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BARON CAPITAL

The Case for Real Estate: Opportunities Abound
With Jeff Kolitch

This is an edited version of a May 20, 2020 Q&A with Jeff Kolitch, Portfolio Manager of Baron Real Estate Fund and Baron Real Estate Income Fund. To access the recording, please dial 866-595-5357, passcode 3318493#.

Key Discussion Points

Perspective on the current real estate market

Continue to be bullish about the prospects for public real estate securities. Positives include: historically low interest rates and mortgage rates, tremendous monetary and fiscal stimulus, minimal inflation, lack of excess supply of real estate inventory, solid balance sheets, and exceptionally attractive valuations

Takeaways from recent earnings calls with real estate companies

Better than feared for most real estate-related companies – REITs and non-REITs (notwithstanding hospitality-related real estate companies). Generally encouraged by most recent trends particularly in the housing market – business troughed in mid-April, strong improvements in second half of April and in May.

The private equity landscape

Private equity firms have begun to invest in public real estate securities due to favorable valuations starting to allocate significant capital to the public real estate markets

Real estate remains "on sale" in the public markets

Despite a rebound in several stocks, many real estate-related companies (REITs, housing-related, travel-related, commercial real estate service, real estate operating companies, tech-related) remain on sale)

Possible changes in the post-pandemic world that may impact real estate

Work from home, e-commerce, and other online activities, demand for affordable housing, increased funding of drug development

Introduction

Jeff Kolitch manages Baron Real Estate Fund and Baron Real Estate Income Fund and has since inception. Jeff has over 25 years of investment experience. He joined Baron from Goldman Sachs in 2005 as a real estate research analyst and was promoted to portfolio manager of Baron Real Estate Fund in 2009.

Baron Real Estate Fund has a five-star rating from Morningstar and ranks in the first percentile of all real estate funds for the 10-year and since-inception time periods. The Fund also ranks in the top decile of all real estate funds for the one- and three-year time periods. Baron Real Estate Income Fund, which we launched in 2017, also has had strong performance. It is ranked in the third percentile for its trailing one-year period through March 31, 2020. In addition to these impressive long-term track records in up markets, we think it's important to note that both funds have continued to significantly outperform during these more challenging times. For the year-to-date period ended May 19, Baron Real Estate Fund outperformed its benchmark by more than 1,400 basis points. Baron Real Estate Income Fund outperformed the REIT index by over 1,600 basis points during the same period.

As of 3/31/2020, the **Morningstar US Fund Real Estate Category** consisted of 226, 199, 136, and 226 share classes for the 3-year, 5-year, 10-year, and overall periods, respectively. Morningstar has awarded **Baron Real Estate Fund** Institutional Share Class 5 stars, 3 stars, 5 stars, and 4 stars for its 3-year, 5-year, 10-year, and overall performance, respectively.

Morningstar calculates the **Morningstar US Fund Real Estate Category** Average using its Fractional Weighting methodology. Morningstar rankings are based on total returns and do not include sales charges. Total returns do account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets. As of 3/31/2020, the Category consisted of 263, 226, 199, and 136 share classes for the 1-, 3-, 5-, and 10-year periods. Morningstar ranked **Baron Real Estate Fund** Institutional Share Class in the 4th, 5th, 26th, 1st, and 1st percentiles, respectively in the category for the 1-, 3-, 5-, 10-year, and since inception periods. The Institutional Share Class was incepted on 12/31/2009 and the category consisted of 138 share classes for the since inception period. Morningstar ranked **Baron Real Estate Income Fund** Institutional Share Class in the 3rd and 53rd percentiles, respectively in the category for the 1-year and since inception periods. The Institutional Share Class was incepted on 12/29/2017 and the category consisted of 243 share classes for the since inception period.

Q&A with Jeff Kolitch

Could you share your perspective on the prospects for public real estate stocks as it stands today?

