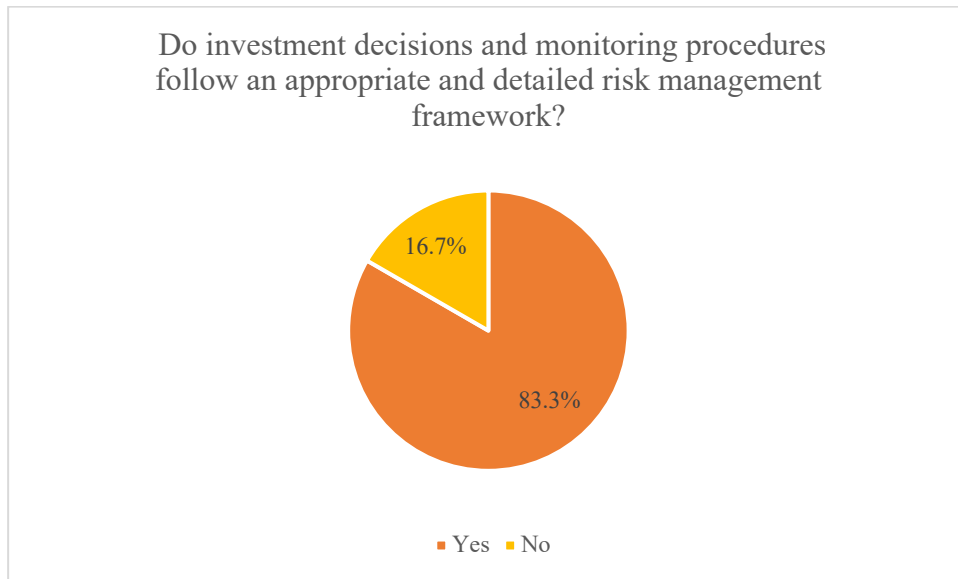
Appendix 14.7 – Tenants’ answers regarding the level of familiarity concerning the ESG topic.



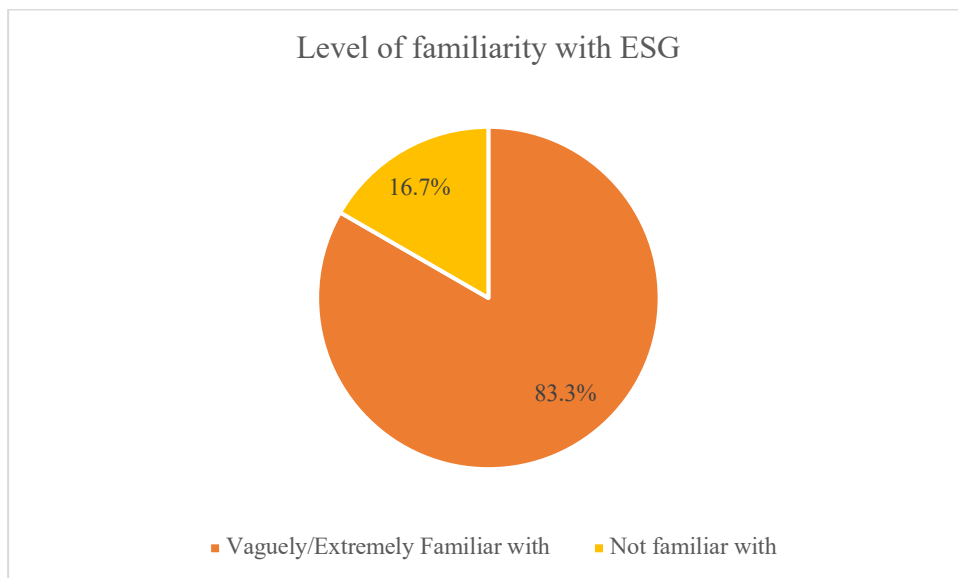
Appendix 14.8 – Tenants’ answers regarding their willingness to pay a premium for a better ESG property or to have the location updated to a more sustainable one.



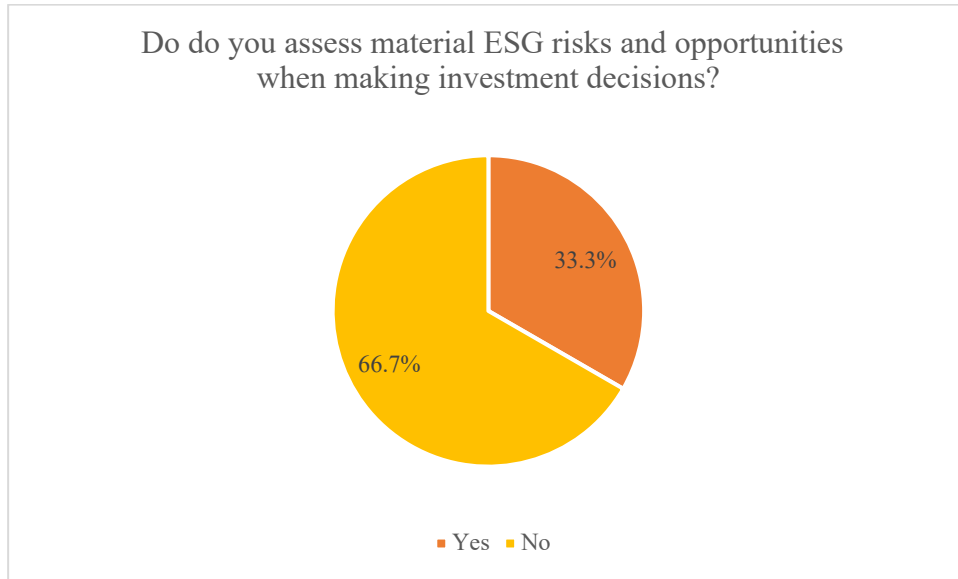
Appendix 14.9 – Real Estate committee perspective on having the right investment procedures as well as an appropriate risk management framework.



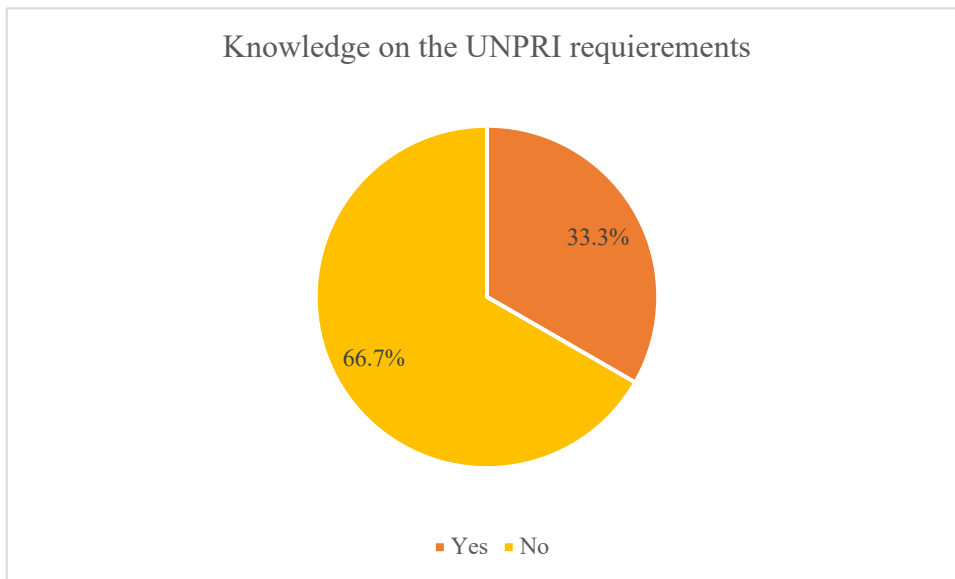
Appendix 14.10 – Real Estate committee awareness about ESG.



Appendix 14.11 – Real Estate committee perspective on assessing material ESG risks and opportunities when making investment decisions.



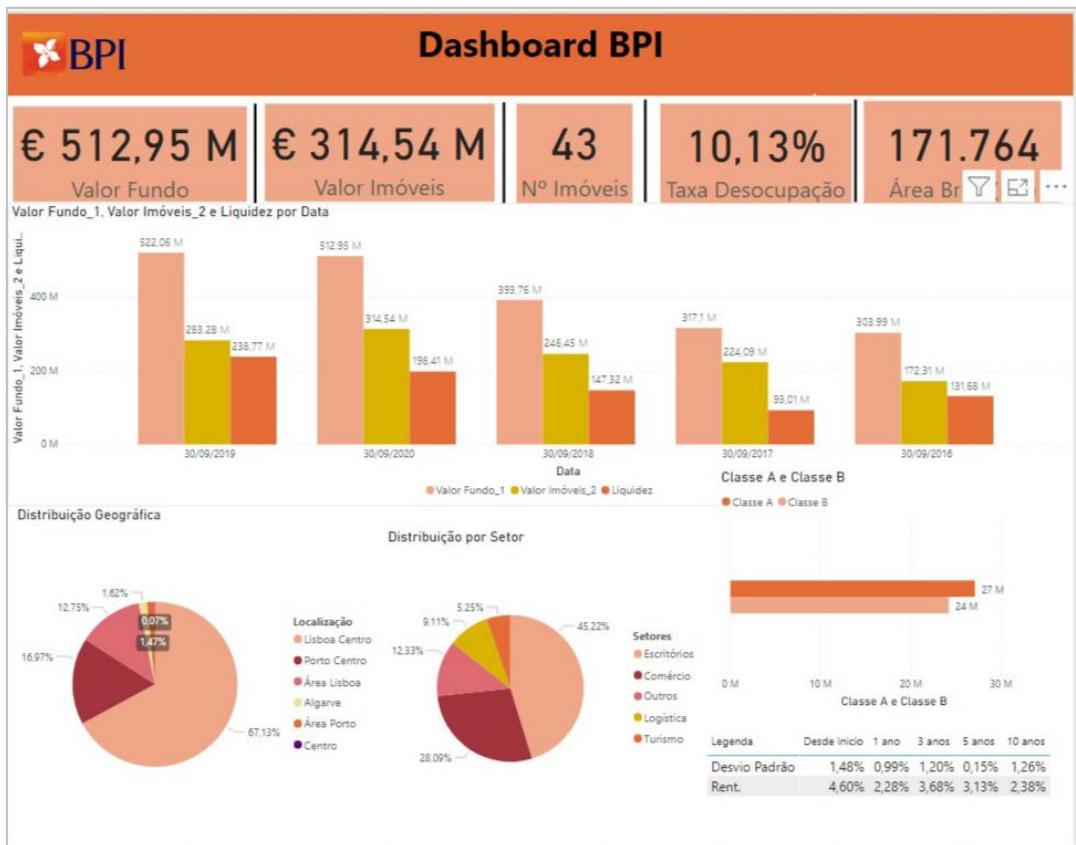
Appendix 14.12 – Real Estate committee perspective on UNPRI requirements.



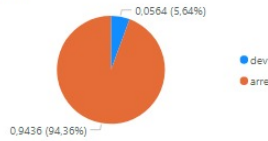
Appendix Chapter 15 – Conclusions

Appendix 15.1 – Power BI Dashboard: Using Tech for Better Results

The Power BI was the software chosen to bridge the thesis' output with the client for risk monitoring purposes, through a dashboard that gathers the systematic and idiosyncratic risks. This tool was primarily chosen due to its versatility and appealing design. With the use of slicers, as well as other filters, information can be changed instantaneously, and the results will change correspondingly. The dashboard depicts the current situation of *Imofomento* regarding each specific risk is updated automatically whenever new information is inserted in the correspondent Excel files.



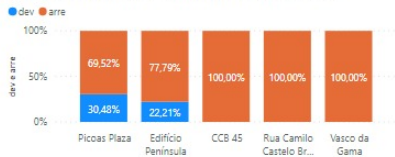
Percentagem devoluta e arrendada dos top 5 imóveis



Percentagem do portfolio constituída pelos top 5 imóveis

158 M

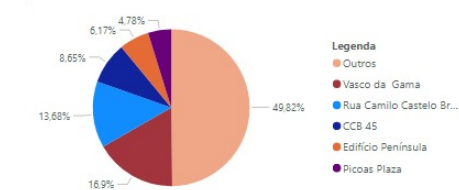
Percentagem devoluta e arrendada dos Top 5 imóveis



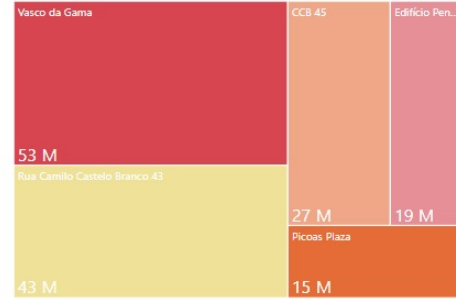
Percentagem do portfolio constituída pelos top 5 imóveis

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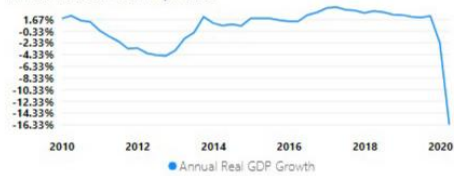
Top 5 imóveis vs restantes



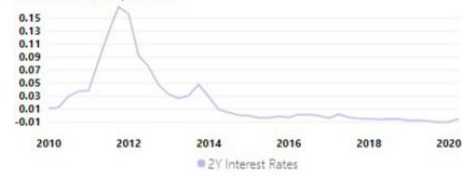
valor v por top 5



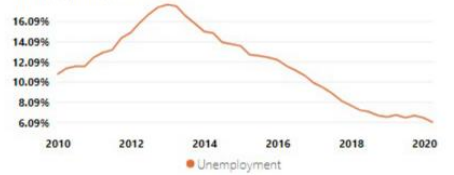
Annual Real GDP Growth por Date



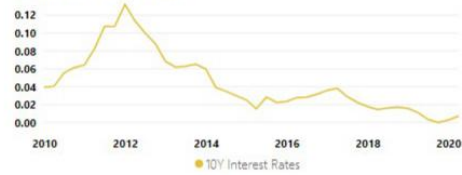
2Y Interest Rates por Date



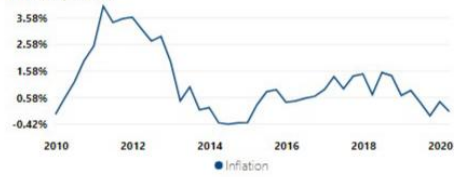
Unemployment por Date



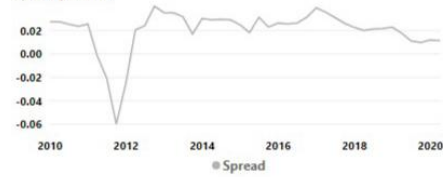
10Y Interest Rates por Date



Inflation por Date



Spread por Date



Appendix 15.2 – Access Database: Using Tech for Better Results

The Access was the software chosen to bridge the thesis’ output with the client for a better data management, through a database that gathers the systematic and idiosyncratic information used for this study’s analysis. This tool was primarily chosen due to its ease when it comes to store and analyse fundamental datasets abouts specific fund’s features. The database created is divided into each specific field pointed out in this study as relevant to keep up with by the fund’s management team. Moreover, this information is directly linked with automated excel files, which enables the fund’s management team to easily update fund’s information throughout time.



Navigation Pane

Edif. Eça de Queiroz	56%	set/2017
Edif. Eça de Queiroz	58%	jan/2017
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A Work Project, presented as part of the requirements for the Award of a Master's degree in Finance from the Nova School of Business and Economics.

Real Estate Risk Management at BPI GA: Hotels

Nova SBE Consulting Project

João Manuel Guerreiro Castelo Ramos

Work project carried out under the supervision of:

Professor Melissa Porras Prado

04-01-2021

Real Estate Risk Management at BPI GA: Hotels

Abstract: Hotel investments have been increasingly present in institutional investors' portfolios, requiring a proper understanding of risks. Therefore, the research analyses the Portuguese hotel sector performance and two individual hotel assets. Moreover, the research addresses ESG issues, the lodging industry trends and the impact of Covid-19. The results show that the two studied hotel assets of *Imofomento* have operating indicators above Portuguese averages considering the respective location and type of accommodation. Also, the trends impacting the industry driven by changing consumer travel preferences are likely to benefit the subject assets. Nonetheless, there are some risks that should be monitored and addressed.

Keywords: Commercial Real Estate; Hotels; Lodging Industry; Hotel Valuation; Portuguese Hotel Market; ESG; Hotel Trends; Covid-19.

