THIRD AVENUE
MANAGEMENT

# REAL ESTATE VALUE FUND

AS OF SEPTEMBER 30, 2021

INSTITUTIONAL: TAREX | INVESTOR: TVRVX | Z: TARZX

PORTFOLIO MANAGER COMMENTARY

JASON WOLF, CFA | RYAN DOBRATZ, CFA

Dear Fellow Shareholders:

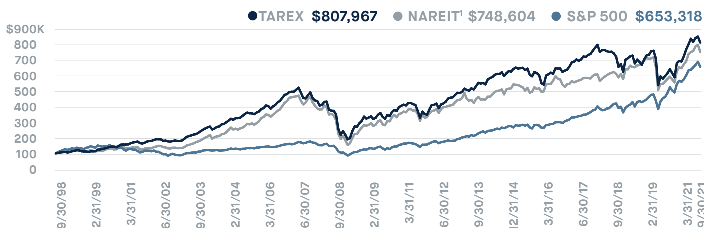
We are pleased to provide you with the Third Avenue Real Estate Value Fund's (the "Fund") report for the period ended September 30, 2021. Through the first nine months of the calendar year, the Fund generated a return of +17.02% (after fees) versus +15.26% (before fees) for the Fund's most relevant benchmark, the FTSE EPRA NAREIT Developed Index.[1]

The most notable contributors to performance during the period included the Fund's investments in a select-set of leading real estate management and services enterprises (Brookfield Asset Management, CBRE Group, and Savills plc) and the preferred equity of the Federal National Mortgage Association ("Fannie Mae"). The primary detractors during the quarter included the Fund's investments in Asia (CK Asset Holdings, Wharf (Holdings) Ltd., and Henderson Land)—each of which remains a positive contributor year-to-date, and importantly, very well capitalized and strategically positioned long-term in Fund Management's view. Further details on these holdings, as well as the Fund's recent investment in the common stock of Preferred Apartment Communities, are included herein.

Recognizing that security prices can fluctuate from quarter-to-quarter, and that true value-oriented investments oftentimes take years to materialize, Fund Management maintains the view that the Fund's long-term results are the most relevant gauge of performance. Since the Fund's inception in 1998, it has earned an annualized return of +9.49% (after fees). As highlighted in the chart below, this performance indicates that an initial investment of $100,000 in the Fund would have a market value in excess of $805,000 (assuming distributions had been reinvested), or more than the same $100,000 would be worth had it been placed into a passive fund tracking the Fund's most relevant benchmark (as well as the S&P 500).[2]

## VALUE OF $100,000 SINCE SEPTEMBER 1998

As of September 30, 2021




Hypothetical Investment since September 30, 1998 (Fund Inception Date September 17, 1998). **Past performance does not guarantee future performance results.**

## ACTIVITY

In the 2020 version of *House Prices and Rent*, famed co-authors Eugene F. Fama and Kenneth R. French note that "There is a large literature on the behavior of home prices. Rents get less attention." Such an observation seems to also be an apt description of the current reporting on the U.S. residential markets.

That is to say, recent trends relating to single-family housing are very-well documented with the combination of increased demand, limited supply, and record-low mortgage rates driving home price appreciation (HPA) of +19.2% over the past year (per the Federal Housing Financing Agency). On the other hand, rents for single-family and multi-family properties garner much less attention having only increased on a headline basis by +2.1% in the same period (according to the U.S. Bureau of Labor Statistics and outlined further in the Third Avenue Value Fund's recent shareholder letter).

Notwithstanding, those out in the field likely recognize that these nationwide rental figures mask some key trends. Notably, there is a wide disparity between markets, with certain regions experiencing remarkable rental rate growth (e.g., the top 10 markets in the Sun Belt region reported +14.6% increases year-over-year per the *Zumper National Rent Report*). Further, a rapid increase in construction costs has left developers commanding higher rents for new projects, thus lifting rates for existing product in competing sub-markets (e.g., industry contacts report a +25% increase in construction costs year-over-year excluding the land component).