Prior to the pandemic, until about late January, we were optimistic about real estate prospects. Steady and growing commercial real estate fundamentals, moderating new construction activity, solid balance sheets, well-covered dividends, open credit markets with low interest rates, and a robust job market – all these were positives for real estate. There was pent-up demand in the housing market with new construction activity 20% below historic levels. We were seeing a healthy rebound in home purchases primarily at the entry-level home. Despite the fact that real estate was 10 years into a recovery, we were not witnessing the typical warning signs that would suggest an end to the real estate recovery.

Of course, we did not anticipate that an exogenous black swan event like a global pandemic would end, on a temporary basis, the economic recovery and the real estate cycle. Fast forwarding to where we are today, **we remain optimistic about the outlook for real estate** but for somewhat different reasons than our pre COVID-19 view. **Many of the ingredients that tend to be supportive of sound real estate fundamentals are still in place**. While there is uncertainty around demand and the timing and the pace of the recovery, when economic recovery resumes, we think a number of factors will benefit real estate.

<u>**First**</u>, we have historically low interest rates with a staggering amount of support from the Fed. The Fed has

made it clear there is no limit to what it will do to support the economy and, in turn, real estate. **Second**, we have historically low mortgage rates. **Third**, there is non-existent inflation. **Fourth**, construction activity has grinded to a halt, so we do not have excess supply. Fifth, balance sheets are solid. Many companies have taken on additional financing to provide a cushion for a prolonged downturn. **And, very importantly, many real estate stocks have corrected sharply and remain 30% to 60% below recent highs.**

We believe the flight from the market has produced some extraordinary and rare investment opportunities. We continue to identify value across several segments of real estate: REITs, housing, travel-related, tech-related, and other real estate-related categories.

First quarter earnings season just wrapped up. What are you hearing from real estate companies? What investment themes are you prioritizing?

So far, things are much better than feared for most real estate-related companies (notwithstanding travel-related real estate companies). We believe the perception and fear is much worse than the reality. For REITs, many of the commercial real estate companies we are invested in are reporting rent receipts in the 90+% category, including office REITS, industrial warehouses, single family rentals, manufactured housing, multifamily or apartment buildings, datacenters, and self-storage.

The key problem areas are the retail segment (malls and shopping centers – collecting rents of 50% or less) and the travel-related real estate segment (hotels and casinos).

In the housing market, earnings results and management commentary has been better than expected and recent business trends are encouraging. There are several signs that housing-related demand troughed in mid-April and have improved dramatically from late April through May.

- **REITs**

  We believe REITs present a highly unusual, tactical, and strategic buying opportunity right now. REITs remain over 30% below their high on February 21. REITs are the cheapest relative to the broader equity market and bonds we've seen since the global financial crisis. While there may be more volatility ahead in the next few weeks or months, looking out over the next year or two, we believe this dislocation is going to reverse as economic activity resumes and credit spreads continue to narrow. With the 10-year treasury at 67 basis points, REITs are yielding 4.9%. Given all of the above, we think REITs are quite attractive. Not all REITs; you need to pick your spots.

  Traditional REIT attributes such as attractive dividends and contracted cash flows did not provided adequate shelter during the early stage of the pandemic. First, there was a broad concern that many tenants were not going to meet rent obligations. While retail malls, shopping centers, and a few other companies are expected to see a large percentage of tenants not paying rent and perhaps store closings, the fear of a major abandonment by other commercial real estate categories is largely unwarranted in our view.

  Second, REITs were pressured by the stress in the credit market caused by plunging oil prices and the abrupt slowdown of the economy. Financing costs became much more expensive in February and March. However, since April, the Fed and the U.S. Treasury have acted to provide liquidity, low interest rates, and additional forms of quantitative easing. As a result, we've already started to see credit markets re-open and credit spreads narrow. For example, **Douglas Emmett, Inc. (DEI)**, a West Coast REIT, just announced financing a $450 million 7-year loan at an average interest rate of 2.6%. **Boston Properties, Inc. (BXP)**, a well-known office REIT, priced $1.25 billion of 10-year unsecured notes at 3.25%. In non-REIT real estate, **D.R. Horton, Inc. (DHI)**, the largest home builder in the country, just raised $0.5 billion of 5-year notes at 2.6%. Even companies in the crosshairs such as gaming companies are tapping the credit markets. **MGM Resorts International (MGM)** just priced $750 million of 5-year notes at 6.75%, which it will likely refinance in two years.