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Moreover, I want to show my appreciation to all *BPI Gestão de Ativos* (BPI GA) real estate team, particularly Ar. Vítor Manuel Canas, who provided me with essential industry knowledge. Also, a word of gratitude to Marta Vieira da Silva, MSc, who provided vital information and contributed with valuable comments. Furthermore, I would like to acknowledge the important contribution of *Garen's* appraisal expert Ar. Fátima Pinto Correia for taking the time to share her experience on the matter.

Last, but definitely not least, I would like to thank my parents, brother and other family members for their moral encouragement and support during this period. Their unconditional support and positive energy were essential throughout this journey to complete the research successfully.

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1 Introduction

The hotel and tourism sector have exhibited significant growth worldwide and particularly in Portugal over recent years, increasingly attracting investors' interest. Nowadays, there is a growing trend to diversify within commercial real estate sectors, and hotel investments are rising in importance. Thus, investors need to address the risks related to such investments.

The goal of this research is to analyse the hotels sub-sector so that the client has a better understanding of the risk and rewards of the sector to develop risk management approaches. It serves as a complement to the report: *Real Estate Risk Management at BPI GA*, which we developed in collaboration with *BPI Gestão de Ativos* (BPI GA) as a consulting project.

Based on a sector structure analysis, literature review and insights acquired from the real estate team of BPI GA and an appraisal expert from *Garen – Avaliações de Ativos, Lda.*, the project aims at understanding the drivers and risks related with hotel performance and valuations. Moreover, the following research evaluates the performance indicators of two hotel assets of the client's open-end commercial real estate fund *Imofomento*. The research will study *Hotel Valverde* and *Aqualuz Suite Hotel & Apartments* by developing a risk assessment that comprises the impact of future trends, the risk of competition and how hotel operating ratios stand relative to Portuguese averages considering the location and type of accommodation.

Furthermore, the research analyses ESG issues impacting the industry and suggests BPI GA to use direct and indirect performance metrics to assess the impact of material sustainability issues related to the environment and human capital on its hotel real estate assets. Lastly, trends affecting the industry driven by changing travel demand patterns and the impact of the Covid-19 health crises are addressed on this research.

2 The Hospitality Industry

The hospitality industry comprises a diverse group of businesses focused on the delivery of services. The industry's different segments have common characteristics that make the hospitality industry one of unique dynamics with a complex buyer-seller relationship. The main characteristics are the perishable nature and inseparability quality inherent to be a service product, given that it is simultaneously produced and consumed and mostly intangible. In addition, the variability within employee's performance and quality of work as well as customer expectations allied with the fact of being impossible to store for future sale results in a highly complex industry. Altogether, the hospitality industry goal is to make a return on investment for owners, shareholders and society (Walker 2016).

Organizations that operate in the hospitality industry are closely interrelated and interdependent with scholars grouping them into different categories depending on their activities, size and profit motives, being the subsectors the following: (1) travel and transport; (2) accommodations (lodging); (3) food and beverages (F&B); (4) entertainment and recreation; (5) tourism offices or destination management organizations and (6) nongovernmental tourism organizations (Okumus, Altinay and Chathoth 2010).

Over the past decades, hospitality and tourism have become a key driver of socio-economic progress not only for generating jobs but also for its contribution to export income and development of infrastructure.

In 2019, on average 65.5% of the gross domestic product (GDP) obtained across European Union (EU) countries comes from services (World Bank 2020), from which the hospitality industry is often named one of the leaders in terms of generation of income and employment.

According to the United Nations World Tourism Organization (UNWTO), tourism contributes 10% to EU's GDP and creates jobs through its direct, indirect and induced effects in the economy for 26 million people, around 9% of total employment in the EU. Moreover, tourism

and hospitality represent a high percentage of overall exports in the EU. According to the World Trade Organization and UNWTO, over the last decade, the industry has shown the capacity to compensate weaker exports growth in other categories as detailed in appendix 2.1 and contribute to reducing trade deficits, therefore being an essential component of export diversification (World Tourism Organization 2019). In fact, according to the Bank of Portugal, the Portuguese economy has been benefiting from the positive contribution of the tourism and hospitality industry. In 2019, the sector reached a new high in revenues amounting €18.4 billion, representing a tourism surplus in the Balance of Payments (BOP) around €13 billion as detailed in appendix 2.2 (Instituto Nacional de Estatística, I. P. 2020). In 2019 according to the UNWTO, the BOP travel and passenger transports caption represented 23% of total Portuguese exports and data released by Eurostat ranks Portugal as the 5th among EU countries with the highest tourism trade surplus as detailed in appendix 2.3.

3 The Lodging Industry

The hospitality industry comprises a vast network of businesses, one of the most important categories, representing the largest investment made by travellers for business or leisure, is accommodation. According to the UNWTO in 2016, EU destinations counted 608 thousand accommodation establishments with a total capacity of 31 million bed-places (44% of capacity from hotels). In Portugal alone, there were 7155 accommodation establishments in 2019, an increase of 19.2% relative to the previous year (Instituto Nacional de Estatística, I. P. 2020). According to Eurostat, the lodging industry comprises all types of lodging facilities, subdivided into three categories: hotels and similar accommodation; holiday and short-stay accommodation and camping grounds, recreational vehicle parks, and trailer parks.

3.1 Hotels and similar accommodation

These are the most common form of paid lodging utilized by travellers and have become an essential element of the urban landscape worldwide. Hotels have evolved from simple beginnings to a diverse range of offers from modest accommodation facilities to high-profile resorts and luxury hotels with huge investments. Hotel and resorts classify according to an agreed criterion that varies between countries and comprises location, size, services and amenities, among others. Over the past years, significant consolidation has occurred in this lodging segment with large hotel chains globalizing the industry (Timothy and Teye 2009). In 2016, EU destinations counted with 202 thousand hotels and similar accommodation¹ (33% of total lodging facilities) offering around 13.7 million bed-places in 6.7 million rooms. On average, each hotel has 68 bed-places distributed in 33 rooms. Nevertheless, the sizes vary considerably between EU countries with 60% of the total hotel establishments having less than

¹ According to Eurostat Glossary, hotels and similar accommodation comprises the provision of daily or weekly furnished accommodation in guest rooms including daily cleaning and bed-making. This type of lodging facilities include accommodation provided by hotels (and similar establishments, for example operating under the name B&B), aparthotels, resort hotels and motels.

25 rooms, 32% have between 25-99 rooms and only 8% have 100 rooms or more (World Tourism Organization 2018). Italy has the largest share of bed-places among European countries, while Portugal, according to INE (2020), counts with 1923 hotels and similar accommodation offering 328.6 thousand bed-places in 146.2 thousand rooms. On average Portuguese hotels have 76 rooms per establishment, which indicates a prevalence of larger hotel establishments with 130% more rooms than the EU average.

3.2 Holiday and short-stay accommodation

These lodging forms are a growing trend globally and distinguish themselves by their self-catering characteristics and more budget-conscious. Short-stay accommodations are typically guesthouses that are predominantly family-owned and mostly located in rural areas, less sensitive to seasonality relative to large hotels and resorts (Timothy and Teye 2009). In 2016 according to UNWTO (2018), EU countries counted with 378 thousand holiday and short-stay accommodation² (62% of total lodging properties), which have a relatively low capacity with an average of 20 bed-places per establishment, therefore accounting for only 24% of the whole offering, representing around 7.5 million bed-places. In Portugal, according to INE (2020), fall into this category rural tourism, housing tourism, local accommodation (with ten or more bed-places) and youth hostels, representing in total 4992 establishments (70% of total lodging properties) with an offering of 123.4 thousand bed-places, close to a third of hotels' capacity.

3.3 Camping grounds, recreational vehicle parks and trailer parks

This segment comprises the oldest form of accommodation, which persists until modern times with people all over the world enjoying camping. Particularly in Europe and North America where nature reserves are part of national strategies, and there are sound regional park systems

² As stated by Eurostat Glossary, holiday and short-stay accommodation comprises the provision of daily or weekly accommodation in self-contained space with areas for living, dining and sleeping, including fully equipped kitchens. This class provides very minimal complementary services and includes cottages and cabins, visitor flats and bungalows, without housekeeping service and youth hostels.

with accommodation and other amenities for domestic and international tourists. People utilize recreational vehicles (RVs) and tent camping for a variety of reasons, with the most notable ones being economic, social and spiritual reasons that have contributed for an increased interest in organized campgrounds, which appeal mainly to youth groups and family groups travelling on holiday breaks (Timothy and Teye 2009). According to UNWTO (2018) in 2016, EU countries counted 28 thousand camping grounds and recreational vehicle parks and trailer parks³ (5% of total accommodation establishments in the EU) with around 9.8 million bed-places on offer, representing 32% of total bed-places. In the EU, France leads the offering of bed-places in camping grounds with about 3 million followed by Italy and Germany with 1.2 and 0.9 million respectively. According to INE (2020), Portugal in 2019 counted 240 camping grounds establishments with an offer of 191.3 thousand bed-places.

³ According to Eurostat Glossary, camping grounds, recreational vehicle parks and trailer parks comprises the provision of accommodation for short stay visitors in camp grounds and recreational camps as fishing and hunt camps as well as space and facilities for recreational vehicle and plain bivouac facilities or protective shelters for placing tents or sleeping bags.

4 Key Participants

The lodging industry has several participants involved that interact with each other, being the main ones the owner, franchisor, manager, owner/manager and tenant/lessee.

4.1 Owner

The owner is the landlord of the lodging facility and typically does not have the expertise to operate it. Therefore, the owner enters into agreements for an independent third party to manage the lodging property. The third-party operator might be a chain operating company with brand recognition, an independent operating company with its unique brand, an operator under a franchise agreement (franchisee) or a tenant subject to an operational lease.

4.2 Franchisor

The franchisors own a trademark and strive to expand and grow their revenues by increasing the number of lodging properties under their franchise system. Franchisors provide another party (the franchisee) the right to market goods and services with brand recognition, marketing support, standardized operational procedures and a centralized reservation system.

4.3 Manager

The lodging property manager is responsible for the facility's day-to-day operations on behalf of the owner, being accountable for determining room rates, employment of staff, developing marketing plans, preparing capital expenditure budgets, and financial reports for the owners, among others. The manager can be considered a franchisor/manager in case of owning a brand with standard procedures and joining the two business segments, both franchisor and manager. Managers that formalize managing contracts with owners charge a fee for their services based on revenue and an incentive fee based on profitability.

4.4 Owner/manager

The owner of the lodging property may also have their personal management team and control all operating activities. These lodging properties may be operated as an independent hotel with the owner's brand or under a franchise agreement.

4.5 Tenant/lessee

These are more common across Europe, where a hotel company enters into a leasing agreement for the right of use of a lodging property belonging to the lessor (owner) in exchange for periodic rent payments. The lessee (tenant) typically pays a premium at the start and is responsible for the lodging property's operation, employing all the staff, undertaking repairs and other expenses following the lease contract. The most common payment schedules are flat rental, percentage of sales, the greater of a fixed amount or a portion of sales and a base fixed rent plus a percentage of sales exceeding a specified amount.

5 Valuation of Lodging Real Estate

The owners of lodging real estate need to know the value of their real estate assets for several reasons. The property's value is the primary consideration affecting buy, sell, or hold decisions, being it crucial to find the market value before the transfer of ownership occurs. Other purposes of valuation are insurance-related, estimating the market value for setting lease rates and for property tax matters, among others (Andrew and Schmidgall 1993).

Owners must request appraisal experts to perform valuations to determine the market value of assets. Some appraisal experts are members of the Royal Institution of Chartered Surveyors (RICS) and follow international standards to ensure valuations achieve high standards of integrity, objectivity and clarity.

The appraised market value of lodging properties⁴ reflects the appraisal expert's interpretation of hotel buyer's and seller's behaviour, often a subjective process that relies on the appraisal experts' experience and their know-how over the marketplace relative to how are market circumstances prevailing and evolving. Moreover, given the specificities of trading-related valuations, appraisal experts usually specialize in the particular type of property and market, knowing the operational aspects and the industry as a whole (RICS Valuation Professional Group 2019).

Appraisal experts can perform valuations of real estate assets through various approaches, namely the cost approach, the sales comparison approach and the income approach (CFA Institute 2020). In what regards lodging properties' valuations, the cost and sales comparison approach have limited usefulness. The cost approach does not take into consideration the income flowing from the property (Andrew and Schmidgall 1993). The sales comparison

⁴ In what regards properties that are normally bought and sold based on their trading potential, which includes lodging properties (hotels), the RICS (2019) has produced guidance as to how to carry trading-related valuations (VPGA 4). The essential characteristic of these properties is the lack of flexibility by being designed for a special use. Therefore, the value reflects the trading/business potential and it is usually used a profits-based approach.

approach relies on vast numbers of similar properties being recently sold, which is not easily applied in the lodging industry due to its great variety among existing properties and the limited number of recent sales publicly disclosed. For these reasons, appraisal experts rely on the income approach to determine the lodging property's market value, being it the discounted future income stream, which is closely tied to the particular trading activity. Therefore, appraisal experts often refer to it as the profits method of valuation.

The valuation engagement performed by the appraisal expert when applying the profits method approach requires the determination of an income stream and an appropriate capitalization rate. The first step is assessing the fair maintainable turnover (FMT)⁵ that the subject property can generate by a reasonably efficient operator (REO)⁶. Thus, disregarding the value of profit generated over and above market prospects by the present operator that would be extinguished upon the sale of the trade related property, in other words disregarding the “personal goodwill” of the property. Afterwards, resulting from FMT and the expected costs incurred by the REO, the appraisal expert assesses the fair maintainable operating profit (FMOP)⁷. Finally, to determine the lodging property's market value, the FMOP is capitalized at an appropriate capitalization rate achieved by the appraisal expert from market evidence, reflecting its risk and reward and its trading potential (RICS Valuation Professional Group 2019).

5.1 The assessment of the fair maintainable operating profit

The assessment of the FMOP performed by the appraisal expert includes the projection into the future of the potential trading activity. Therefore, to better understand the underlying characteristics of this assessment, a more in-depth analysis is made based on Harper (2008).

⁵ According to RICS (2019), the FMT is the level of business obtained by a reasonably efficient operator (REO) on the assumption that the property is properly equipped, maintained, repaired and decorated.

⁶ According to RICS (2019), an REO is an assumption made by the appraisal expert that considers market participants as competent operators, acting in an efficient manner. Thus, it involves estimating the potential trading activity rather than the actual levels of trade achieved under the current operator/ownership.

⁷ As mentioned by RICS (2019), the FMOP is the expected level of profit achieved by an REO prior to finance costs and depreciation associated with the asset (rent if leasehold).

The assessment requires the appraisal expert to thoroughly understand the trading/business history of the lodging property, which is a complex matter that involves discussions with the management of the hotel, an analysis of the local market to gauge the competitive environment and the possibility of new lodging properties being constructed nearby. Most important, it also requires an analysis of the trading/business accounts, generally performed by the use of operating ratios relating both to revenues and expenses.

First, the appraisal expert looks at the revenue mix of the property, depending on the market area and the lodging property characteristics (detailed in appendix 5.1 and 5.2) there is the possibility of generating a broad mix of revenues, generally grouped into three main categories, namely rooms revenue, food and beverages revenue and other revenue (usually includes leisure club and convention/meetings rooms revenue).

Regarding the rooms department, which is commonly the main source of revenues, the appraisal expert investigates the demand generators in great detail by segmenting the market and observing the proportion of business generated by each segment. Furthermore, the expert considers the rooms department's yield by analysing the revenue per available room (RevPAR), which is the standard benchmarking ratio used to measure performance in the lodging industry, especially when executing hotel valuations. RevPAR is the occupancy rate multiplied by the average daily rate (ADR).

The occupancy rate represents the management's effective use of resources and indicates the percentage of rooms sold relative to total rooms available, while the average daily rate is a crucial ratio to measure the rooms department turnover. The ADR is calculated by dividing the total rooms' revenue (over whatever period) by the number of rooms occupied, including only paid or sold rooms.

Besides the in-depth analysis of the rooms' revenue, the appraisal expert looks to understand what has changed year-on-year on the other departments by studying the fluctuations of the

F&B revenue and other revenue sources. Furthermore, each department has its operational expenses, which appraisal experts determine by analysing margins and achieving cost percentages representing the overhead expenses divided by total department revenue.