In Fund Management's view, these trends are unlikely to abate in the near-term and serve to form a constructive backdrop for existing owners of class-A multi-family product in the major Sun Belt markets—including the Fund's most recent addition: Preferred Apartment Communities, Inc. ("Preferred Apartments").

Founded in 2011, **Preferred Apartments** is a US-based Real Estate Investment Trust ("REIT") that predominantly owns class-A multifamily properties and grocery-anchored shopping centers in the Sun Belt region. More specifically, the company owns (i) 11,400 multi-family units that were 96.8% leased at an average rent of $1,400 per month and (ii) 54 shopping centers were 91.1% leased with Publix and Kroger as the primary anchors—with more than 80% of its properties in Florida, Georgia, Texas, North Carolina, Virginia, and Tennessee.

While the company's portfolio is largely located in strong sub-markets and comprised of assets that provide predictable cash flows, Preferred Apartments has taken a less traditional route to accumulate these investments. To wit, at its inception, the

company was managed by an external adviser that pursued a strategy of issuing substantial amounts of preferred equity to fund the acquisition of a wide set of property types (e.g., multi-family, retail, office, student housing, etc.). The company also engaged in making selective loans for new construction, oftentimes with an option to acquire the properties from the developer upon completion.

However, Preferred Apartments changed paths in 2020 recognizing that companies with such a strategy rarely attain a competitive cost of capital (e.g., a stock price at, or above, Net-Asset Value or “NAV”). Since that time, the company has acted swiftly under its new CEO and (i) internalized its manager, (ii) monetized the vast majority of its office and student housing investments, and (iii) meaningfully reduced the amount of preferred equity outstanding with the proceeds.

Despite the progress, Preferred Apartments common stock continues to trade at prices that represent a discount to its peers—as well as Fund Management’s estimates of NAV. This is likely due to its continued diversified nature (the public markets tend to place a premium on single property-type enterprises) and higher than normal levels of preferred equity remaining (preferred equity typically accounts for 5-10% of company’s capital base relative to nearly 30% for the company today).

With that being the case, Preferred Apartments may very well take advantage of the strong “bid” for income-producing assets to further streamline its portfolio (as outlined in more detail in the Fund Commentary section), while also continuing to convert preferred equity to common stock. In the meantime, it seems likely that Preferred Apartments stands to benefit from the aforementioned fundamental backdrop. In fact, the company has reported that the rates for new leases in its multi-family portfolio had increased by +21.3% relative to the previous year through July 2021.

During the period, the Fund also increased its investment in **Wharf (Holdings) Limited** (“Wharf”). Held in the Fund in its current form since 2020, Wharf is a Hong Kong-based real estate operating company that owns a high-quality portfolio of commercial properties and a well-located land bank in Hong Kong and mainland China. Its income-producing assets are primarily comprised of a 20 million square foot portfolio of mixed-use properties that are located in strong sub-markets and more than 90% leased. Meanwhile, the company’s significant land bank is Hong Kong centric with unique holdings in Victoria Peak. To a lesser extent, the company is also involved with lodging and logistics through its Marco Polo-branded hotel assets and Modern Terminals subsidiary, respectively.

At its core, Wharf is precisely what Fund Management seeks out in listed real estate. The company is incredibly well capitalized with strategic assets and very modest debt levels (in this case net cash when factoring in its substantial securities portfolio). Wharf is also very well managed and overseen by an aligned control group (the Woo family owns more than 60% of the stock), which Fund Management has been invested alongside in various forms dating back to 2005. Further, the company has strong prospects to increase its corporate value through incremental leasing in its commercial portfolio, launching additional residential projects, and making timely acquisitions. For the time being, though, the company’s stock also trades at a material discount to NAV, currently priced below 50% of stated book value[3] and less than ten times recurring earnings.