- **Travel-related companies**

Travel-related real estate companies – hotels, casinos, timeshares, cruise lines – have all been in the eye of the pandemic storm. Many of these share prices have corrected sharply and even after bouncing off their lows remain 40% to 70% off recent highs. In our opinion, many of these companies continue to price in concerning news. **We are comfortable owning some travel-related companies as a component of a diversified real estate portfolio,** but we acknowledge that investing in them requires a certain comfort level with the current lack of visibility into forecasting future cash flows.

In our opinion, the time to sell these stocks was earlier this year. Now is the time to perhaps initiate positions or even double down. <u>**First**</u>, we think these companies are cyclically depressed and have the potential to rebound sharply when the economy begins to reemerge. <u>**Second**</u>, they are perhaps the biggest beneficiary of a possible medical breakthrough whenever that happens. <u>**Third**</u>, many of these companies have sufficient liquidity to survive the crisis, which means there is no going-concern risk. We have spent considerable time speaking to companies across the hospitality space and we're very comfortable with their liquidity profile in a zero-revenue environment for the next year or two. <u>**Lastly**</u>, we believe many of these companies are trading at large discounts to conservative estimates of replacement cost or net asset value or other valuation metrics that we consider.

- **Residential real estate**

We remain bullish on the prospects for housing-related securities – homebuilders, building product and services companies, and the home centers. We are encouraged by what we are seeing in the residential or housing market. It may sound counterintuitive, but it's possible the pandemic has motivated people living in an urban center to buy or rent a home in the suburbs sooner than anticipated. The earnings results have been much better than we expected. There are signs that housing demand is bottoming sooner and shallower than initially feared.

For example, home builder D.R. Horton just delivered better-than-expected results. Orders were down just 11% year-on-year in April without any heavy discounting and there are indications that May is picking up materially. Several other home building companies are reporting similar results. Real estate brokers have also reported that home-buying demand is moving up at an encouraging rate.

It's the same story with housing-related building product and home center companies. **Lowe's Companies, Inc. (LOW)**, the world's second largest home center company, reported that first quarter U.S. same-store sales were up 12% year-on-year and online sales were up 80%. **Trex Company, Inc. (TREX)**, which makes outdoor decks, reported first quarter sales up 13% year-on-year. Trex expects sales to be down only 10% year-on-year, against a terrific year last year.

There are structural tailwinds in place right now for U.S. housing. We have cyclically depressed levels of construction activity, low inventory levels, the millennials starting to buy. We have historically low mortgage rates. This is nothing like what occurred during the global financial crisis where our country was significantly oversupplied relative to the demographic and demand needs.

- **Technology-related and industrial real estate**

  Datacenters and wireless tower companies performed exceptionally well in the first quarter. Industrial REITs are benefiting from the "Amazon effect" of more people buying online and wanting things delivered if not overnight, today. In our view, **technology-related real estate companies – data centers, wireless tower companies, and industrial logistics companies remain compelling as a multi-decade investment opportunity driven by powerful secular growth trends** such as the technological revolution in e-commerce, cloud computing, mobile data, artificial intelligence, etc.

What are you seeing in the private equity markets?

There's significant private equity capital poised to purchase real estate. A recent *Wall Street Journal* article reported more than $300 billion of equity capital has been targeted for investment in real estate. At 70% leverage, $300 billion of cash translates to around $900 billion of buying power. The enterprise value of the entire REIT index is about $1.2 trillion. This means these firms could buy up 75% of the REIT market! We're not suggesting that's going to happen, but we want to convey the significant capital available to capitalize on this dislocation in the market.