Finally, the appraisal expert deducts the total undistributed expenses from the total departmental profits, including marketing and sales expenses, administrative costs, utility costs, and property equipment maintenance costs. The last deduction to obtain the property's final FMOP is the fixed costs, which typically include reserves for renewals of equipment, insurance costs and head office costs.

The FMOP assessment result will ensure the appraisal expert has a clear understanding of how the lodging property has been trading historically and, consequently, where it is likely to be trading in the future. Then, an accurate projection of trading is determined also taking into account how comparable properties trade/performance, resulting in a precise projection of the FMOP based on the principle of REO (Harper 2008).

5.2 The drivers behind fair maintainable operating profit

A lodging property performance is strongly influenced by the demand of its location and the nature of such demand. Thus, it is crucial to understand and identify the demand profile and then look at the drivers behind it and how demand generators are likely to change it. The trips taken by visitors⁸ that include overnight stays will be the push factor of lodging properties' demand. Therefore, the use of non-monetary indicators collected from flows of both domestic⁹ and inbound tourism¹⁰ is a relevant source of information for the lodging industry (United Nations 2010). Apart from tourism flows, the number of arrivals and nights spend are also

⁸ According to UN (2010), a visitor is a traveller on a trip to a destination outside his/her usual environment for any purpose other than being employed and for less than 1 year. If the trip includes overnight stay, the visitor is considered a tourist.

⁹ As mentioned by UN (2010), domestic tourism encompasses the activities of a resident visitor within the country of reference either as part of a domestic tourism trip or as part of an outbound tourism trip.

¹⁰ According to UN (2010), inbound tourism comprises the doings of a non-resident visitor on an inbound tourism trip within the country of reference.

useful indicators to reflect the lodging industry's performance, being the combination of both the average length of stay.

5.2.1 The importance of segmenting demand

Academic literature has found that different people travel for different reasons, each has its own motives to fulfil, they may be psychological, physical, emotional or economic needs. Thus, travel purposes are diverse among different people, ranging from business and professional, leisure, recreational and holidays to health and religion or simply visiting friends and relatives. Since everyone is different, comes from different places and has unique motives, the tourism product sought, which translates into lodging property demand, varies from person to person and country to country. Hence, there is an array of market and tourism types that can be divided and segmented for the purpose of research and analysing performance (Timothy and Teye 2009). According to the United Nations (2010), tourism can be characterized by main purpose, types of "tourism product", origin and destination, duration of trip, modes of transport, and accommodation type, detailed in appendix 5.3.

5.2.2 The economic drivers of tourism demand

The hospitality and tourism industry has been experiencing healthy growth globally over the last decade, mainly driven by the effect of globalization, which has been occurring fast with people all over the world having the opportunity to freely work and go on vacation in several places (Walker 2016). As a matter of fact, according to the World Tourism Organization (2019), the share of the global population requiring traditional visas is on the decline. In 2018, 53% of the world population needed a traditional visa compared with 75% in 1980, while eVisas and visas on arrival are on the rise. Hence, these policies of opening borders and enhanced visa facilitation allied with an increase in disposable income and vacation interest by robust middle-classes in emerging markets are strongly contributing to tourism demand and international visitors' arrivals. In 2018, China was the world's largest tourism spender, a total of US\$277

billion, followed by the United States of America (USA) and Germany (World Tourism Organization 2019).

Additionally, as Harper (2008) mentioned, demand for lodging properties, which is mostly driven by tourism demand, is affected by transportation patterns and accessibilities. Over the past two decades, air travel demand has been strong due to reasonable and affordable airfares. In fact, UNWTO (2019) states that the number of unique city pairs linked by air transportation has more than doubled, being slightly over 20 thousand in 2018. According to the International Air Transport Association (IATA) in 2018, the average cost of air transport was half that of two decades ago and passenger demand was robust, exceeding 4.3 billion journeys. The stable crude oil and jet fuel prices in 2018 have also contributed to the lower fares, which enable more people to fly more often. Air transport has been essential to world tourism, and international tourists travelling by air transport are estimated to have spent around US\$850 billion in 2018 (International Air Transport Association 2019).

The technological environment has also been a significant driver contributing to tourism demand over the past two decades by changing how product and services are marketed and consumed. In this environment, non-traditional and smaller lodging operators with limited marketing budgets can better compete due to the lower marketing, reservation management, and information gathering costs made possible by the internet. Moreover, the internet also increased the industry's exposure through online booking and travel websites (such as *Priceline*, *Hotels.com* and *Kayak*), which enable hotels to increase occupancy by using short notice discounts to sell vacant rooms. Nowadays, consumers have increased accessibility to products using online channels and the possibility to use social media to co-create product-service experiences over technology interfaces (Okumus, Altinay and Chathoth 2010). Furthermore, according to UNWTO (2019), an increasing sum of destinations quantifies tourism arrivals and measures trends in real-time for enhanced management of visitor flow.

New technology-related hardware and software and artificial intelligence (AI) are transforming tourism by promoting hyper-personalized customer experiences that improve business performance. Thus, according to Okumus et al. (2010), lodging property managers can benefit from technology aid on redefining the service transaction and should track and analyse the development of new products and technology-related opportunities.

Finally, economic and sociocultural variables also play a role in tourism demand affecting the hospitality businesses significantly. In what regards economic factors, according to Okumus et al. (2010), variables such as GDP growth rate, interest rates, inflation rates, mortgage rates, consumer confidence and stock market performance are crucial for tourism demand. These variables represent economic cycles that translate into more significant business activity and more business and leisure travel when on an upward trajectory. Moreover, changes in source markets and competitive destinations exchange rates impact tourism demand patterns and might affect a specific destination's competitiveness. Furthermore, Harper (2008) mentions that increases in inward investments and companies' movement to an area contribute to positive changes in demand for lodging properties. Therefore, it is of utmost importance to scan the economic environment and cycles to assess how it will impact the costumers' propensity to consume hospitality products and services (Okumus, Altinay and Chathoth 2010). Furthermore, Okumus et al. (2010) note that sociocultural issues such as cultural changes as well as demographic and psychographic changes promote emerging trends by influencing lifestyles. Thus, the conceptualization of products and services in the tourism and hospitality industry should be based on and take into consideration each customer group's idiosyncratic needs and wants, and how these affect demand.

Altogether, several factors can drive the demand for tourism, nevertheless, it is also important to consider the competitiveness of a destination and its desirability for international tourism. According to Walker (2016), attributes such as service quality, natural environment, weather,

entertainment, infrastructure and value for the price play an important role. Moreover, the destination's political stability, health, safety, and security substantially impact its reputation, thus ensuring a favourable political and regulatory environment should be the destinations' priority to increase competitiveness and attract tourists (Walker 2016).

5.2.3 The drivers of guest preference

Guest preference is a crucial driver behind lodging properties' performance, thus lodging businesses increasingly look to keep customers satisfied and retain them for future experiences. Major hotel chains have been expanding up and down the value chain over the last years so that they can have a continuous series of diverse "tourism products" that try to meet all the customer's varying needs. According to Bender et al. (2008), an interview to top executives of major multinational lodging corporations revealed a change in the corporate structure to incorporate loyalty and reward guest programs. These programs are now an integral part of the lodging industry and a core attribute of hotel brands, resulting in the increasing power of the brand. The increased importance of brands has also been driven by technology and how changes in the product distribution models promoted by the internet impact customers and guest preference (Bender, Partlow and Roth 2008). In recent years many hotel chains developed and improved their loyalty programs offer. For example, in 2019, Marriott completed the integration of their three loyalty programs into a single name, Marriott Bonvoy™, in which customers have access to rich benefits and travel experiences. According to Marriott International Inc. (2020), the loyalty program generates significant repeat business that would otherwise go to competing hotels. In fact, in 2019, over 50% of room nights in Marriott's lodging brands were booked by Loyalty Program members (Marriott International, Inc. 2020). In 2019, approximately 72% of hotel rooms in the United States of America were affiliated with a national or regional brand, which is believed to contribute towards attracting and retaining guests. Outside the USA, brand affiliation is less common, and most markets are

served mostly by independent operators. Nevertheless, branding is more prevalent in new hotel developments. According to Marriott International Inc. (2020), chain affiliation will rise in many markets as international travel accelerates, local economies grow and barriers decline. Moreover, Marriott International Inc. (2020) believes hotel owners will increasingly seek the benefits of centralized reservation systems and marketing programs offered by major international chains as well as the benefits of brand's loyalty programs. In fact, according to Harper (2008), appraisal experts should include the potential of a brand name or the rights to a trading name in lodging properties' valuations, given that it forms part of the "property goodwill"¹¹, thus having a meaningful impact on the fair maintainable operating profit.

5.3 The drivers behind capitalization rate selection

The assessment of a lodging property's market value through the profits approach has two components, namely an accurate estimation of the FMOP and the appropriate capitalization rate (cap rate) to be applied to the stabilized earnings. The appraisal expert uses significant judgement to complete the valuation engagement and determining the correct capitalization rate is fundamental in reaching an accurate valuation. Hence, the appraisal expert must understand the cyclical nature of the market and how external factors influence the lodging business and acquisition decisions, given that it is essential that every market evidence is considered (Harper 2008).

Most appraisal experts use evidence from the rates of return obtained in relevant market transactions of similar properties, regarding both the duration of investment and risks perceived by market participants, to assume a capitalization rate for the property subject to valuation. Then, the assumed cap rate suffers an adjustment up or down in accordance with possible differences in the property's characteristics that reflect a higher or lower investment risk

¹¹ According to Harper (2008), when assessing the purchase price, a prospective buyer should remove any element of "personal goodwill", which is the extra trade that is generated by the current operator, but include any "property goodwill" that refers to goodwill relative to the property rather than the owner or operator, such as existing brand or trading names.

(Manganelli, Morano and Tajani 2014). We should note that a slight change in capitalization rates correspond to a significant inverse variation in the estimations of property values. The choice of cap rate is a subjective process based upon the appraisal expert's experience and his/her judgment over the risks and rewards associated with the property and its trading potential.

According to Harper (2008), most of the criteria adopted by appraisal experts considers the location, quality and economic environment of the property. The author points to a selection of factors that could affect hotels' profitability and future growth in capital value. One should note that everything that has the potential to affect a property's future benefits, namely profitability, capital growth or a combination of both, will have an impact on the appropriate capitalization rate. Thus, to better understand the factors that could have an impact, a more in-depth analysis is made based on Harper (2008), it is worth noting that a lower capitalization rate normally suggests a more desirable property with lower risk.

In what regards location, the market will first consider the geographic location of the property in terms of its surroundings, with cap rates being lower for areas in the city centre. The suitability of the site is also important, depending on the hotel's characteristics (for example a business hotel), it should be in an appropriate location (highly visible in the city centre). Moreover, changes in the economic environment and improvements in the surrounding infrastructure will impact the capitalization rate. As the location or market area becomes more desirable, the cap rate will be lower. Furthermore, the alternative properties in the location are also considered, if there are many alternative properties of similar suitability, then the cap rate will be higher.

The appraisal expert also considers the quality of the asset and management team. The hotel's quality and condition will be reflected in the cap rate, with better quality hotels showing less capital expenditure needs, thus commanding lower cap rates. The type of property and its

classification generally also have an impact, with 5-star hotels perceived as less risky than small-scale accommodation, therefore having lower cap rates. Moreover, appraisal experts ponder alternative uses with potential opportunities to improve the property's value and quality reflected in the capitalization rate. In addition, appraisal experts also contemplate the quality of management and its decisions by assessing the business mix and the risks attached to the different income streams and the historic trading profile, attributing a lower cap rate for properties with stable trading history and growth potential.

Finally, the appraisal expert assesses the economic and market environment, and trading demand is a crucial component. If the hotel market is expanding, then there will be increased competition to acquire hotel properties. Additionally, the market expectations towards a type of property in a specific location or the possibility of "treasure hunting" will lead to purchasers offering higher prices to beat other competitive purchasers' challenge, consequently lowering the cap rate. Furthermore, other factors such as flexibility and brand appeal can lead to more competition for the property and a lower cap rate, since the property presents a commercial advantage for the future owner and operator.

Determining the appropriate capitalization rate is a complicated task that requires full exposure to a range of factors, which will lead to many adjustments due to the hotel business's individual nature. Moreover, when the property is under a lease agreement, the appraisal expert should consider additional factors such as the quality of tenant and financial standing, the suitability for the operation, the stated goals, track record, and the tenant's market perceptions. In addition, the specificities of the lease agreement, considering the rent affordability and if there is a guarantor of rent, also impact the selection of the capitalization rate.

5.3.1 The risk of increased competition

The appraisal expert must assess the competitive supply of hotels in the area, as current and expected levels of competition could impact profitability dramatically and consequently value,

therefore it is a significant risk factor to consider in the lodging industry (Harper 2008). Generally, hotels face intense competition for individual guests, group reservations and conference business, thus it is important to assess first what constitutes competition. According to Host Hotels & Resorts (2020), a competitor in the lodging industry can derive from major hospitality chains with recognized brands or smaller hotel chains with local hotel owners. Moreover, competition can also derive from the new supply of hotels with improved amenities that reduce incumbent hotels' ability to compete for guests effectively. The competition for guests is based on location, room rates, availability of rooms, property size, conference space and amenities, to name a few.

Moreover, the industry is facing a new source of supply competition that has presented a rapid growth over recent years, namely online short-term rentals that have a more variable impact on the hotel industry than the typical changes in supply promoted by traditional hotel development (Host Hotels & Resorts 2020). Typically, lodging supply growth is mainly driven by lodging demand and other factors such as capital availability, interest rates, and construction costs, resulting in developers planning new supply during an upcycle. Still, due to long lead-times for construction, properties may open for business when demand growth is slowing, and the economy is weaker. According to Smith Travel Research (STR) and CBRE Hotels' Americas Research, the historical supply growth in the USA lodging industry does not follow the same levels of lodging demand growth. It presents a sluggishness characteristic when adjusting to decreases in demand as detailed in appendix 5.4, which can lead to the possibility of excess supply and increased competition that decelerates the growth of hotel profitability as seen by the decrease of RevPAR growth.

6 Portuguese Hotel Market Overview

The Portuguese hotel market was enjoying a unique condition that resulted in their positive performance until 2019. According to the Portuguese's Secretary of State of Tourism, Portugal's offer matches today's definition of luxury: authenticity, creativity and innovation. Thus, Portugal has been awarded numerous tourism prizes over the recent years, namely the "Best Destination in the World" in the last three years (2017, 2018, 2019) by the World Travel Awards, the highest tourist distinction.

All these factors allied with the recognized work of Portuguese tourism organizations such as *Turismo de Portugal* in promoting the country's destinations have resulted in increased tourist arrivals and consequently improved demand for accommodation. The lodging demand has undergone ten years of consecutive growth, with overnight stays increasing from around 37 million in 2010 to slightly above 70 million in 2019. The leading Portuguese destinations continue to be the Algarve and Lisbon followed by Oporto. These three regions represent a total share of 71.77% of overnight stays, with the Algarve region alone having around 30% of overnight stays as detailed in appendix 6.1. Regarding tourists' preferences over the type of lodging facility, from the total 70 million overnight stays in 2019, around 57 million were in hotels and similar accommodation. In fact, over the last five-year period, most guests visiting Portugal stayed in hotels and similar accommodation as detailed in appendix 6.2.

6.1 Competitive environment

The rapid growth observed in overnight stays since 2014 was not followed initially by lodging properties supply of bed-places, which presented a more moderate increase and a relative delay when adjusting to demand changes as seen in appendix 6.3. Demand growth peaked in 2014 and subsequently decelerated its growth, while supply growth remains stable at around 5% over the last five years. The different growth paces of demand and supply until 2017 created a

positive environment that triggered a double-digit growth in RevPAR. However, in the last couple of years, demand growth stabilized in more moderate levels due to the already high occupancy rate during the summer months, the high season in Portugal. Thus, supply growth exceeded demand growth in 2018 and 2019, which created an increasingly competitive environment that resulted in RevPAR increase decelerating to 3.96% and 3.16% in 2018 and 2019, respectively.

