OAKTREE INSIGHTS

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SPECIAL EDITION: INVESTING IN REAL ASSETS TODAY

OAKTREE

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INVESTING IN REAL ASSETS TODAY

FOREWORD

Oaktree recently hosted an investment professional panel to discuss investing in real assets today. John Frank, Oaktree's Vice Chairman, moderated the discussion and was joined by Emmett McCann (Co-Portfolio Manager, Infrastructure Investing), Keith Gollenberg (Managing Director, Real Estate), and Hermann Dambach (Managing Director, European Principal Group). What follows is based on that conversation.

John Frank: Keith, let me pose the first question to you. We've had an eight-year economic expansion in the U.S. The majority of your investments are in U.S. real estate debt and equity. Is this a good time to invest in real estate? Hasn't the recovery already occurred?

Keith Gollenberg, *Managing Director, Real Estate***:** After the recent financial crisis, we primarily focused on opportunistic real estate investments that we could buy, fix and then sell for a profit. These were largely "broken" assets in need of redevelopment, but in good locations across secondary real estate markets. While this side of the business has slowed down for core markets, we continue to find attractive opportunities in those secondary markets, though it's important to proceed with caution and discipline. In addition to opportunistic real estate, we also invest in performing real estate-related debt, and this side of our business has been growing tremendously, given the amount of outstanding real estate debt that needs to be refinanced. Traditional lenders such as banks, CMBS issuers and insurance companies won't lend at the leverage levels that real estate owners require. Before the crisis, banks were providing loans at 75% loan-to-value ratios ("LTV"), or greater. Today, however, more stringent regulatory standards have forced banks to require more borrower equity, meaning they are now only able to lend at 50-55% LTV. This has left a lending gap that is providing us with attractive opportunities to lend against performing real estate at up to 75% LTV.

John Frank: Hermann, how does this compare to the markets you cover?

Hermann Dambach, *Managing Director, European Principal Group***:** We see opportunities for similar reasons. German banks, for example, insist on 30% equity (that is, no greater than 70% LTV) and debt reduction via amortization. As a result, we are seeing attractive opportunities to lend to high-quality borrowers at LTV ratios closer to 85-90%.

John Frank: Emmett, there has been a lot of money raised for infrastructure over the years and returns haven't been [as high] as expected. What is your view on this?

Emmett McCann, *Co-Portfolio Manager, Infrastructure Investing***:** When I started investing in U.S. infrastructure 15 years ago, the mantra was "Infrastructure is like a bond: buy a toll road, throw it in your portfolio, let it throw off income, and don't worry about it." I remember an Australian investor who bought a toll road for 60 times EBITDA and levered it a further 40x; that didn't end well. The early infrastructure market left some scars. On a relative basis, infrastructure as an asset class has typically provided downside protection because of the predictable nature of its cash flows, but you are still investing in living, breathing businesses like airports and power plants. These are complicated businesses, with a lot of inefficiencies that can impact those cash flows. We take an operationally focused, value-add approach to our infrastructure investing. This means that in addition to having a team of individuals focused on spreadsheets, financial performance and capital structure, we also have a team of operators who have run these asset-heavy infrastructure businesses before and know how to improve operational efficiency and operating leverage. Our team looks for businesses with an essential purpose – such as power plants that sell electricity to big cities and waste management businesses – through multiple economic cycles. Then we take a private equity approach to improving businesses by, for example, building what we believe are best-in-class management teams. Like Oaktree's real estate team, we also like to "buy it, fix it and sell it profitably," to borrow Keith's expression, and we avoid highly levered investments like that toll road I mentioned because it's hard to reduce costs in a downside scenario with that kind of leverage in place.

John Frank: Keith, Emmett, I know local operators are important to your business. Can you please elaborate further on this?

Keith Gollenberg: We like to team up with local operating partners who specialize in the types of U.S. real estate we target: office, industrial, multifamily, hotel and residential. We think these partners can help us mitigate risks and enhance the value of these assets. A foreign owner doesn't have the relationship with the local leasing broker who is helping a local tenant look for space. These local relationships are important because they help us get increases in operating efficiencies and in rent.

Emmett McCann: Our deals require effective management of local dynamics and effective communication and coordination with local stakeholders. We feel this is best achieved by partnering with former industry executives who have the expertise and longstanding relationships that help facilitate this communication and coordination. For example, we have partnered with a former senior executive of Continental Airlines. Safety is his first, second and third priority, followed by operational excellence. He has a passion for transportation, so he is really drawn to the business and is able to work with important stakeholders. We also have a partner for our railroad investments who has worked on improving a number of small railroads (and I'd note that there are over 500 privately held railroads in the U.S.). Given their years of relevant industry experience, these operating partners have developed the regional expertise we need to succeed in acquiring and operating these infrastructure projects. We don't think success is possible without that kind of localized knowledge.