However, similar to the Fund’s other holdings in the region (which accounted for 11% of the Fund’s total capital at the end of the quarter), Wharf’s stock price has declined more recently alongside valid concerns about the near-term prospects for the residential markets in Mainland China. While the Fund’s holdings have much more significant investments in other activities (e.g., recurring cash flow[4] investments such as commercial properties and other types of real assets), market participants seem to be reassessing any company with ties to the residential markets following the Chinese government’s implementation of its “Three Red Line” policy in June 2021.

At a high level, this policy limits activities for residential developers that do not meet certain financial metrics (i.e., less than a 70% liability to asset ratio, a net debt to equity ratio of less than 100%, and a cash to short-term-borrowing-ratio[5] of at least 1.0 times) and the ripple effects from these changes have already been far reaching. Most notably, the policy has led to liquidity concerns for a number of Chinese developers that are not expected to qualify without wholesale changes (e.g., China Evergrande, Fantasia Holdings, et al). As a result, property sales have stalled as prospective buyers (which tend to place deposits for future purchases) assess the impact on various developers and projects.

Although Fund Management does not anticipate a near-term resolution, it is very-much our expectation that these changes will lead to longer-term consolidation in the Chinese residential markets, thus leaving significantly higher market share in the hands of well-capitalized participants. In fact, it is not inconceivable that the Fund’s investments in the region could be a part of the solution. While they currently have less than 10% of their assets invested in related activities, on average, each entity easily qualifies under the “Three Red Line” guidelines and has a long-history of making credit-enhancing investments. For instance, it was just in 2012 that Wheelock & Co. (Wharf’s predecessor company) made a substantial capital infusion into China Greentown (a listed Chinese developer)—an investment that seemed contrarian at the time but ultimately proved to be quite rewarding for stakeholders.

In addition to these changes, the Fund also exited its position in the Class A shares of **Lennar Corp.** (the leading home-builder in North America by revenues) while retaining its much-more significant investment in the company’s Class B shares (which trade at more than a 15% discount to the A shares despite equal economics). Fund Management anticipates that Lennar will further outline its plans to split-off its ancillary businesses and other strategic investments in the months ahead. Estimated to include $5 to $6 billion of assets at book value (implying $16-19 per Lennar share), such a development would mark a significant transformation for this long-time holding. It could also recast **Five Point Holdings** (another core position in the Fund) given Lennar’s 40% ownership interest in this entity and its stated intention of “rationalizing” such investments (per the 2020 Annual Report).

The Fund also engaged in other modest activity, including (i) extending out its hedge on the Hong Kong Dollar, (ii) trimming back its holdings in Seritage Growth Properties, JBG Smith Properties, and CK Asset Holdings, and (iii) collecting a special dividend from Berkeley Group Holdings during the period.

## POSITIONING

After incorporating the activity in the period, the Fund had 41% of its capital invested in **Residential Real Estate** companies that have strong ties to the U.S. and U.K. residential markets, where there are serious supply deficits after years of under-building. In conjunction with record-low inventory levels and vacancy rates, there is also very substantial demand for new product at an affordable price point (both for-sale and for-rent). Therefore, these holdings seem poised to benefit from a further recovery in residential construction and ancillary activities. At the end of the quarter, these positions included a diversified set of businesses including homebuilding (Lennar Group and Berkeley Group), timberland ownership and management (Weyerhaeuser and Rayonier), land development (Five Point Holdings and Stratus Properties), the ownership and development of rental properties (American Homes 4 Rent, Grainger plc, Essex Property Trust, and Preferred Apartments), as well as other ancillary businesses (Lowe's and Trinity Place Holdings).

The Fund also had 38% of its capital invested in **Commercial Real Estate** enterprises that are involved in long-term wealth creation. These holdings are largely capitalizing on secular trends within property, including structural changes that are driving more demand for industrial properties and self-storage facilities (Prologis, Segro plc, First Industrial, U-Haul, Big Yellow, and National Storage) as well as the further densification and improvements taking place in select urban corridors (CK Asset Holdings, JBG Smith Properties, Derwent London, Henderson Land, Wharf Holdings, and Vornado Realty Trust). In Fund Management's view, each of these enterprises is very well-capitalized, their securities trade at discounts to private-market values (especially in light of the prevailing interest rate environment), and they seem capable of increasing NAV—primarily by increasing rents, undertaking development and redevelopment activities, as well as by making opportunistic acquisitions.