Overall, during the period between 2014 and 2019, demand in terms of overnight stays increased by 44%, while supply in terms of bed-places offering increased by around 30%. When disaggregating supply, we observed that hotel and similar accommodation offer the majority of bed-places, followed by local accommodation¹² (short-term rental), which had a rapid development across the country, with the number of beds doubling in the last five years. Hotels and similar accommodation supply of bed-places increased by 15% from 2014 to 2019, while local accommodation supply increased by 101% in the same period as detailed in appendix 6.4. Altogether, the yearly growth in supply has been mainly driven by local accommodations and hotels and similar accommodation. Regarding hotels and similar accommodation, the highlight goes to high classification hotels such as 4-star hotels and 5-star hotels. The former is the one with the highest representation in Portugal and the latter the one with the highest bed-places supply growth in 2019 as detailed in appendix 6.5 and appendix 6.6. The presence of international hotel brands is not yet very high, being the leading chains operating in Portugal the *Pestana Group* and *Vila Galé*, both Portuguese, followed by the French *Accor Group* (Deloitte 2019). However, in Lisbon, 25% of hotel rooms are operated by international hotel chains, which CBRE (2020) expects to increase as more high-profile brands enter the city and reinforce their presence.

¹² The data from the Portuguese national statistics office (INE) only considers local accommodations with 10 or more bed-places, which represents a total of 3223 establishments offering 88 thousand bed-places in 2019.

6.2 Segmenting Portuguese tourism demand

In this section, the focus will be tourism demand seeking hotels and similar accommodation, which will be segmented so that there is a clear understanding of the motives and tourism product sought by these tourists visiting Portugal. Regarding the segmentation between domestic and inbound tourism, the nights spent in Portuguese hotels and similar accommodation are mainly driven by international tourists representing 71%, from which the majority are European as detailed in appendix 6.7. The leading source markets of Portuguese inbound tourism are the UK with 8.6 million nights spent, followed by Germany and Spain with 4.8 and 4.3 million nights spent in hotels and similar accommodation respectively. Outside of Europe, the highlight goes to Brazil and the USA with a combined 5 million nights spent in hotels and similar accommodation in 2019.

Portugal lodging demand is highly exposed to international markets compared with other European countries since on average nights spent in EU hotels and similar accommodation are 50% non-resident (international). According to the UNWTO (2018), holidays, leisure and recreation are the primary purpose for non-resident trips to EU destinations, representing around 60% of international arrivals, while business and professional represents 15%. Another 24% of tourism trips have other purposes such as religious reasons, visiting friends and relatives (VFR) and health treatment. According to the Portuguese national statistics office (INE), who studied the motives for domestic tourists spending nights in hotels and similar accommodation, Portuguese residents travelled more in 2019, being the main purpose of nights spent in hotels holidays (83.93%), followed by business and professional (8.13%) and VFR (4.65%). Regarding modes of transport, according to UNWTO (2018), international tourists prefer air travel with 67% of international tourists arriving at Southern and Mediterranean Europe by air, while domestic tourists (Portuguese residents) travel by owned private vehicles (89.3%).

In 2019, the duration of stay in Portuguese hotels and similar accommodation was on average 2.69 nights with international tourists spending on average 3.11 nights, while domestic tourists spent on average 2.02 nights. The trip duration varies by type of lodging facility with aparthotels having a longer length of stays, on average, 4.14 nights. Moreover, within hotels, on average, high classification hotels have longer stays than low classification hotels, 5-star hotels have 2.85 nights, while 2-star and 1-star hotels have 1.87 nights.

Altogether, tourism demand in Portugal relies mainly on international (non-resident) tourists seeking short-stays with the main purpose being holiday and recreational trips. These characteristics of Portuguese lodging demand were shaped by the reputation of its two main destinations, Lisbon and the Algarve. According to CBRE (2020), Lisbon is a popular city break destination, being awarded several international prizes such as “World’s Leading City Break Destination” in 2020 and “Best Destination City Break” in 2018 by the World Travel Awards. The Algarve region is famous for being a premier sun and beach holiday destination, being a consolidated resort and a renowned golf destination that appeals mostly to a holiday, leisure and recreational type of tourism trips. For all these reasons, tourism demand in Portugal and consequently lodging demand is highly exposed to seasonality and the risks associated with it, as detailed in appendix 6.8, the summer months concentrate the most nights spent in hotels and aparthotels.

6.3 Hotel Performance

The increased influx of tourists with the number of international passengers arriving at Portuguese airports rising 68% over the last five-year period, and 8% in 2019, leads to a positive performance of the sector. Hence, Portuguese hotels and similar accommodation had a sustainable and robust increase in their operating ratios over the last decade (CBRE and Vieira de Almeida 2020).

The occupancy rate presented an upward trend with average net occupancy in Portugal increasing 31% from 2012 to 2019, as detailed in appendix 6.9. The average occupancy rate of hotels and similar accommodation was higher in Lisbon's metropolitan area than the national average and the Algarve. The upward trend decelerated in terms of growth in 2018 and 2019, mostly due to an increase in the competitive environment brought about by the significant increment of alternative offers such as local accommodation (short-term rental). In what regards the occupancy rate of hotels and similar accommodation, Portugal was slightly above the European average in 2019. According to Eurostat, the EU average is 49.05%, being the leading countries Cyprus (71.8%), Malta (66.2%) and Spain (61.48%), while Portugal has an occupancy rate of 51.94% (Instituto Nacional de Estatística, I. P. 2020). According to UNWTO (2018), the occupancy rate in EU hotels was higher when the hotel size is larger, as a whole, establishments with 250 or more rooms had higher occupancy rates on average (66%), while those with less than 25 rooms have lower occupancy rates on average (33%). One should note that the monthly occupancy rate varies substantially in countries highly exposed to seasonality, which is Portugal's case. In fact, the average occupancy rate of hotels and similar accommodation in Portugal was higher in August (75.3%), followed by July (66.2%) and September (64%), when analysing this effect in the Algarve and Lisbon regions detailed in appendix 6.10, the seasonality impact on occupancy rates is more prevalent in the Algarve.

The revenue per available room (RevPAR) is also presenting a sustainable and robust growth in Portugal driven by an increase in prices and an improvement in occupancy rates, as detailed in appendix 6.11, the growth in RevPAR presented a double-digit rise from 2015 to 2017. In the last couple of years, it stabilized around 3.5% growth, mostly due to the competitive environment. Once again, the highlight goes to the region of Lisbon, which presented an impressive increase of 102% from 2012 (€40.55) to 2019 (€82). It is worth noting that RevPAR is similarly impacted by seasonality, being substantially higher during the summer months.

7 The Portuguese CRE market and Hotel Investments

The Portuguese commercial real estate (CRE) market is on an upward trend since 2012, mostly driven by the improved economic outlook of the country, the good financing conditions brought about by the low interest rate environment and a notorious growth in external demand from foreign investors wishing to diversify their portfolios. As a matter of fact, prior to the Covid-19 pandemic, the CRE market in Portugal was buoyant, reaching a new record in 2019 with sales of commercial property exceeding €3.5 billion (Athena Advisers 2020).

Traditionally, investment institutions rely on commercial real estate to diversify their investment portfolios and tend to limit most of their investment to core sectors such as retail, office and industrial properties. However, in recent years, a strong movement is taking place to diversify within property holdings, with hotel investments becoming increasingly popular among investors. Moreover, hotel operators are adopting an asset-light approach to their operations, being increasingly willing to sell their assets and enter into lease agreements so that they can avoid ownership risks. Thus, global hotel transaction volumes reached US\$66 billion in 2019 mainly due to the travel and tourism sector's positive performance, which led to new investors such as hedge funds and high-net-worth individuals to gravitate towards hotel assets for the first time (JLL 2020). As a result, private equity groups and generalist institutional investors that are yield-driven faced more competition in 2019 and continued to move towards secondary markets like Portugal. Hence, Portugal in 2019 registered the largest hotel real estate transaction by value to date, an acquisition by Invesco Real Estate of three hotels, *AVANI Avenida Liberdade Lisbon*, *Tivoli Avenida Liberdade Lisboa* and *Tivoli Oriente Lisboa* from Minor International for €313 million.

In Portugal, the most relevant asset management firms within the Portuguese real estate fund industry are Interfundos, Square Asset Management, Norfin, Fundger and BPI GA, who are also increasing their interest in hotel assets. In fact, many of them already have non-listed open-

end real estate funds with portfolios comprising assets under management (AUM) allocated to lodging properties. For instance, Square Asset Management that administers *CA Património Crescente* has 6.44% of AUM allocated to hotels for the purpose of diversification, being the fund awarded in 2020 by MSCI the “Best Balanced Real Estate Portfolio” for the tenth consecutive year.

7.1 BPI GA

Among Portuguese mutual fund managers, *BPI Gestão de Ativos* (BPI GA) is the third-largest in AUM, managing over €2.5 billion. Regarding commercial real estate investments, BPI GA’s major fund is *Imofomento*, an open-end real estate fund with a core investment style that is well-diversified through investments in various CRE sectors, including hotels, as detailed in appendix 7.1. *Imofomento* is the third-largest Portuguese open-end real estate fund in AUM, managing a total of €542 million. As of September 2020, within the portfolio, the fund had two hotel assets comprising around 5% of AUM, namely *Palácio Condes de Azevedo* and *Hotel Valverde*. Recently, the fund acquired the *Aqualuz Suite Hotel & Apartments*, another hotel property that increased the tourism sector’s weight on total AUM to 8.1% as of November 2020. Based on the valuation reports performed by *Garen – Avaliações de Ativos, Lda.* and *Prime Yield – Consultadoria e Avaliação Imobiliária, Lda.*, we will analyse *Hotel Valverde* and *Aqualuz Suite Hotel & Apartments* by applying the prior sections of this research.

7.1.1 Hotel Valverde

Hotel Valverde is a 5-star hotel located in Lisbon’s city centre, in the famous Avenida da Liberdade. The hotel presents a quality of furnishings and superior service near the highest standards, even though it is relatively small with only 22 rooms, the hotel aims to give a personal and exclusive level of service, therefore it is often described as a boutique hotel.

BPI GA acquired the property in June 2008 for €6.39 million, then it was converted into a hotel and opened to the public in July 2014, when the owner established a 15-year lease agreement

with the current tenant, *Vila Avenida Hotel S.A.*, which is the tenant responsible for the operation of both *Hotel Valverde* and *Palácio Condes de Azevedo*. BPI GA established a lease agreement with the tenant that includes a payment schedule of monthly fixed rents of around €15000, plus a percentage of sales exceeding a specified amount, which is incremental by the net profits of the hotel operation. According to *Garen*, under normal operations and assuming a reasonably efficient operator (REO), the variable rent can get around €31000 per month, which results in a possible total effective annual rent of around €550000 under normal business conditions.

Over the last four years, *Hotel Valverde* benefited from the growth verified in the Portuguese economy and tourism sector, reaching a peak in market value at €10.3 million as of December 2019 as detailed in appendix 7.2, before the Covid-19 pandemic affected the global economy and created uncertainty around the future prospects of the sector.

As of June 2020, *Garen* estimated the market value of *Hotel Valverde* at €9.2 million, representing around 44% capital growth since the acquisition date, mostly driven by the improved operating indicators that led to a better rooms department turnover and an overall increase in FMOP. These operational indicators, both occupancy rate and RevPAR, saw a particular robust growth in Lisbon's 5-star hotels' segment as described in appendix 7.3, with RevPAR increasing 79% from 2012 (€69.28) to 2019 (€123.94). According to *Garen's* valuation report, which considered the average daily rates practised in the market by similar properties during high and low seasons, *Hotel Valverde* had an appropriate ADR around €230 per night and the occupancy rate under normal business conditions was around 80%, which indicates a RevPAR 48% higher than the average 5-star hotel in Lisbon.

Regarding the appraisal expert's selection of capitalization rate, *Hotel Valverde* benefited from its premier location in Lisbon Zone 1 – Prime central business district (CBD). The property is highly visible near important national and international business headquarters, serving potential

business tourism and near luxury shops that appeal to high-profile tourists. According to the appraisal expert, the asset's quality is high with good finishes and excellent amenities, including a bar, restaurant, swimming pool, and a reading room. Moreover, the property is undertaking renovation work to improve common areas and increase room capacity.

Finally, in what regards the economic and market environment, the subject property benefits from its location. Lisbon registered a healthy hotel performance over the last decade, driven by robust tourism growth, which increased competition to acquire hotel properties. According to Cushman & Wakefield (2019), Portugal is consistently featured among the top target markets with high levels of transaction activity. Over the last years, 73% of properties transacted were Upscale to Luxury classes with investors preferring Lisbon and 59% of transacted volume involving non-branded properties pursuing value-added strategies by branding the acquired asset (Cushman & Wakefield 2019). Moreover, institutional investors from abroad are increasing the competition of traditional domestic players, which associated with the relatively limited number of properties on the market for sale, leads to compressing capitalization rates. According to Cushman & Wakefield (2019), based on actual available transactions and the investors' sentiment, Lisbon's hotel cap rates decreased from around 10% in 2012 to close to 6% in 2018. Altogether, these factors led to the appraisal expert selecting a capitalization rate for *Hotel Valverde* of 5.75%.

Overall, *Hotel Valverde* is considered a relatively low-risk investment that has provided *Imofomento* with strong capital returns since acquisition. The lease agreement presents a variable structure in line with the evolving trend of leases verified in the Iberian hotel investment market, which shifts some of the operational risks towards the owner. The property might be affected by competition in the future, with the majority of rooms' pipeline in Portugal expected for Lisbon within Upscale classes. In 2019, Lisbon counted with 22 new hotel establishments (Deloitte 2019). Moreover, non-branded properties will face competition from

branded ones, which take advantage of loyalty programs and appeal to the increasing number of international tourists visiting Lisbon. Furthermore, various international brands are introducing soft-brands into the market, driven by the desire to appeal to guests looking for authenticity from small and well-located independent properties. Many international chains keep their connection relatively hidden (*Ascend Collection* and *Autograph Collection*) while benefiting from chain systems and support.

Other risks might come from changes on the drivers of tourism demand originated from political tensions, terrorist attacks, environmental hazards or the weakening of economic indicators, as proven by the recent Covid-19 pandemic that impacted the economy and tourism demand. Moreover, the Brexit referendum effects are still materializing, and British citizens' overnight stays will likely decrease due to exchange rate depreciation of the pound and the possibility of overseas travel restrictions (Santos 2020). It is also worth noting that the recovery of selected competitive markets such as Turkey and Greece might also affect Portuguese tourism demand. Nonetheless, *Hotel Valverde* presents an advantage by reflecting individuality and unique personality as a boutique hotel, being a critical differentiator that meet today's demand needs.

7.1.2 Aqualuz Suite Hotel & Apartments

Aqualuz Suite Hotel & Apartments is a 4-star aparthotel that provides a solution for tourists that enjoy autonomous apartment-style living with the convenience of hotel-like amenities. The property is located in Lagos (the Algarve) and like most aparthotels, it is a traditional choice of long-stay leisure tourists. However, the recent trend of home-sharing has led some tourists to reconsider their short-stay accommodation choices and opt for aparthotels instead of traditional hotels, benefiting this type of lodging facility.

BPI GA acquired the property in November 2020 from *BLOCO Q – Sociedade Imobiliária, S.A.* for €22 million. *Aqualuz Suite Hotel & Apartments* has 202 autonomous fractions, from

which 179 are hotel apartments, and the remaining 23 are services to support the aparthotel such as a garage, restaurant, retail shops and a health & fitness club, in total the property has 25733 sqm. On the acquisition date, BPI GA established a 20-year lease agreement with *Aqualuz Turismo e Lazer Unipessoal Lda.* to operate the aparthotel, comprising a monthly fixed rent of €87500, annually updated according to inflation, plus a variable component representing 5% of the total gross operating result. According to *Prime Yield*, under normal business conditions and assuming a reasonably efficient operator (REO), the variable rent can get around €109000 per year, which results in a possible total effective annual rent of approximately €1.16 million under normal business conditions. Moreover, there is a second lease agreement with *Diamond Fitness Lda.* to operate the health & fitness club for ten years ending in May 2029 with a fixed monthly rent of €8500. Altogether, the annual rent obtained from the property can mount to €1.26 million.

Regarding the drivers behind the valuation's FMOP component, namely occupancy rate and RevPAR, the Algarve region has seen a robust growth similar to the country. The Algarve is a famous sun-and-sand tourism destination with several international awards, namely the "World's Leading Beach Destination" in 2020 from the World Travel Awards. Thus, over the past five years, tourism accommodation demand in the Algarve increased by 26% to 21 million overnight stays in 2019, which pressured overall operating ratios in the region upwards, including occupancy rate and RevPAR of 4-star aparthotels that saw a 69% increase in RevPAR from 2012 (€30.8) to 2019 (€52.1) as detailed in appendix 7.4. In Lagos, the demand for hotels and similar accommodation comes mainly from international tourists that represented 87.30% of overnight stays in 2019 as detailed in appendix 7.5, most of them travel by air. From 2014 to 2019, the International Airport of Faro increased the number of international passengers in 47%, recording 4.2 million airport arrivals in 2019.