It's not a question whether it's going to happen, it's a question of when. For instance, **Blackstone, the world's largest commercial real estate investor, deployed about $1 billion in public equity securities through March**. **Of the $1 billion that Blackstone invested, about $600 million went into hotel companies**. We imagine when we get the next filing, it's going to be a number much larger than that. **It also invested a couple hundred million dollars in office REITs, as well as industrial real estate and apartments**.

You've said that you believe real estate remains "on sale" even after the post-dip bounce in April. Could you provide some examples of companies you believe offer attractive upside over the next 12 to 36 months?

Yes, we continue to identify value across all segments of real estate. Several real estate companies remain "on sale". We are bullish.

A few REIT examples include: Gaming REIT **MGM Growth Properties (MGP)**. The company just announced it is increasing its dividend while most companies are decreasing them. It has a strong tenant, no liquidity concerns, and a 7.25% dividend yield, which is more than 10 times what U.S. treasuries will get you. It's currently a $25 stock that we think will works its way to $40 over the course of a very reasonable timeframe.

West Coast office REIT **Douglas Emmett, Inc. (DEI)** is down 35% year-to-date, just thrown out with almost everything in the REIT sector. It owns premier real estate office and apartment assets in supply-constrained West LA submarkets. It is led by a terrific CEO, Jordan Kaplan. Based on transactions in its markets in the last year or so, its office assets are worth at least $1,000 per square foot. Yet this phenomenal company is trading at approximately $440 a square foot for its office assets.

Across the country in New York City, there's a lot of press right now about how this region is going to face major headwinds for the next several years. But you need to ask to what extent these concerns are already reflected in the share price. The office assets of New York office REIT **Vornado Realty Trust (VNO)** are currently valued at $270 per square foot. The replacement costs are probably $1,000 a square foot. The stock's down 45% year-to-date. Yes, there are headwinds, but we think that's not news when you're looking at a company that's trading at a discount of more than $700 a square foot.

Hotelier **Park Hotels & Resorts Inc. (PK)** is a $9 stock today. It was $35 in the last 12 months. The company just completed a bond financing yesterday and has sufficient liquidity for quite some time, in our view. Its hotels are starting to reopen. It has quality assets and it's trading at a significant discount to our assessment of intrinsic or net asset value.

An example of a travel-related real estate company is casino owner Wynn Resorts Ltd. (WYNN). Its shares have bounced from $50 to $85 today. And so we ask rhetorically, have you missed the buying opportunity? We do not believe so. In January of this year, it was a $152 stock or almost 80% higher than the current price. We have done an analysis that suggests that Wynn's U.S. real estate is currently valued in the public markets at only $17 a share. Yet our conservative assessment of net asset value is $40-45 a share!

In the technology-related real estate category, we believe GDS Holdings LTD (GDS) is a highly compelling opportunity. The company is the premier data center company in Asia. It is the fastest growing data center company in the world. We believe GDS will grow its cash flow 40% to 50% per year the next few years which equates to 4 to 5 times the growth rate of its U.S. data center peers. Despite its superior growth, the company is valued at a similar valuation multiple to most other data center companies.

Commercial real estate services firm CBRE Group (CBRE) is just $39 per share. The stock has corrected 40% year-to-date. This is an example of a true best-in-class company that is on sale.

Lastly, I would be remiss not to mention alternative asset manager **Brookfield Asset Management, Inc. (BAM)**. It recently bought Oaktree, the world's premier distressed credit asset management firm. We think CEO Bruce Flatt is one of the best capital allocators in the world. At $29/share, we believe this stock trades at a healthy discount to our assessment of intrinsic value.

What changes in the post COVID-19 world may impact real estate?

We have been assessing Covid-19's possible long-term impacts on real estate. Our preliminary assessment is that there will be "winners" and "losers."