An additional 18% of the Fund's capital is invested in **Real Estate Services.** These businesses are generally less capital-intensive than direct property ownership and as a result have historically offered much higher returns on capital—provided the business has a favorable competitive positioning within the real estate value chain. At the present time, these holdings primarily include franchises involved with asset management (Brookfield Asset Management and Patrizia Immobilien), brokerage and property management (CBRE Group and Savills plc), as well as mortgage and title insurance (FNF Group, Fannie Mae, and Freddie Mac).

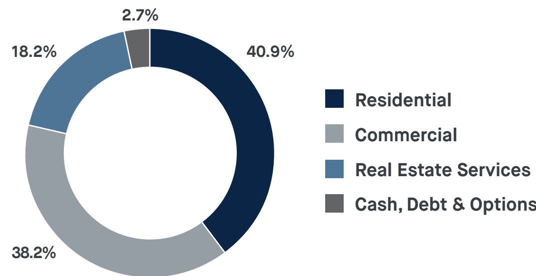
The remaining 3% of the Fund's capital is in **Cash & Equivalents.** The Fund also has certain hedges in place, primarily relating to its Hong Kong Dollar exposure.

The Fund's allocations across these various business types are outlined in the chart below. In addition, Fund Management reports the Fund's exposure by *geography* (North America, Europe, and Asia-Pacific) and *strategy* (Core/Core-Plus, Value-Added, Opportunistic, and Debt) for comparison with institutional reporting standards for direct real estate allocations.

### ASSET ALLOCATION AS OF SEPTEMBER 30, 2021

(allocations subject to change)

#### BY BUSINESS TYPE




#### BY GEOGRAPHY

#### BY STRATEGY

## FUND COMMENTARY

During the quarter, the Journal of Portfolio Management released its *Special Real Estate Issue* where its authors examined the historical performance of real estate private equity funds over a 20-year period (1999-2019). In addition, the authors carefully compared these results to other real estate alternatives such as (i) publicly-traded real estate (herein "listed real estate") and (ii) open-ended core property funds (herein "private-REITs") over the same period.

The materials from the study which most resonated with Fund Management included the findings that there was "a similar overall performance between real estate private equity funds and private-REITs" whereas "private equity real estate funds have underperformed listed real estate funds even before adjusting for risk, leverage, illiquidity and the uncertain investment timing associated with unfunded capital commitments." The study also noted that this report "provides additional support for the superior performance of listed real estate relative to a private market alternative."

Despite the findings, readers well versed in the real estate capital markets will likely recognize that there are tradeoffs associated with each type of allocation. For instance, real estate private equity funds are oftentimes able to undertake activities that listed real estate companies tend to eschew—which may provide outsized returns under skilled managers, such as large scale repositioning projects. Further, the returns generated by private-REITs may not have matched listed real estate on a historical basis, but the overall returns to its investors may have ended up being superior to the extent they remained invested throughout the period. That is not always the case in listed real estate, as the daily "mark-to-market"[6] of real estate securities oftentimes leads participants to exit at moments of uncertainty.

The simple fact is that all three types of allocations have their own merits and serve as critical components of the real estate ecosystem. Moreover, tracking the patterns of capital flows amongst these vehicles can oftentimes have important implications.

This is especially the case today as allocations to real estate and other "real asset" strategies are on the rise given the perceived combination of offering current yield and inflation protection—at the same time that the return prospects for more traditional allocations seem less attractive (as outlined in more detail in the Fund's recent shareholder letter). To put that in context, it is reported that the amount of "dry powder" in real estate private equity funds has reached record high levels exceeding $300 billion on a global basis (per Preqin). Further, the amount of capital flowing into the private-REIT format is accelerating with new subscriptions exceeding $3 billion per month in the US alone (per Robert A. Stranger & Co.).