Aqualuz Suite Hotel & Apartments, according to *Garen*'s valuation report, presents operating ratios in line with the ones recorded in the Algarve for this type of accommodation. *Garen* calculated the average daily rate based on similar properties in the region and adjusting for the high and low seasons, resulting on an appropriate ADR around €101 per night and the occupancy rate under normal business conditions around 52%, which indicates a RevPAR for *Aqualuz Suite Hotel & Apartments* similar to the average 4-star aparthotel in the Algarve.

In what regards the selection of the capitalization rate by the appraisal expert, *Aqualuz Suite Hotel & Apartments* benefits from a location close to the historic city centre of Lagos (2 km), the beach (1 km) and a golf course (3 km). However, the accessibilities are not as good, since the property is far from the International Airport of Faro (90 km). The amenities are adequate for 4-star classification quality standards, including four swimming pools, a spa, a restaurant serving local food, a bar, and a health club.

Finally, the region's economic and market environment is positive with the Algarve being a well-known and consolidated resort destination attracting foreign investors. According to Cushman & Wakefield (2019), the coastal areas outside prime cities attracted 49% of hotel investment in the Iberian Peninsula between 2014 and 2018. Moreover, many investors are gaining an appetite for new hotel segments such as innovative serviced apartment concepts driven by emerging generational mindsets (millennial tourists).

Moreover, driven mostly by new demand patterns, the boundary between short-stay and long-stay is less distinct, and new market concepts continuously blur the line between hotels and residential segments. Thus, hotel developers frequently incorporate ideas from all these segments interchangeably. Nowadays, the supply of aparthotels is relatively limited in Portugal and few branded products exist in the market, however, many international operators have plans to enter the market with disruptive concepts. Altogether, these factors led appraisal experts to select a capitalization rate of 8% for *Aqualuz Suite Hotel & Apartments*.

Overall, the two appraisal experts' market value estimation of *Aqualuz Suite Hotel & Apartments* made in June 2020 assume a negative impact of Covid-19 on operating ratios that lasts until 2023. Only afterwards experts consider the mentioned values under normal business conditions, resulting in an estimation of asset's market value around €25 million by *Garen* and €26.4 million by *Prime Yield*.

We can conclude that *Aqualuz Suite Hotel & Apartments* was a good investment decision made by BPI GA, by diversifying within the hotel segment and investing in aparthotels. Aparthotels are expected to grow in demand by meeting the new home-sharing trend that has led to the increase of short-term rental platforms such as *Airbnb* while guaranteeing guests an offer in terms of health, safety and hotel-quality amenities that assures the quality of stay. Like *Hotel Valverde*, *Aqualuz Suite Hotel & Apartments* investment is exposed to operating risks, since it has a variable lease structure and two different tenants.

Other risks for the property might come from the inability to attract long-stay tourism and create loyalty among new generational customers (millennials) due to the competition with new branded concepts. Moreover, high exposure to seasonality and over-tourism risks in the Algarve region can impact the property. It is also worth noting that all the risks applied to *Hotel Valverde* related to changes in drivers of tourism demand and recovery of selective competitive markets also apply to *Aqualuz Suite Hotel & Apartments*. Additionally, the Brexit referendum effects will likely be more significant on this property since the Algarve region is a preferred destination of British citizens (Ernst & Young - Augusto Mateus & Associados (EY-AM&A) 2018).

Moreover, the reliance on a significant share of international tourism might present additional risks related to the possibility of weakness in the main international markets visiting Portugal (UK and Germany) and the increased exposure to Faro airport's ability to meet demand needs by increasing the number of new city pairs and international arrivals capacity. According to

ANA airports' data from 2016, Faro airport relies mainly on low-cost carriers representing 71% of air traffic. Nowadays, low-cost carriers remain a significant share of arrivals and might be affected by a possible liquidity crisis and bankruptcies due to the Covid-19 pandemic.

Nonetheless, *Aqualuz Suite Hotel & Apartments* is well-positioned to attract leisure tourists wishing an apartment-style vacation with the convenience of hotel-like amenities. Moreover, the property might benefit from the increased legislation that aims to regulate the short-term rental sector promoted by digital platforms (*Airbnb* and *HomeAway*). Laws such as restricting the number of new establishments aim at diminishing the significant disruption these platforms can cause in the marketplace.

7.1.3 Sustainability issues of the Industry and ESG assessment

Over the last decade, Environmental, Social and Governance (ESG) issues have been rising, moving into the spotlight of many institutional investors wishing to manage the risks associated with them. The ESG issues relate to the natural environment's quality, the rights and interests of communities and the relationship between the management team, owners and remaining stakeholders (PRI Association 2018).

The lodging industry presents some material sustainability issues since its operations are relatively resource-intensive, relying heavily on human capital, which is typically low-skilled labour with long working hours. Moreover, hotel operations can negatively impact the local environment by being located in sensitive ecological habitats and mostly in coastal areas. Therefore, the mismanagement of material sustainability issues has the potential to affect assets performance and valuation (SASB 2014). According to SASB (2014), lodging industry characteristics are driving the importance of sustainability performance, mostly focused on the environment and human capital through issues related to ecosystem protection, climate adaptation, and fair labour practices.

Regarding the environment, hotel operations are mostly resourced intensive with sizeable physical infrastructure, thus requiring extensive and stable sources of water and energy. Large resort hotels in coastal areas are at most risk from flooding, weather changes and beach erosion. Owners need to pressure operators to manage resources efficiently to minimize externalities and harmful releases to the environment that contribute to the decline of local ecosystems. Climate change and rising sea levels lead to uninsurable buildings and might impact tourism activities by decreasing tourist traffic, representing a material risk for hotel assets (Kyriakidis and Felton 2008). Moreover, brand value is also increasingly affected by the effort to protect ecosystems through resource efficiency and the interest to protect local communities. Many companies address this issue by fostering high-profile partnerships and accreditations that help promote environmental concerns and share the company's stewardship message. For instance, *Fairmont Hotels and Resorts* has several projects that aim at ongoing operational improvements in waste management, energy and water conservation, and works to implement best practices to develop ways of reducing the carbon foot-print of hotels (Fairmont n.d.).

In what regards human capital, hotel operators should focus on delivering long-term value to employees by promoting employee engagement, incentives, proper compensation and diversity. The lodging industry is highly competitive and has limited skilled and talented human resources. Thus, it is of utmost importance to attract and retain highly competent employees by assuring employees' health and safety and promoting employee morale so that guests' experience is near the highest standards. Mismanagement of human capital can represent a material risk, in many jurisdictions resulting in legal and regulatory fines from labour law violations. Moreover, the high employee turnover typical of the lodging industry also represents a risk by resulting in adverse outcomes such as loss of skills, high costs of training, and lack of worker loyalty. Therefore, owners should engage with hotel operators to ensure fair labour practices are in place and to promote investment in programs to improve worker skills and

understanding of company values. Worker' satisfaction leads to improved interactions with guests and ultimately, better hotel performance (Madera, Dawson and Neal 2013).

Finally, BPI GA should consider the lodging sector ESG assessment and analyse how *Imofomento*'s hotel assets perform in terms of sustainability. We recommend using direct and indirect performance metrics collected from tenants' operations to draw a significant conclusion and define strategies to mitigate potential risks. Regarding environment issues, beyond the record of the number of lodging assets located in flood hazard areas and near areas of protected conservation status (the portion of assets in natural reserves), BPI GA should measure total energy consumed and total water withdrawn (percentage of water recycled). Moreover, BPI GA should promote alongside tenants the development of environmental management policies and active engagement with local stakeholders. To analyse human capital, we recommend that BPI GA records the employee turnover of its lodging properties (both voluntary and involuntary employee turnover). Moreover, BPI GA should register the number of legal settlements (related to labour law violations) and the average hourly wage of employees (including the employee's percentage earning the minimum wage). Altogether, addressing sustainability issues will positively impact lodging asset's financial results by improving the revenue and growth outlook and reducing operating expenses and contingent liabilities (SASB 2014).

8 Trends in the Lodging Industry

The lodging industry outlook remains positive over the long-term, even though some short-term headwinds caused by external shocks such as the Covid-19 pandemic brought some uncertainty. According to OECD (2020), tourism will likely continue the growth trajectory over the long-term, mostly driven by positive structural shifts, including technological, demographic and socio-economic changes fueling the tourism phenomenon.

Private sector initiatives and expansion plans aim to satisfy the new demand patterns and support this dynamic sector's growth. Moreover, governments are willing to develop policies that seek to maximize the benefits of tourism by leveraging digital transformation and ensuring sustainable tourism, promoting the travel and tourism competitiveness of such countries (OECD 2020).

According to UNWTO (2019), new consumer travel trends promoted by the rise of the “access” economy brought about by technology influence tourism products. Nowadays, consumers travel “to change” and “to show”, enjoying living like a local and looking for authenticity, transformation and experiences to record on social media. Thus, the industry's major players demonstrate an increased interest to meet changing guest expectations by moving from a traditional hospitality model to an augmented hospitality model. On this new model, companies offer the customer “money cannot buy” experiences, promoting the connection between guests and locals. Moreover, hotel companies are developing brands with strong personalities (soft brands and lifestyle brands) with open concepts, innovative digital ecosystems, strong F&B offers and modern designs.

Accor's expansion plan with new lifestyle brands joining the *Accor* universe reinforces their global leadership position in this sector, offering tourism products that look to compete with the alternative accommodation space provided by emerging start-up disruptors. An example is the launch of *Jo&Joe* in 2016, a millennial-focused hybrid brand that breaks traditional codes

by blending elements of a hostel, private rental and hotel. In addition, taking the trend a step further, *Accor* in partnership with *sbe Entertainment Group* (in brands such as *Hyde*, *Mondrian* and *Delano*) offers lifestyle luxury options mixing design-driven hotels with nightlife and disruptive F&B to appeal guests looking for a premium experience.

Another trend taking place in the industry is the consumers' growing desire for alternative lodgings with the boundary between long-stay and short-stay accommodation becoming less distinct. As the world adopts flexible working and living, the hotel sector is experiencing a blend of spaces with innovative serviced apartment concepts emerging. Consumers increasingly seek innovative formats, and new extended-stay conceptions aim at integrating those needs by offering design-led fully-equipped studios, socially immersive public spaces that encourage socializing and cultural well-being by immersing guests in local art and events within the hotel.

Several companies have new products on the pipeline with innovative concepts to adapt to customer expectations. In Europe, *Edyn's* expansion plans offer a destination-focused aparthotel model with designed environments and community immersion. At the same time, *Zoku* aims at creating a new category in the hotel industry with an aparthotel product marketed as a relaxed place to socialize, work and live.

According to JLL (2020), new investors are gravitating towards hotel assets, many for the first time, such as hedge funds and high-net-worth individuals. Institutional investors have currently around US\$330 billion of dry powder waiting for investment opportunities in the real estate sector. The rising interest from investors in the hotel industry performance will lead to some of that capital to be deployed into the global hotel investment market. Following that trend, many investors today are increasingly conscious of ESG issues. Thus, investors will look to opportunities in the hotel industry that meet sustainability ratings and have a positive environmental and social impact on local communities.

Consumers are also increasingly aware of sustainability issues and most look to pursue a healthy life, which will pressure hotel companies to be sustainable and integrate their tourism product offerings in the local environment in a non-invasive manner. Governments are also involved in the trend towards sustainable tourism by promoting forward-looking policies that aim at delivering net-benefits to local communities and combat climate change. According to UNWTO (2019), sustainability is a vital part of competitiveness as business and destinations can use resources efficiently and become more competitive.

9 Covid-19 impact on the Lodging Industry

The Covid-19 pandemic crisis brought uncertainty to the hotel and tourism sector, reducing the number of overnight stays drastically following government restrictions to contain the ongoing health crisis. According to the UNWTO (2020), there was a 70% decline in international tourist arrivals in the first eight months of 2020 relative to the homologous period. Even though international tourism was weak, the hotel business recuperation relied mostly on the strengthening of domestic tourism. Some analysts expect the sector recovery to take a smooth trajectory with ups and downs of operational indicators such as occupancy rate as governments gradually lift restrictions (Vokřínek 2020).

According to Cushman & Wakefield (2020), who interviewed several prominent Portuguese hotel and tourism stakeholders to understand how industry players are navigating these uncertainty times, the recovery will take a while. Nonetheless, it will generate important technological adoptions and innovations that will increase the industry's efficiency.

In the short term, there will be higher competition between hotels due to the overnight stay sharp decline, resulting in lower occupancy rates that will pressure prices down and reduce hotel profits. As a result, the more mainstream hotels that transmit a “cookie-cutter” feel to guests will suffer higher competition in this environment. In contrast, unique hotels with strong personalities are able to differentiate and continue to attract new demand (Cushman & Wakefield 2020). Additionally, many businesses that support the lodging industry such as restaurants and the arts, entertainment and recreation industry are facing difficulties due to the pandemic, which decreases the desirability and competitiveness of destinations.

The Covid-19 pandemic is likely to bring some cautious to hotel investors, especially the newcomers who did not fully realize the business's risks. Many investors adopted lease agreements with hotel operators (tenants) that enable higher returns with variable rent components, which also expose them to the business's operational risk. Thus, industry analysts

expect the number of transactions to decrease initially, followed by a smooth revival in transaction activity as investors gain confidence in the recovery driven by positive vaccine news.

For the long-term, this health crisis promoted changes in habits that might prevail, such as guests valuing hygiene and security of the hotel as much as they value location and price. Also, the crisis encouraged creativity among industry players that looked to create new products and solutions. The pandemic accelerated technology adoption with many hotel operators implementing mobile service payments, digital keys, and electronic locks. Also, hotel operators increased investment to engage with clients and maintain brand awareness to anticipate the recovery by creating new contents through online channels. Moreover, F&B was severely affected, and many hotels operated only the rooms department while diminishing F&B menus and operations by relying mainly on room service.

Furthermore, the Covid-19 pandemic had a significant impact on air travel with intercontinental flights (from Asia and America) decreasing substantially. Air travel recovery is likely to be slow with many low-cost and flagship carriers facing liquidity problems that might turn into bankruptcies. Several destinations that rely heavily on international tourists arriving by air will suffer until the air traffic recovers. To overcome this situation, national tourism agencies developed new models by promoting domestic tourism and rail connections as well as looked to attract new source markets.

Another impact of this Covid-19 pandemic is related to the deceleration in the growth of online short-term rental since many operators converted their local accommodation from the short-term rental on online digital platforms (*Airbnb*) into long-term residential contracts demand (Cushman & Wakefield 2020). Thus, there is an opportunity for aparthotels to gain demand share from the reduction of local accommodation supply. Moreover, the supply of new hotel facilities is also decreasing since hotel developers and companies are postponing construction

and opening plans, which might result in a considerable oversupply shock when the tourism sector recovers.

According to Cushman & Wakefield (2020) hospitality lab, even though forecasts are difficult to perform, industry players expect a return to levels close to normality only in summer 2021 with urban hotels benefiting from domestic tourism and reopening of retail activity. Many argue that the hotel sector is better capitalized than during the previous crisis (Global financial crisis of 2008) and will become more efficient as a result of new technological adoptions and strategic changes that improve the ability to overcome a future pandemic crisis better prepared.

10 Conclusion

The research seeks to support the client's understanding of the hotels commercial real estate sub-sector by analysing the Portuguese hotel sector performance, ESG issues, the lodging industry trends and the impact of Covid-19 on this industry. An analysis of two hotel assets belonging to BPI GA's open-end real estate fund *Imofomento* allows us to conclude that the fund's hotel investments presented a good performance. Moreover, the two assets have operating indicators above Portuguese averages, considering the location and type of accommodation and are well-positioned to navigate the industry trends.

Nonetheless, there are still some risks that might compromise the future performance of BPI GA's two hotel assets. On the short-term, the main one derives from the Covid-19's impact on the industry. The crisis impacted international tourists' arrivals, resulting in a decrease in hotel operating performance that affected the variable rent component of the owner's lease agreements.