John Frank: Oaktree in general believes in specialization within our investment groups. I'll segue to Hermann, who represents that specialization in a particular way as head of our German office. His expertise has helped the managers of multiple Oaktree strategies avail themselves of opportunities in Germany and across Europe. Hermann, you are Oaktree's "local partner" for our strategies that target investments in certain jurisdictions such as Germany and the Netherlands. How do you work with operating partners?

Hermann Dambach: We have successfully employed operating partners across residential and commercial real estate and also in rail assets, whereby the asset value has been protected thanks to careful management by these operators. The common theme among these investments involves identifying an operating partner that we believe has a differentiated business model with the potential to add value and manage the assets better than their competitors. For example, we identified a locomotive-leasing business that, in addition to state-of-the-art equipment, provides a lot of services that add value for their customers. Lessees can lease these locomotives for the term of the freight contract (rather than having to buy them outright and incur significantly more acquisition and maintenance costs) and avail themselves of the company's support services. These services, in turn, allow the company to charge premium pricing for its locomotive leases, while enabling our smaller customers to compete with their larger, publicly traded peers. This leasing company has more than doubled its fleet and has begun to add more customers, including the big incumbents.

John Frank: I'm not sure there are industries that are more cyclical than real estate. Keith, how are you positioning your equity and debt activities based on our place in the cycle, particularly given our focus on protecting the downside?

Keith Gollenberg: Our job is to make sure we protect against the impact of the cycle going the wrong way. We don't bet on the upside case but instead focus on what could go wrong. So our first step is to underwrite what we can charge by renting or leasing the asset. Most of the real estate we look at for our Real Estate Opportunities strategy is privately owned and less liquid than a bond, so how you finance those investments is also important. I've been in the business for 30 years and have seen three major and three minor real estate cycles. Many foreclosed assets that we've purchased have turned into our best equity investments, enabling us to participate in the recovery. The key is not to sell – or be forced to sell – at the trough.

John Frank: Emmett, cycles don't seem as important for infrastructure. Do you agree?

Emmett McCann: We think primarily about secular themes that run through the assets we invest in over a long period of time and that are not impacted by short-term events. In energy, there is a massive amount of hydrocarbons that needs to be transferred to areas where people live. On the transportation side, American infrastructure is in terrible shape. It's embarrassing to travel through our airports and on our roadways. We now get a D+ up from a D-. The gravity of the situation has given rise to attractive investment opportunities. In the past, the U.S. has paid for infrastructure in three ways. First, we issue tax-exempt bonds, but we are hitting structural liquidity limits because states and cities can't issue debt forever. We also charge user fees like taxes, tolls and charges, but it's hard to increase these, given the anti-tax sentiment. Finally, we've paid for our infrastructure with federal dollars, but this was reduced under Obama and I'm fairly certain it won't increase under Trump. Sources of funds are dwindling and needs are increasing. PPP (the public-private partnership structure, which is one of the ways in which we invest) has become an entrenched part of the political vernacular. People still need to be educated on the concept, but it's becoming more familiar.

John Frank: We hear infrastructure spending is going to explode under Trump.

Emmett McCann: Infrastructure is more of a state and local game in the U.S. That's where decision-making authority resides. It's helpful when the President of the United States speaks of infrastructure spending, and he can prime the market and allocate federal tax dollars to the sector. But you need political will at the local level to enable the project to happen. The federal government can help – but not drive – an infrastructure project. For example, the La Guardia airport project in New York would not have happened if the local governor hadn't given his approval.

"Real estate and infrastructure are intertwined, and so you may have a waning real estate asset class that results in an uptick in infrastructure spending."
– Emmett McCann, Co-Portfolio Manager, Infrastructure Investing

John Frank: Hermann, is there a "cycle" that you can identify in your activities, and how do you think about investing at this stage of the cycle in Europe?

Hermann Dambach: I'll go back to the rail example since, like other aspects of transportation, rail assets are cyclical. Recently, European economies have started to expand again, and this is beneficial for demand. However, pricing is also cyclical, and we need to determine where we are in the cycle in order to assess the attractiveness of a particular investment. Pricing is primarily driven by supply and demand, and so far, new supply has not created overcapacity, which would potentially deflate secondary market values. Manufacturers have been disciplined on the production side, and low interest rates have not lifted values either. We think this is a good time to invest in rail assets. In addition, a few years ago the ownership of most locomotive leasing companies was transferred to private equity investors. Given their eventual need to exit, we expect to see – and perhaps participate in – a consolidation of these leasing companies in the next phase of the cycle.

John Frank: What should we do with shopping malls in the U.S.? Since Oaktree's approach to real estate is to buy, fix and sell, what's our approach to this asset class?

Keith Gollenberg: Since the financial crisis, we have invested approximately $18 billion of equity into real estate, and only a small number of these investments have been in the retail sector. The best-performing regional malls in the U.S. are owned by public REITS. They are "fortress" malls in great locations with great tenants for the local demographics. Other malls are showing significant signs of distress, and these could eventually be repurposed for higher and better uses such as parking lots in more urban locations, or even farmland outside the cities.