Winners may include:

Industrial REITs: Broader e-commerce needs resulting from the accelerated growth of online sales as businesses and consumers seek faster delivery should benefit industrial REITs such as Prologis and Rexford.

Technology-related: Datacenter and wireless tower REITs will clearly benefit from the transition to videoconferencing and increased home-based consumer and commercial activity, whether it's online shopping or video streaming or working from home.

Niche real estate categories: We may see a boost for **manufactured housing REITs** due to an acceleration in demand for more affordable housing. **Single-family rental REITs** could benefit as more people opt for single-family over multi-family housing. We think there will likely be more funding directed toward drug development and R&D spending, which would benefit **life science office REITs** such as **Alexandria Real Estate Equities, Inc. (ARE)**. An acceleration in the adoption of **online sports gaming** will benefit companies like **Penn National Gaming**, **Inc. (PENN),** which is in the process of pivoting from a bricks-and-mortar regional gaming company to an omni-channel online gaming company. Finally, we think **Americold Realty Trust (COLD)**, which owns temperature-controlled warehouses, will benefit from greater e-grocery penetration as people get used to ordering groceries online.

Losers may include:

Retail: The acceleration in the shift to online shopping is, in our view, a permanent one, and many retailers (malls and shopping centers) are going to have to reevaluate the number of physical stores needed.

Health care: Health care REITs with large portfolios of senior housing real estate are likely to face material vacancy and slowing demand.

Office: There certainly is the possibility of greater work-from-home adoption post-crisis as businesses decide that they can function well remotely and require less office space. On the margin, we have talked about the possibility of this secular headwind developing over the next two decades and it appears that it is being fast-tracked by the pandemic. On the other hand, many companies have been packing many employees in a very dense space, in a trend called densification. So, there's a possibility that that trend may reverse, with floor plans being reconfigured to allow more space given social distancing considerations. Bottom line, the trend toward work-from-home is likely a negative coming out of the pandemic, but we think the assumption that all office real estate is doomed is a gross exaggeration of reality.

Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus and summary prospectuses contain this and other information about the Funds. You may obtain them from the Funds' distributor, Baron Capital, Inc., by calling 1-800-99BARON or visiting www.BaronFunds.com. Please read them carefully before investing.

Baron Real Estate Fund's annualized returns for the Institutional Shares as of March 31, 2020: 1-year, (2.81)%; 5-years, 1.27%; 10-years, 10.98%; Since Inception (12/31/2009), 11.44%. Annual expense ratio for the Institutional Shares as of December 31, 2019 was 1.08%. The **MSCI USA IMI Extended Real Estate Index**'s annualized returns as of March 31, 2020: 1-year, (19.91)%; 5-years, 0.57%; 10-years, 7.85%; Since Fund Inception (12/31/2009), 8.56%.

Baron Real Estate Income Fund's annualized returns for the Institutional Shares as of March 31, 2020: 1-year, (2.43)%; Since Inception (12/29/2017), 1.04%. Annual expense ratio for the Institutional Shares as of December 31, 2019 was 5.63%, but the net annual expense ratio was 0.80% (net of the Adviser's fee waivers). The **MSCI US REIT Index**'s annualized returns as of March 31, 2020: 1-year, (21.96)%; Since Fund Inception (12/31/2009), (6.87)%.

The performance data quoted represents past performance. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate; an investor's shares, when redeemed, may be worth more or less than their original cost. The Adviser reimburses certain Baron Fund expenses pursuant to a contract expiring on August 29, 2030, unless renewed for another 11-year term and the Fund's transfer agency expenses may be reduced by expense offsets from an unaffiliated transfer agent, without which performance would have been lower. Current performance may be lower or higher than the performance data quoted. For performance information current to the most recent month end, visit www.BaronFunds.com or call 1-800-99BARON.

The **Baron Real Estate Fund's** 10-year historical performance was impacted by gains from IPOs and/or secondary offerings, and there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs and secondary offerings will be the same in the future.