In the long-term, the outlook is positive with BPI GA's hotel assets set to benefit from trends such as guest' interest in authenticity, uniqueness and alternative lodgings that may benefit the segments of boutique hotels and aparthotels. However, increased competition from branded chains and the rising consumer and investor's interest in sustainability might present a challenge. Thus, BPI GA should monitor properties risks and engage with tenants to address sustainability issues.

Overall, investor's interest in the industry and the long-term prospects of the sector demonstrate the desirable risk-reward profile. In 2019, the global hotel transactions reached US\$66 billion. However, investment value decreased in 2020 amid the Covid-19 pandemic with international investors retreating to their home markets. Nonetheless, investors are confident about the hotel sector long-term projections, since many institutional investors with a more extended investment horizon strategy are actively looking for opportunities.

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12 Appendix

Appendix Section 2: The Hospitality Industry

Appendix 2.1 – According to the UNWTO and WTO, over the last decade, the tourism industry has shown the capacity to compensate weaker exports in other categories by outpacing merchandise exports growth since 2012. Source: UNWTO (2019).

<https://www.e-unwto.org/doi/pdf/10.18111/9789284421152>

For the seventh year in a row, total export revenues from **international tourism** grew faster than merchandise exports

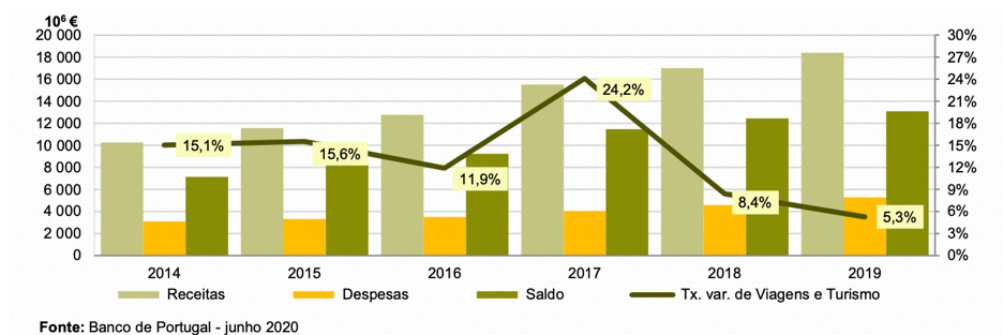


Export revenues from international tourism and merchandise exports (% change)

Source: World Tourism Organization (UNWTO) and World Trade Organization (WTO).

Appendix 2.2 – According to the Bank of Portugal data release, the BOP travel and passenger transports caption reached a new high in revenues and surplus in 2019. Columns refer to revenues, expenses and surplus, respectively. Source: INE (2020).

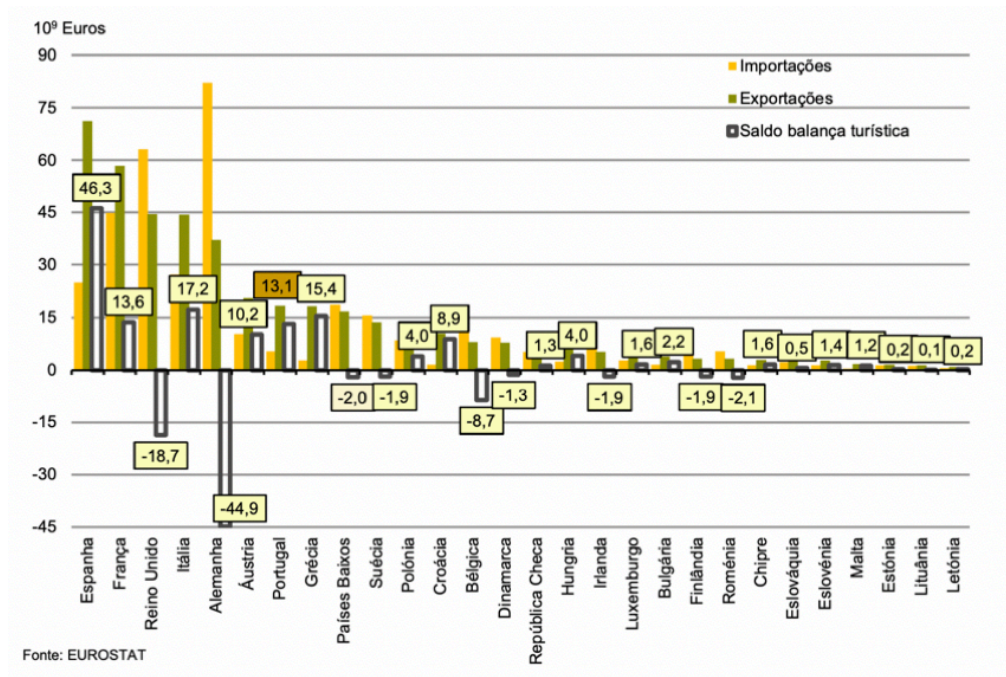
https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_publicacoes&PUBLICACOESpub_boui=133574&PUBLICACOESmodo=2



Fonte: Banco de Portugal - junho 2020

Appendix 2.3 – According to Eurostat, Portugal ranks 5th among EU countries in terms of tourism surplus in 2019. Columns refer to imports, exports and tourism balance surplus, respectively. Source: INE (2020).

https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_publicacoes&PUBLICACOESpub_boui=133574&PUBLICACOESmodo=2



Appendix Section 5: Valuation of Lodging Real Estate

Appendix 5.1 – Characteristics of a market area. Source: Andrew and Schmidgall (1993).

Characteristics	Description
Population	Size, gender and age
Income	Effective buying income
Retail Activity	Retail sales
Convention Activity	Size of the convention centre, number of conventions and number of delegates
Tourist Attractions	Attendance statistics and seasonality of attractions

Air and Highway Transportation	Major airlines serving the market area, historical and projected traffic counts and passenger activity
Employment	Labour force, unemployment, the estimated number of employees in the market area
Office Development	The square foot of major offices recently completed and under development
Area Development	Major projects planned, under construction or that will have an impact on the future demand of lodging properties

Appendix 5.2 – Characteristics of lodging properties. Source: Andrew and Schmidgall (1993) and Timothy and Teye (2009).

Characteristics	Description
Location	This refers to the location in relation to demand generators. Location can be urban, rural, mountain, airport, beach, lake, island, highway.
Accessibility/visibility	Accessibility is essential for properties dependent upon tourist business and located near highways.
Age & Size	Everything else being the same, the newer the better. Square meters, number of rooms and number of beds.
Rate structure	For price-sensitive markets, the lower the room rates, the better, assuming everything else constant. Lodging properties classify into budget, standard, deluxe or luxury.
Price/value	This refers to room rates compared with the service provided and concerning competitive properties.
Quality of facilities	Quality is judged relative to competitive properties. Adequate meeting space is essential for a convention lodging property and star ranking might be applied (1 to 5-star).
Affiliation and reservation system	Chain affiliates vary significantly in the number of room sales provided via their reservation systems.
Amenities	This refers to food and beverage facilities, gift shop, swimming pool, golf, spa, among others. Lodging properties classify in terms of amenities as full, limited services or all-suite.
Guest Profile	Leisure, corporate, family, gaming or conventions.
Corporate Structure	Independent, chain, franchise, management contract.

Appendix 5.3 – Characteristics of tourism trips. Source: United Nations (2010).

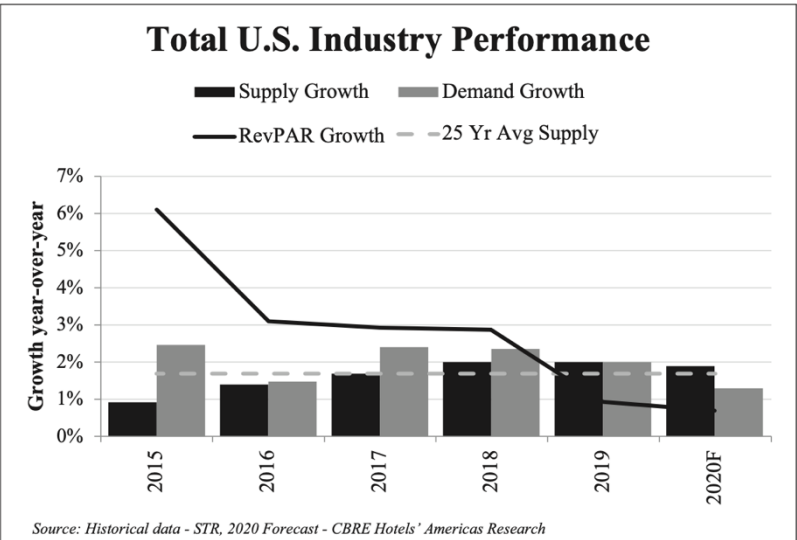
https://unstats.un.org/unsd/publication/seriesm/seriesm_83rev1e.pdf

Characteristics	Description
Main purpose	<ul style="list-style-type: none"> - Personal: Holidays, leisure and recreation; Visiting friends and relatives; Education and training; Health and medical care; Religion/pilgrimages; Shopping; Transit; Other. - Business and professional.
Types of “tourism product”	<p>The main types of “tourism product” are:</p> <ul style="list-style-type: none"> - City tourism; Sun-and-sand tourism; Agro-tourism; Health tourism; Winter tourism; Ecotourism; Culinary tourism; Other.
Duration of trip	<p>A trip’s duration is an important indicator to assess the level of demand for overnight accommodation services.</p> <ul style="list-style-type: none"> - Long stays (four nights or more); - Short stays (less than four nights).
Origin and destination	<ul style="list-style-type: none"> - Domestic tourism analysis should characterize the place of usual residence of the visitor; - Inbound Tourism classifies all arrivals by country of residence instead of nationality.
Modes of transport	<ul style="list-style-type: none"> - Air: Scheduled flight; Unscheduled flight; Private aircraft; Other modes of air transport. - Water: Passenger line and ferry; Cruise ship; Yacht; Other modes of water transport. - Land: Railway; Motorcoach or bus and other public road transportation; Vehicle rental with driver; Owned private vehicle; rental vehicle without operator; On foot; Other modes of land transport.
Types of accommodation	<ul style="list-style-type: none"> - Paid service accommodation: short-term accommodation (lodging properties); - Non-commercial accommodation: provided by family, friends or relatives; - No type of produced accommodation: the case of backpackers; - Alternatives to short-term accommodation: owned vacation homes and other forms of shared use and ownership (timeshares, fractionals, private clubs).

Appendix 5.4 – Historical development of supply, demand and revenue per available room (RevPAR) for the USA’s lodging industry given by STR and forecast for 2020 presented by CBRE Hotels’ Americas Research. Source: Host Hotels & Resorts 2019 annual report.

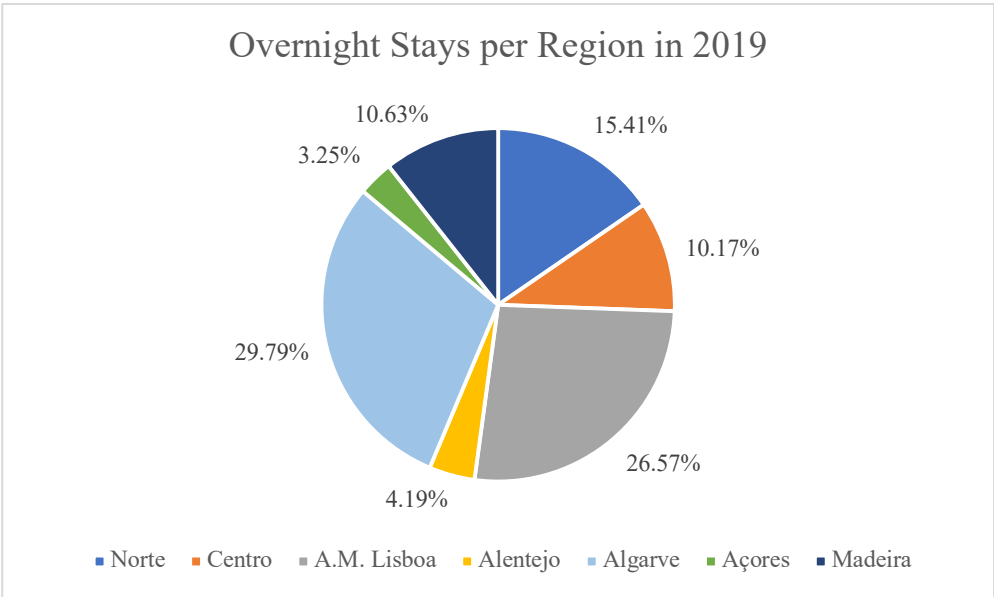
<https://ir.hosthotels.com/static-files/fad172fe-f1ed-42a6-8697-d39a31e3b58d>

U.S. Lodging Industry Supply, Demand and RevPAR Growth

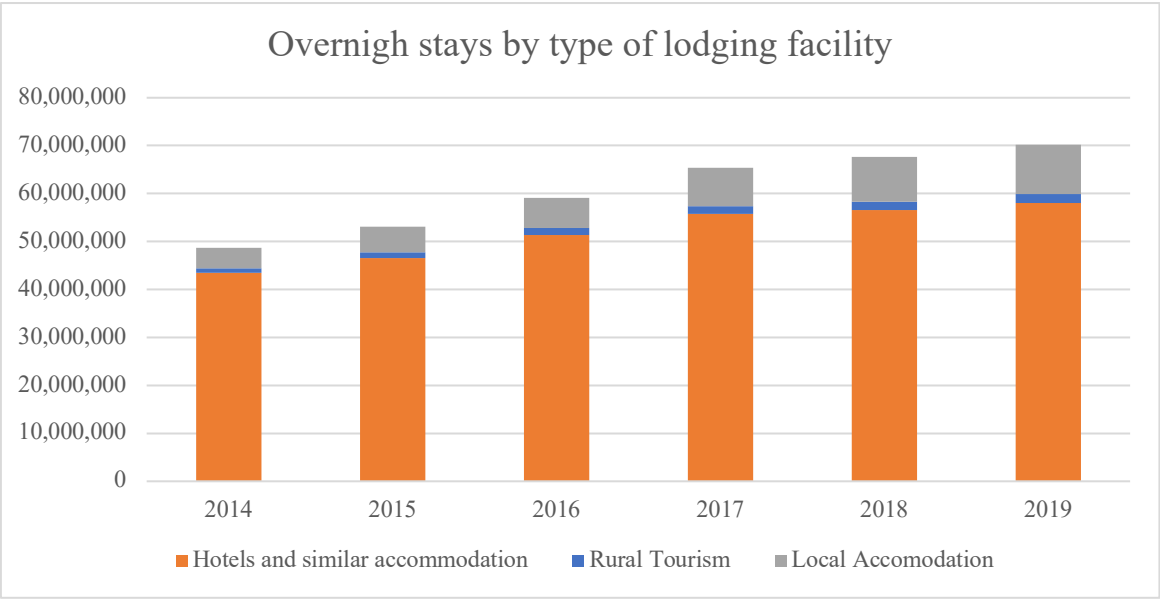


Appendix Section 6: Portuguese Hotel Market Overview

Appendix 6.1 – Demand in overnight stays by region of destination. Data source: INE (2020).

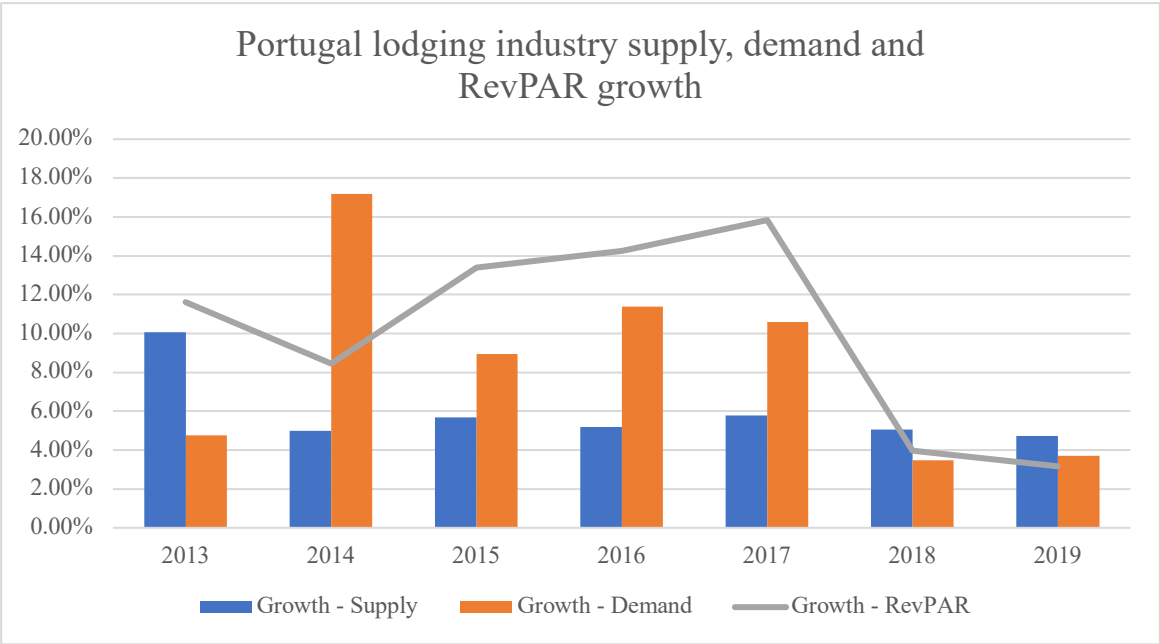


Appendix 6.2 – Demand in overnight stays by type of lodging facility. Data source: INE (2020).