Hermann Dambach: Amazon is eroding the revenue base of malls in Germany. During the financial crisis, one of the first things that real estate investors bought was shopping malls. But the way forward for that theme is not as clear anymore.

Emmett McCann: What Keith and Hermann are alluding to could present some interesting transportation and infrastructure opportunities: there's a revolution going on in the way we as consumers get our goods, and those goods have to be transported. Whereas we used to go out and buy them, more and more they're being delivered to our doorstep. Amazon is buying its own planes and ships, and now logistics players are reacting. Real estate and infrastructure are intertwined, and so you may have a waning real estate asset class that results in an uptick in infrastructure spending.

Keith Gollenberg: And who knows? Farmland could be a target asset class for us one of these days.

BIOGRAPHIES

JOHN FRANK

Vice Chairman

Mr. Frank is Oaktree's Vice Chairman and works closely with Howard Marks, Bruce Karsh and Jay Wintrob in managing the firm. Mr. Frank joined in 2001 as General Counsel and was named Oaktree's Managing Principal in early 2006, a position which he held for about nine years. Prior thereto, Mr. Frank was a partner of the Los Angeles law firm of Munger, Tolles & Olson LLP. While at that firm, he acted as principal lawyer in a number of notable merger and acquisition transactions; as primary outside counsel to a number of public and privately held corporations; and as special counsel to various boards of directors and special board committees. Prior to joining Munger Tolles in 1984, Mr. Frank served as a law clerk to the Honorable Frank M. Coffin of the United States Court of Appeals for the First Circuit. Prior to attending law school, Mr. Frank served as a Legislative Assistant to the Honorable Robert F. Drinan, Member of Congress. Mr. Frank holds a B.A. degree with honors in history from Wesleyan University and a J.D. magna cum laude from the University of Michigan Law School, where he was Managing Editor of the Michigan Law Review and a member of the Order of the Coif. He is a member of the State Bar of California and, while in private practice, was listed in Woodward & White's Best Lawyers in America. Mr. Frank is a Trustee of Wesleyan University, Polytechnic School, Good Samaritan Hospital of Los Angeles and the XPRIZE Foundation.

HERMANN DAMBACH

Managing Director, Oaktree GmbH

Prior to joining Oaktree in 2004, Mr. Dambach served as an executive director in the Financial Sponsors department of Morgan Stanley. Before that, he spent four years at Credit Suisse First Boston in the Global Energy Group. Prior experience includes nine years with Chase Manhattan Bank AG and four years with Südwestdeutsche Landesbank. Mr. Dambach holds degrees in business administration for Banking & Management (Diplom Bankbetriebswirt) from Bankakademie Frankfurt e.V. and from Sparkassenakademie in Rastatt (Diplom Sparkassenbetriebswirt).

KEITH GOLLENBERG, CFA

Managing Director

Mr. Gollenbedrg joined Oaktree in 2008 as a senior member of the real estate team and focuses on the investment and management of its real estate funds. Mr. Gollenberg has extensive experience in the commercial real estate debt and equity markets, having originated, purchased or issued billions in whole loans, B notes, mezzanine, preferred equity, equity, CMBS, CDO, REIT, and other debt and equity investments. Prior to joining Oaktree, Mr. Gollenberg led the creation of and spent three years at CBRE Realty Finance, Inc., where he most recently served as Chief Executive Officer and President. Before that, Mr. Gollenberg spent over 21 years at CIGNA Investment Management, where he most recently served as senior managing director of Capital Markets, responsible for investing in and issuing all types of real estate debt products. Mr. Gollenberg received a B.S. degree in business administration with a concentration in accounting and economics cum laude from the University of Hartford. He is a CFA charterholder and served as Chairman of the Commercial Real Estate Finance Council.

EMMETT MCCANN

Managing Director and Co-Portfolio Manager

Mr. McCann is a managing director and co-portfolio manager of Oaktree's Infrastructure Investing strategy, specializing in the transportation sector. He joined Oaktree in 2014 from Highstar Capital with over 19 years of experience in private equity, investment banking and finance. Prior to joining Highstar in 2009, Mr. McCann helped lead Morgan Stanley's infrastructure effort in Europe and North America. Prior to joining Morgan Stanley, he worked in infrastructure investment banking at Goldman Sachs. Over his career, Mr. McCann has advised multiple government agencies (both in the U.S. and internationally) on Public-Private Partnerships ("PPP") across the transportation sector. Mr. McCann currently serves on the boards of directors of the Ports America Companies, Aerostar Airport Holdings, LoneStar Airport Holdings LLC and CrowdVision Ltd. He holds a B.A. degree in finance from the University of Wisconsin-Madison and an M.B.A. with honors from the University of Chicago.

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