In Fund Management's view, these capital shifts are likely to have two major ramifications for the Third Avenue Real Estate Value Fund. One, the Fund has important investments in certain real estate (and real asset) managers that are receiving a significant share of these allocations, thus expanding the value of their franchises in the process (e.g., Brookfield Asset Management, Prologis, Patrizia Immobilien, CBRE Group, and Savills). Two, it seems as if buying portfolios from listed real estate players (or even public companies outright) will be the path of least resistance for the sponsors of these private vehicles to deploy such large sums of capital.

The latter point here is particularly notable. More explicitly, the Fund's decades-long strategy of investing in the securities of real estate enterprises that control desirable assets (but trade at discounts to the private market value of their corporate values for temporary reasons) often means the "catalyst" for surfacing value is some type of resource conversion event (e.g., mergers, acquisitions, privatizations, spin-offs, et al).

Therefore, Fund Management anticipates that the pace of corporate actions involving the Real Estate Value Fund's holdings will gather momentum in the ensuing quarters (please see the historical list below). Not only would such activity highlight value for certain positions, it would also supplement the *Special Real Estate Issue's* noted appeal of listed real estate with one other compelling aspect. That is, the proposition of being able to buy into very-hard-to-replicate real estate enterprises at prices that are substantially less than what a "control buyer" would pay for the assets in a negotiated transaction.

## THIRD AVENUE REAL ESTATE VALUE FUND MERGER & ACQUISITION ACTIVITY (2010 – 2021)

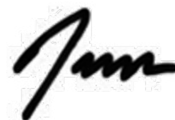
| Company | Offer Date | Exposure |
|---|---|---|
| St. Modwen Properties | May-21 | U.K. logistics and housing |
| Wheelock and Company | Feb-20 | Hong Kong and China, residential, retail etc. |
| Forest City Realty Trust | Jul-18 | NYC office, life science, retail, multifamily |
| Westfield Corporation | Dec-17 | U.S. and U.K. malls |
| Global Logistics Properties | Jul-17 | China/Japan/U.S. logistics |
| Post Properties | Aug-16 | U.S. Sun Belt multifamily |
| Newhall Holding Company | May-16 | Californian master-planned communities |
| Parkway Properties | Apr-16 | U.S. Sun Belt office |
| Songbird Estates | Nov-14 | Canary Wharf |
| Commonwealth Property Office | Oct-13 | Australian office |
| Thomas Properties | Sep-13 | U.S. Sun Belt office |
| Prologis European Properties | Apr-11 | European industrial assets |
| Wheelock Properties | Apr-10 | Hong Kong real estate development |

Source: Company reports, press releases, Third Avenue Management.

We thank you for your continued support and look forward to writing to you again next quarter. In the meantime, please don't hesitate to contact us with any questions, comments, or ideas at realestate@thirdave.com.

Sincerely,

The Third Avenue Real Estate Value Team



Jason Wolf, CFA

Ryan Dobratz, CFA

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This publication does not constitute an offer or solicitation of any transaction in any securities. Any recommendation contained herein may not be suitable for all investors. Information contained in this publication has been obtained from sources we believe to be reliable, but cannot be guaranteed.

The information in this portfolio manager letter represents the opinions of the portfolio manager(s) and is not intended to be a forecast of future events, a guarantee of future results or investment advice. Views expressed are those of the portfolio manager(s) and may differ from those of other portfolio managers or of the firm as a whole. Also, please note that any discussion of the Fund's holdings, the Fund's performance, and the portfolio manager(s) views are as of September 30, 2021 (except as otherwise stated), and are subject to change without notice. Certain information contained in this letter constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "project," "estimate," "intend," "continue" or "believe," or the negatives thereof (such as "may not," "should not," "are not expected to," etc.) or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events or results or the actual performance of any fund may differ materially from those reflected or contemplated in any such forward-looking statement. Current performance results may be lower or higher than performance numbers quoted in certain letters to shareholders.