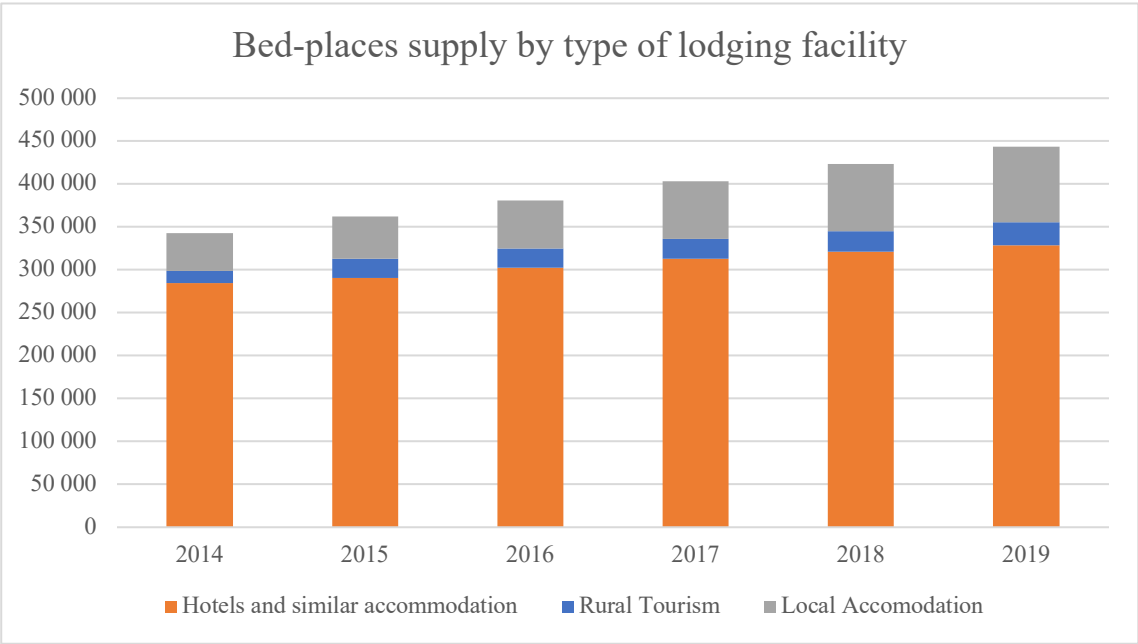


Appendix 6.3 – Portugal lodging industry competitive environment and impact on RevPAR.

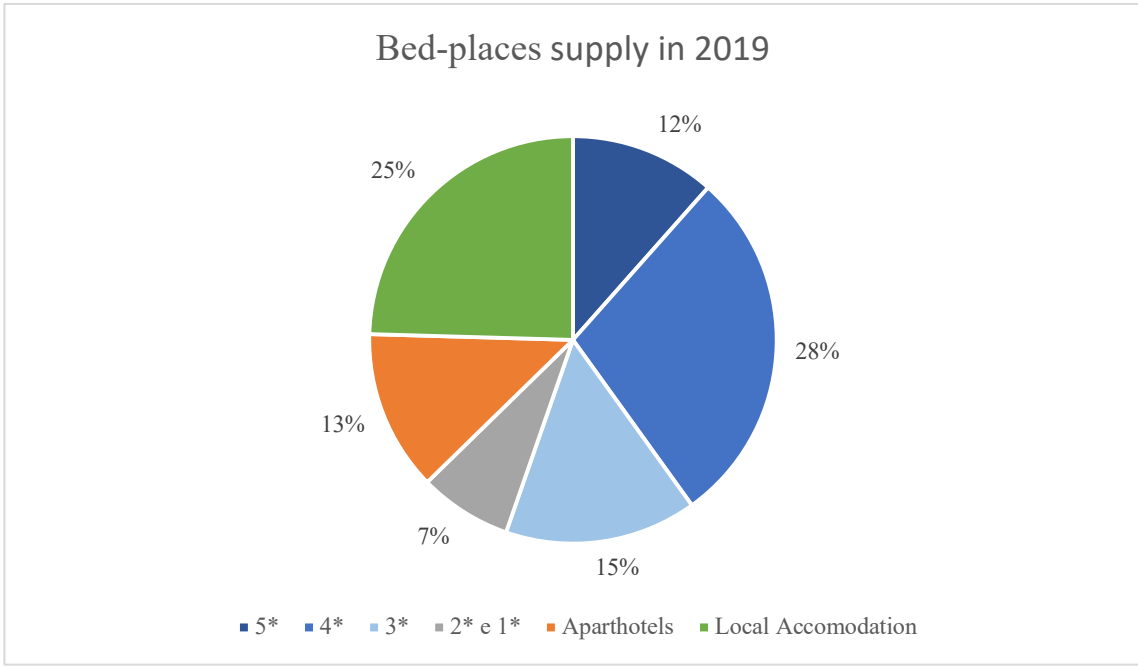
Demand (given by overnight stays), supply (provided by bed-places) and RevPAR growth of hotels and similar accommodation. Data source: INE (2020).



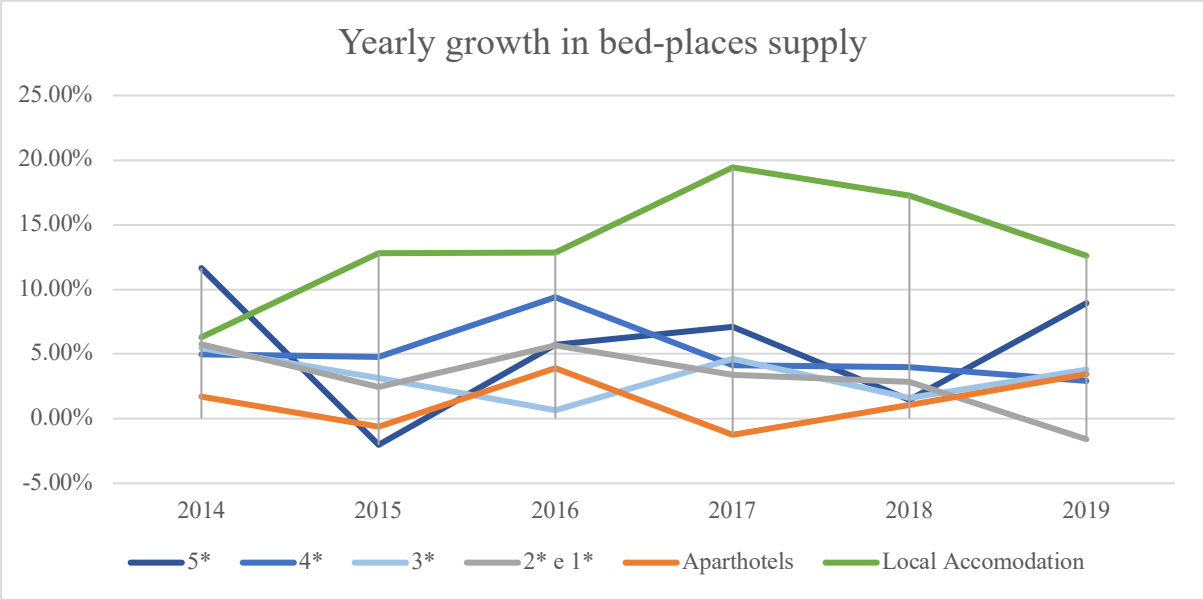
Appendix 6.4 – Portuguese supply of bed-places by type of lodging facility. Data source: INE (2020).



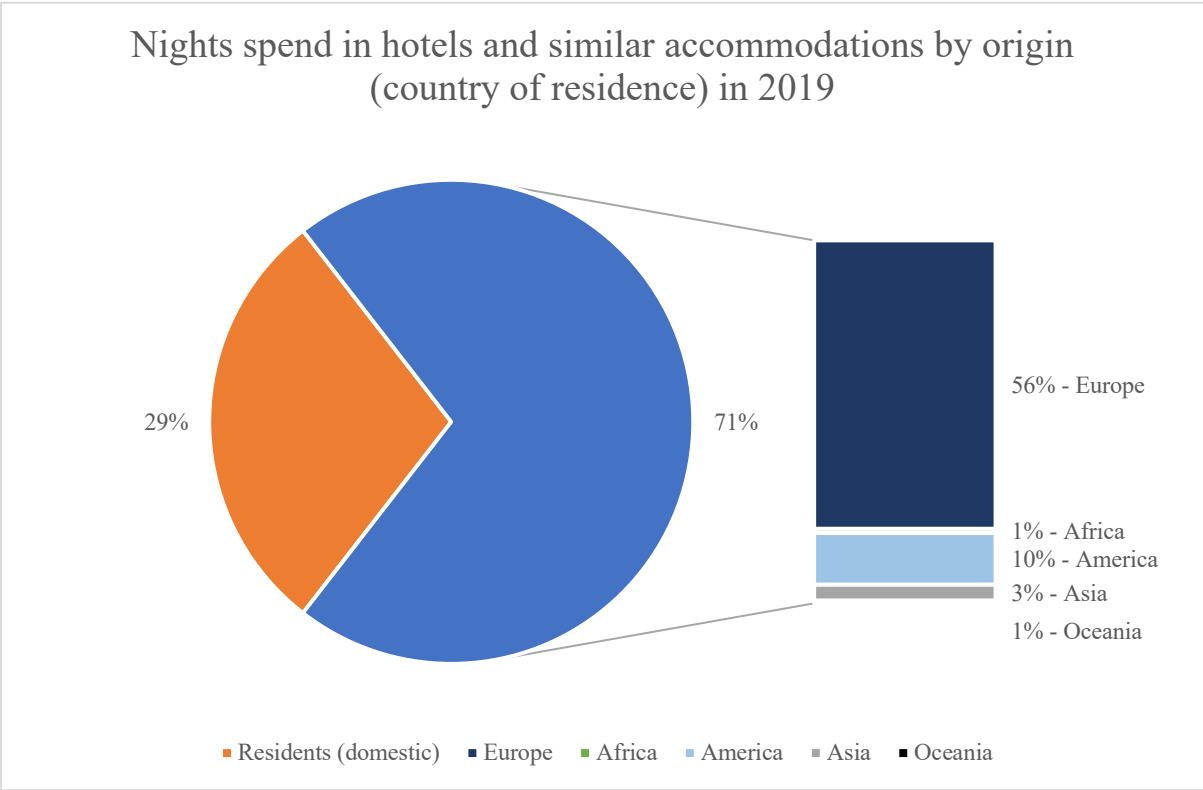
Appendix 6.5 – Hotels and similar accommodation and local accommodation supply of bed-places by type of lodging facility in 2019. Data source: INE (2020).



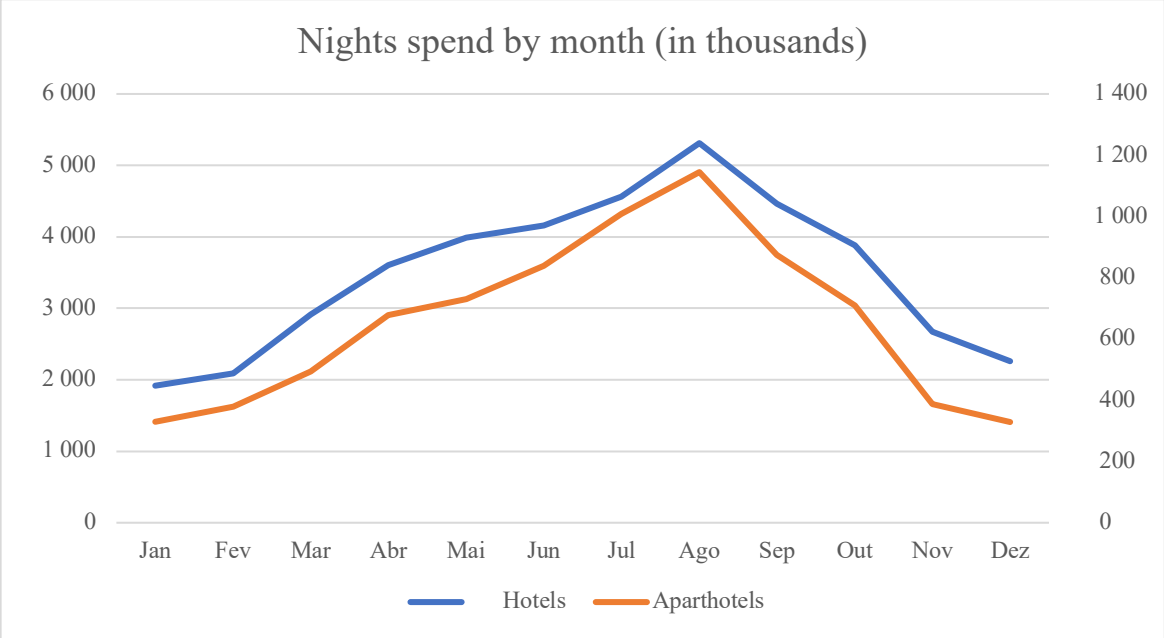
Appendix 6.6 – Yearly supply growth of bed-places by type of lodging facility, from 5-star hotels to aparthotels and local accommodation. Data source: INE (2020).



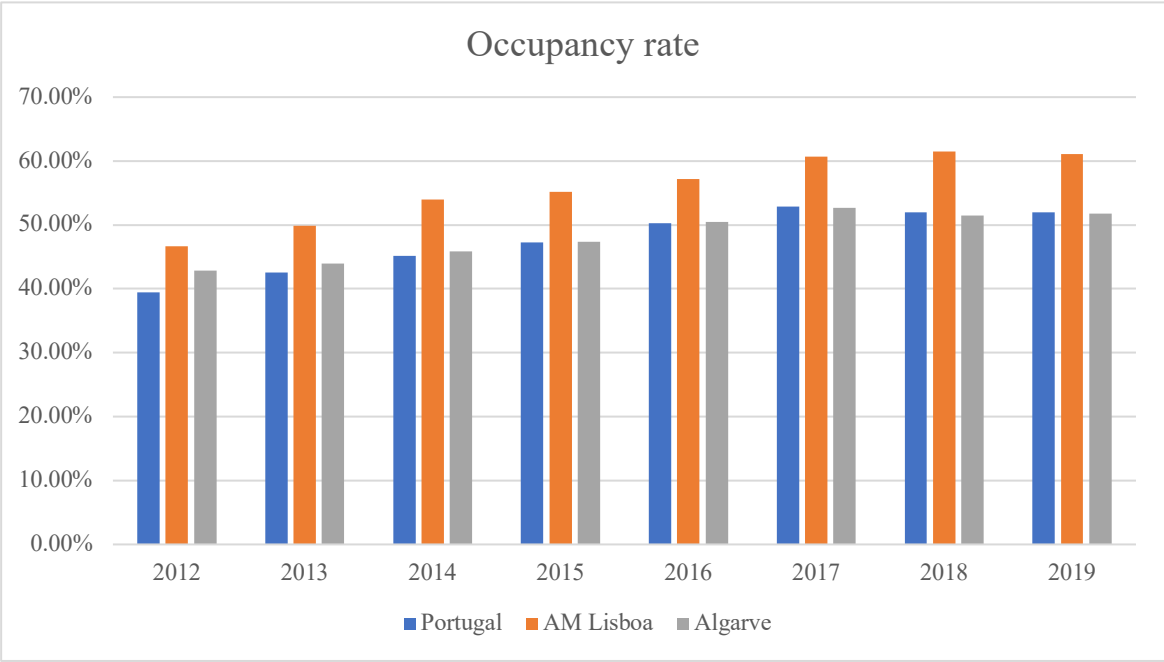
Appendix 6.7 – Segmentation of lodging demand between residents and non-residents. Data source: INE (2020).