Risks: In addition to general market conditions, the value of the Fund will be affected by the strength of the real estate markets as well as by interest rate fluctuations, credit risk, environmental issues and economic conditions. The Fund invests in debt securities which are affected by changes in prevailing interest rates and the perceived credit quality of the issuer. The Fund invests in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and more difficult to sell during market downturns.

The discussion of market trends is not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this document reflect those of the respective writer. Some of our comments are based on management expectations and are considered “forward-looking statements.” Actual future results, however, may prove to be different from our expectations. Our views are a reflection of our best judgment at the time and are subject to change at any time based on market and other conditions and Baron has no obligation to update them.

The Morningstar Rating™ for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

Portfolio holdings for both funds as a percentage of net assets as of March 31, 2020 for securities mentioned are as follows: - Douglas Emmett, Inc. - Baron Real Estate Fund (0.8%), Baron Real Estate Income Fund (0.8%); Boston Properties, Inc. – Baron Real Estate Income Fund (1.0%); D.R. Horton, Inc. – Baron Real Estate Fund (2.3%); MGM Resorts International – Baron Real Estate Fund (1.2%), Baron Real Estate Income Fund (1.3%); Lowe’s Companies, Inc. – Baron Real Estate Fund (3.1%); Trex Company, Inc. – Baron Real Estate Fund (1.3%); MGM Growth Properties LLC – Baron Real Estate Fund (1.3%), Baron Real Estate Income Fund (2.1%); Wynn Resorts Ltd. – Baron Real Estate Fund (2.0%); GDS Holdings Limited – Baron Real Estate Fund (7.1%), Baron Real Estate Income Fund (7.1%); CBRE Group, Inc. – Baron Real Estate Fund (4.9%); Brookfield Asset Management Inc. – Baron Real Estate Fund (4.9%); Alexandria Real Estate Equities, Inc. – Baron Real Estate Fund (2.7%), Baron Real Estate Income Fund (3.7%); Penn National Gaming, Inc. – Baron Real Estate Fund (4.1%), Baron Real Estate Income Fund (3.7%); Americold Realty Trust – Baron Real Estate Fund (2.3%), Baron Real Estate Income Fund (3.7%).

Neither Fund held Vornado Realty Trust or Park Hotels & Resorts, Inc. as of March 31, 2020.

Top 10 holdings for both funds as of March 31, 2020

Baron Real Estate Fund

Holding	% Assets
GDS Holdings Limited	7.1
Equinix, Inc.	5.9
CBRE Group, Inc.	4.9

Brookfield Asset Management, Inc.	4.9
Penn National Gaming, Inc.	4.1
American Tower Corp.	3.5
Vulcan Materials Company	3.3
Prologis, Inc.	3.1
Lowe's Companies, Inc.	3.1
Home Depot, Inc.	3.0
Total	42.9

Baron Real Estate Income Fund

Holding	% Assets
Prologis, Inc.	7.7
American Tower Corp.	7.3
GDS Holdings Limited	7.1
Equinix, Inc.	6.9
Invitation Homes, Inc.	4.6
Rexford Industrial Realty, Inc.	4.3
QTS Realty Trust, Inc.	4.1
Alexandria Real Estate Equities, Inc.	3.7
Penn National Gaming, Inc.	3.7
Americold Realty Trust	3.7
Total	53.1

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

The **MSCI USA IMI Extended Real Estate Index** is a custom index calculated by MSCI for, and as requested by, BAMCO, Inc. The index includes real estate and real estate-related GICS classification securities. **MSCI US REIT Index** is an unmanaged free float-adjusted market capitalization index that measures the performance of all equity REITs in the US equity market, except for specialty equity REITs that do not generate a majority of their revenue and income from real estate rental and leasing operations. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI. The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. The indexes and the Fund include reinvestment of interest, capital gains and dividends, which positively impact the performance results. The indexes are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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