Date of first use of portfolio manager commentary: October 15, 2021

1 The **FTSE EPRA/NAREIT Developed Real Estate Index** was developed by the European Public Real Estate Associa on (EPRA), a common interest group aiming to promote, develop and represent the European public real estate sector, and the North American Association of Real Estate Investment Trusts (NAREIT), the representative voice of the US REIT industry. The index series is designed to reflect the stock performance of companies engaged in specific aspects of the North American, European and Asian Real Estate markets. The Index is capitalization-weighted. Please see Appendix for performance table and information.

2 **S&P500 Index** - The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S.

3 **Book Value** - Book value can be thought of as the net asset value (NAV) of a company, calculated as its total net assets minus liabilities.

4 **Cash Flow** – The term cash flow refers to the net amount of cash and cash equivalents being transferred in and out of a company.

5 **Cash-to-short-term-borrowing-ratio** – The cash ratio is a measurement of a company's liquidity, specifically the ratio of a company's total cash and cash equivalents to its current liabilities. The metric calculates a company's ability to repay its short-term debt with cash or near-cash resources, such as easily marketable securities.

6 **Mark-to-market** - Mark to market (MTM) is a method of measuring the fair value of accounts that can fluctuate over time, such as assets and liabilities.

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# REAL ESTATE VALUE FUND

AS OF SEPTEMBER 30, 2021

INSTITUTIONAL: TAREX | INVESTOR: TVRVX | Z: TARZX

## FUND PERFORMANCE

As of September 30, 2021

| | 3 mo | 1 yr | 3 yr | 5 yr | 10 yr | Inception | Inception Date |
|---|---|---|---|---|---|---|---|
| Third Ave Real Estate Value Fund (Inst. Class) | -0.59% | 31.91% | 4.04% | 4.69% | 9.46% | 9.49% | 9/17/1998 |
| Third Ave Real Estate Value Fund (Inv. Class) | -0.63% | 31.61% | 3.79% | 4.43% | 9.18% | 7.49% | 12/31/2009 |
| Third Ave Real Estate Value Fund (Z Class) | -0.59% | 31.99% | 4.13% | N/A | N/A | 2.24% | 3/1/2018 |

## TOP TEN HOLDINGS

Allocations are subject to change without notice

| | TAREX |
|---|---|
| Five Point Holdings, LLC, Class A | 7.6% |
| Brookfield Asset Management, Inc. | 7.5% |
| Lennar Corp. | 5.9% |
| Prologis, Inc. | 5.4% |
| Weyerhaeuser Co. | 5.0% |
| Rayonier, Inc. | 5.0% |
| AMERCO | 4.6% |
| Segro PLC | 4.5% |
| CK Asset Holdings, Ltd. | 4.1% |
| Lowe's Companies, Inc. | 4.0% |
| **Total** | **53.6%** |

**Past performance is no guarantee of future results; returns include reinvestment of all distributions. The above represents past performance and current performance may be lower or higher than performance quoted above. Investment return and principal value fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. For the most recent month-end performance, please visit the Fund's website at www.thirdave.com. The gross expense ratio for the Fund's Institutional, Investor and Z share classes is 1.18%, 1.47% and 1.08%, respectively, as of March 1, 2021. TAM has agreed to waive all accrued entitlements related to the fiscal periods Oct 31, 2017 and Oct 31, 2018, which would have been subject to repayment until Oct 31, 2020 and Oct 31, 2021, respectively.**

**Distributions and yields are subject to change and are not guaranteed.**

**Risks that could negatively impact returns include: overbuilding and increased competition, increases in property taxes and operating expenses, lack of financing, vacancies, environmental contamination and its related clean-up, changes in interest rates, casualty or condemnation losses, and variations in rental income.**

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Current performance results may be lower or higher than performance numbers quoted in certain letters to shareholders.

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Third Avenue offers multiple investment solutions with unique exposures and return profiles. Our core strategies are currently available through '40Act mutual funds and customized accounts. If you would like further information, please contact a Relationship Manager at:

622 Third Avenue, 32nd floor
New York, New York 10017
www.thirdave.com

**E:** clientservice@thirdave.com
**P:** 212.906.1160