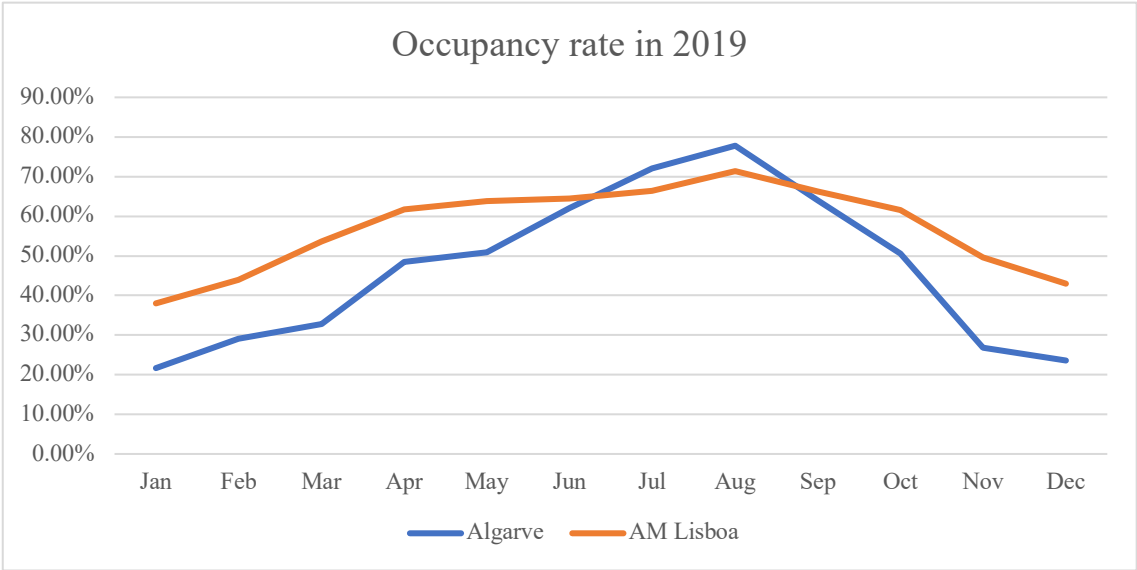
Appendix 6.8 – The impact of seasonality on hotels (primary axis) and apart-hotels (secondary axis) nights spend in 2019. Data source: INE (2020).



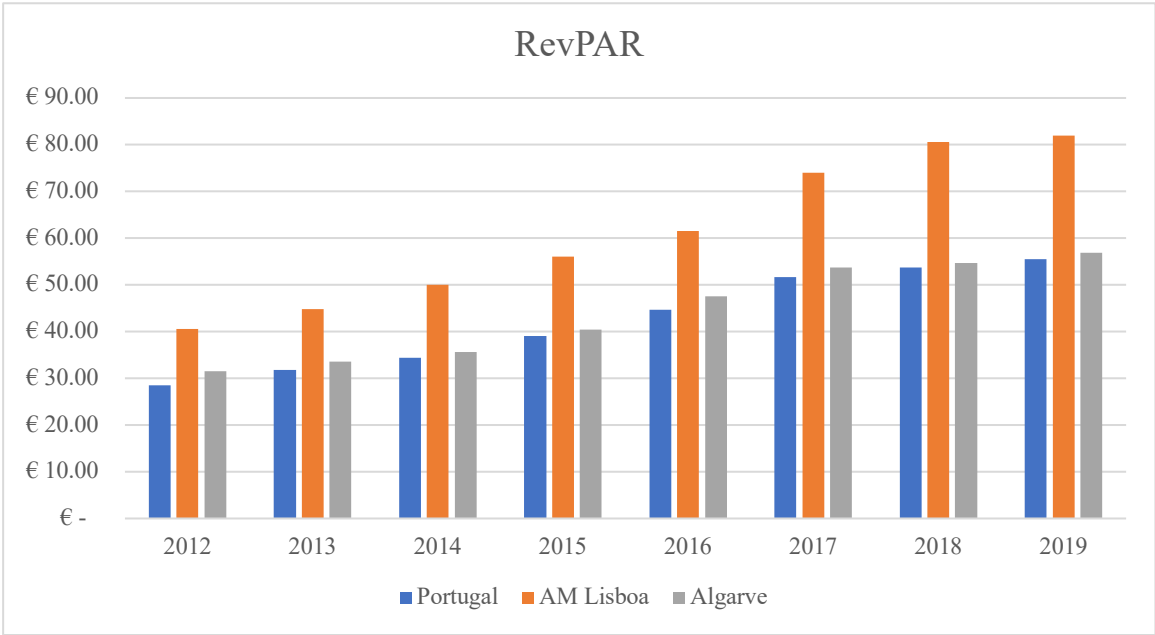
Appendix 6.9 – The development of the occupancy rate of hotels and similar accommodation in Portugal, the Algarve and Lisbon (NUTS II) from 2012 to 2019. Data source: INE (2020).



Appendix 6.10 – The impact of seasonality on hotels and similar accommodation occupancy rates in 2019. Data source: INE (2020).

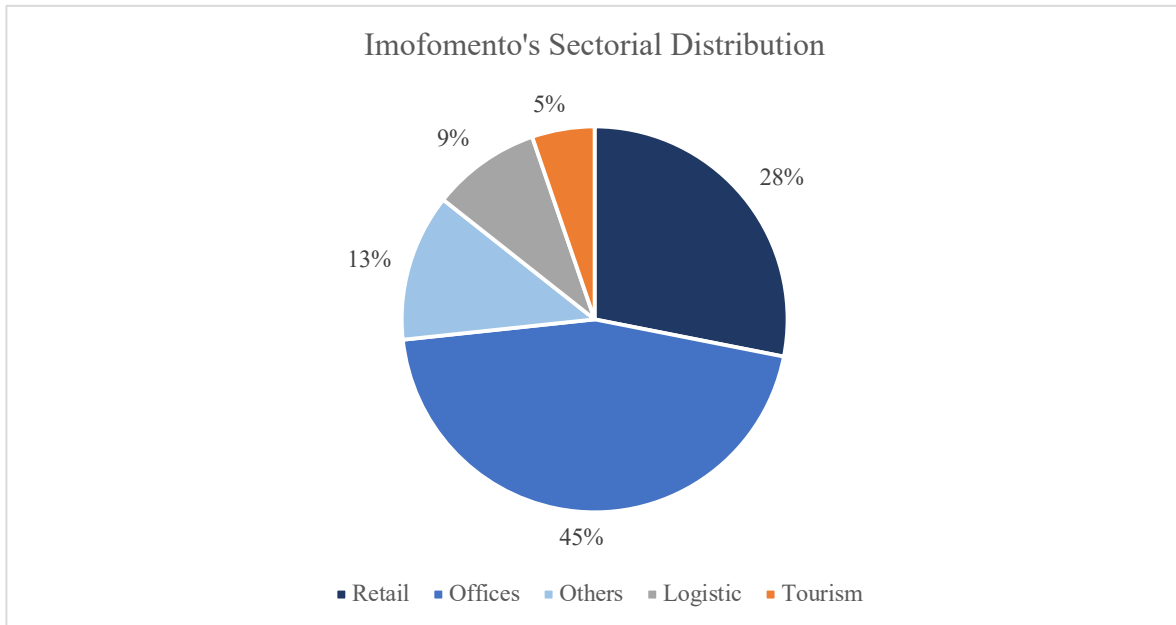


Appendix 6.11 – The development of RevPAR of hotels and similar accommodation in Portugal, the Algarve and Lisbon (NUTS II) from 2012 to 2019. Data source: INE (2020).

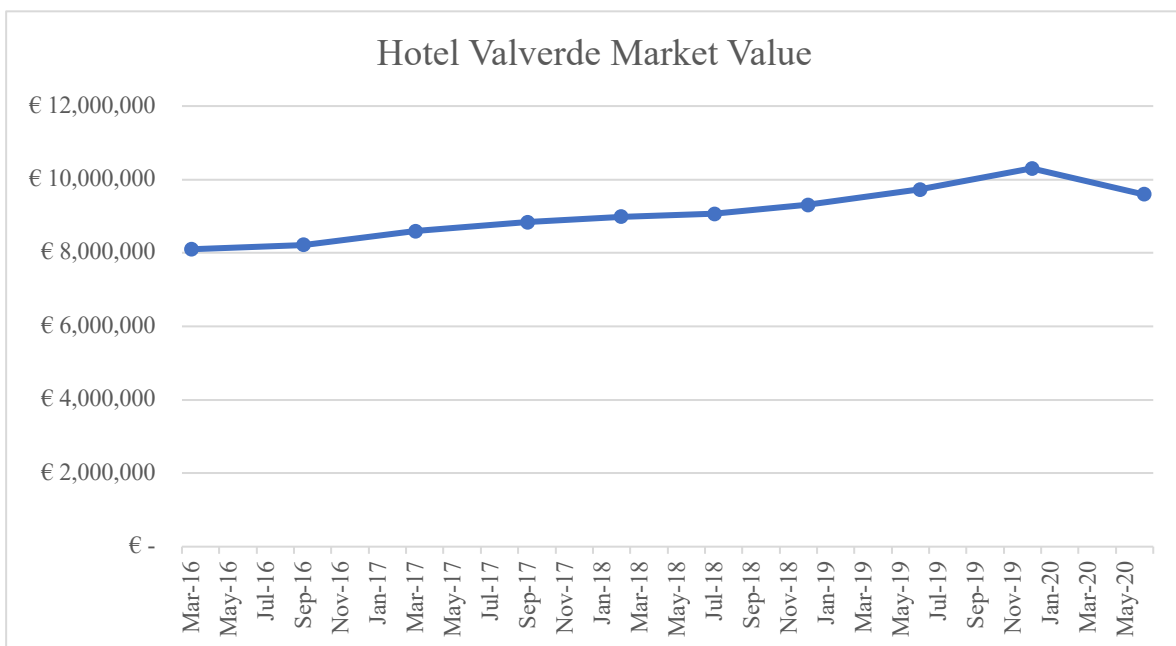


Appendix Section 7: The Portuguese CRE market and Hotel Investments

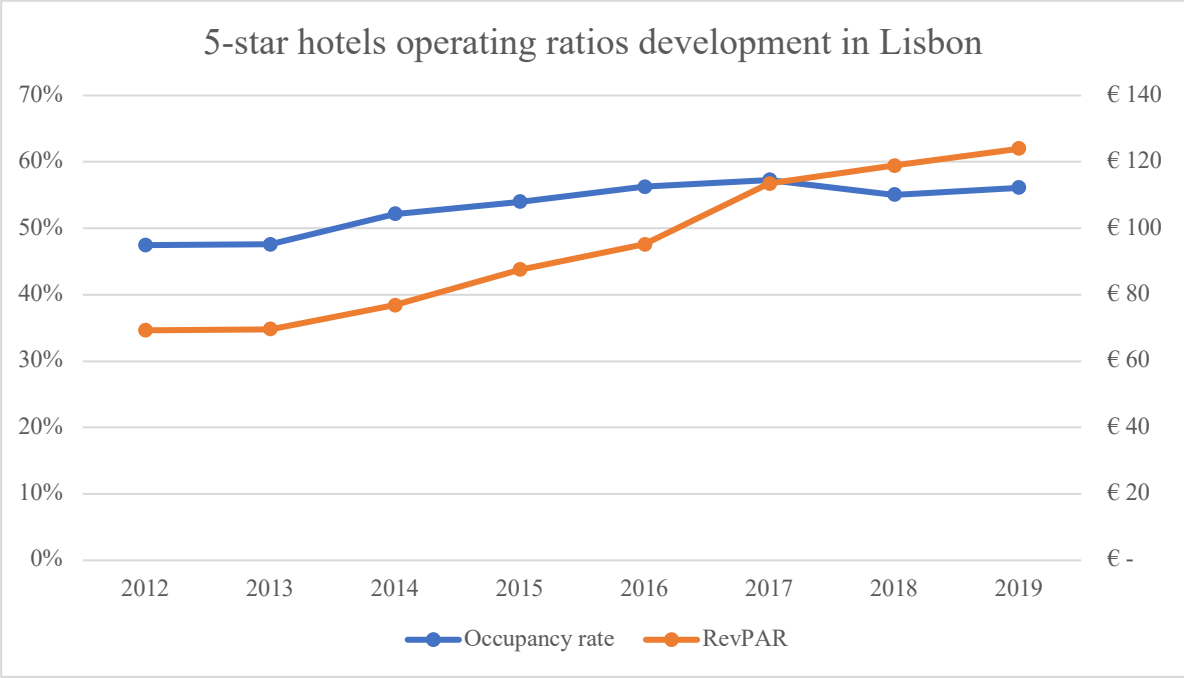
Appendix 7.1 – Imofomento’s portfolio as of September 2020 by sector. Data source: BPI GA



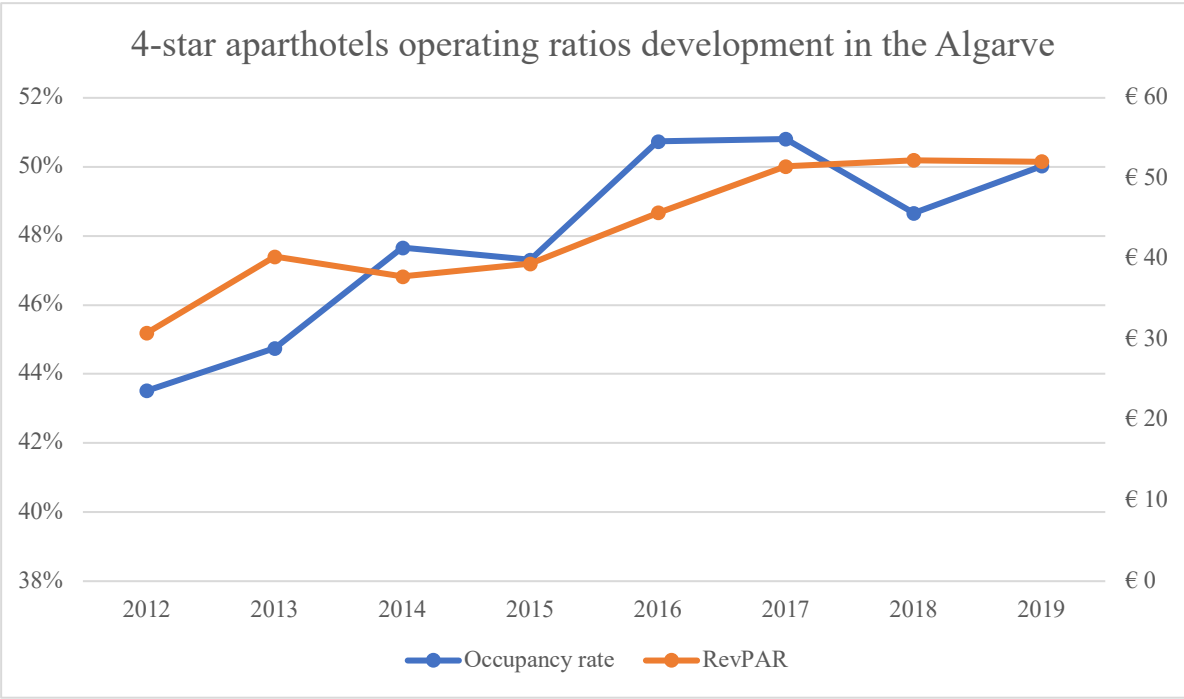
Appendix 7.2 – Market Value development of Hotel Valverde from 2016 to 2020. Data source: BPI GA.



Appendix 7.3 – Operating ratios (Occupancy rate and RevPAR) development of 5-star hotels in Lisbon from 2012 to 2019. Data source: INE (2020).



Appendix 7.4 – Operating ratios (Occupancy rate and RevPAR) development of 4-star aparthotels in the Algarve from 2012 to 2019. Data source: INE (2020).



Appendix 7.5 – Segmentation between residents and non-residents of overnight stays in hotels and similar accommodation in Lagos’ municipality from 2013 to 2019. Data source: INE (2020).

