May 2021

INTRO

We generally resist the urge to comment on every headline or short-term stock price movement. But occasionally, we make an exception. This is one of those times. Since we recently outlined our investment thesis for Equity Commonwealth (EQC) in our annual letter to investors, then shared an additional publication highlighting our work, we felt an update was warranted.

At Broyhill, our largest positions are generally those investments where we have well-defined and limited downside risk. We believed our investment in EQC exemplified these characteristics. But, given the decline in the stock over the last week and the material shift in the company's strategy, we are taking a moment to update you on our thinking.

WHAT HAPPENED

EQC announced it is acquiring Monmouth Real Estate Investment Corporation (MNR) in an all-stock deal valued at $3.4B. As a result, we expect the company to transition out of the office sector by selling its four remaining office assets and eventually deploy its ~$2.5B cash hoard in the industrial sector.

Monmouth is an industrial REIT with 120 properties totaling ~ 25M square feet. The portfolio is comprised of mostly newer, build-to-suit properties for investment-grade tenants.

It is a net leased portfolio with high-quality tenants and long lease durations. So, what's not to like? Well, for starters, FedEx represents over half of the company's rental income. As a result, while industrial peers have enjoyed accelerating growth, driven by increasing e-commerce adoption, MNR's growth has been muted as most of their leases lack contractual rent bumps.

THE CONSENSUS VIEW

To say this deal came as a surprise to the market would be an understatement. Generally speaking, the majority of EQC's shareholder base fell into one of two categories – 1) short-term investors seeking a liquidation of the portfolio and return of capital for a quick gain; or 2) long-term investors (like Broyhill) allocating capital to Sam Zell and his team to redeploy into distressed assets (potentially in the struggling office or hospitality sector). The purchase of MNR accomplished neither of these objectives.

Rather than deploy capital into the office sector, where management has a long track record of success, the team surprised the market by making a big acquisition in one of the hottest sectors in commercial real estate. As a result, this deal caught investors off guard, and they reacted as they typically do – they sold first and asked questions later.

At first blush, it seems rational for shareholders to question the logic of this deal, given the amount of capital flowing into industrial real estate. Questions on the company's earnings call highlighted several concerns. Why is this deal more attractive than the alternatives? After a multi-year exit from the office sector, why rush to do a deal now, when cracks are just beginning to show in commercial real estate markets?

If fundamentals in office have changed dramatically or asset prices have yet to reflect value, why not just return capital? What value does the EQC management team bring to the table that other established players in the space lack? What are the alternatives if the deal fails to close?

OUR VIEW

Admittedly, our initial reaction wasn't much different. But after getting past the initial shock and getting up to speed on the portfolio, we can see the strategic rationale of this move.

- **EQC is buying the cheapest portfolio of assets in the industrial sector from which to build from.** MNR has historically traded at a discount to the industry and the broader REIT universe, as management has prioritized longer leases with higher quality customers over a higher growth profile. While this deal is far from the distressed acquisition we were hoping for, we are getting decent value for what we are paying for.

- **We also think the value here is greater than it appears at first blush.** Given MNRs newer buildings and longer average leases (tenant retention is a key factor in managing expenses as leasing costs - commissions, improvements, etc. - are much higher for new tenants relative to renewals), the company's capital requirements are likely well below average. As a result, "Economic NOI" (net of normalized capital expenditures, which many investors are still happy to ignore) is likely higher for MNR than it appears.

- **The portfolio's high, recurring cash flows provide Zell and his team with an optimal platform to execute more accretive acquisitions over time.** Importantly, the all-stock deal means that the combined company will retain an enormous amount of dry powder to capitalize on what Zell believes will be the faster-growing sector in real estate for the foreseeable future.

- **We expect that in time, investors will reward EQC with the premium multiple that a Zell-managed company has historically deserved,** as the team deploys capital (potentially up to $5B with leverage) to round out the portfolio, reduce exposure to FedEx, and raise the growth profile,

BOTTOM LINE

Rapidly rising rents and falling cap rates have driven a large spike in industrial property values in recent years. While EQC has had success in office, it is fair for investors to question the value that this management team brings to one of the hottest sectors in commercial real estate.

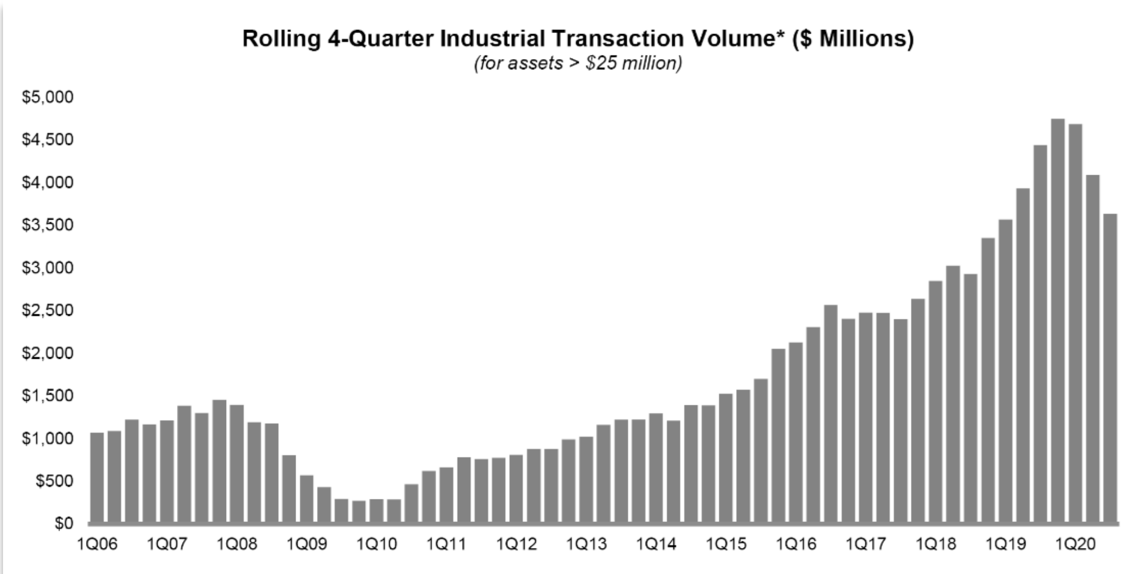
At the end of the day, our investment in EQC was a bet on the jockey, not on the horse. In this case, our jockey is one of the greatest real estate investors in the world. We invested under the assumption that his ability to deploy capital would generate attractive returns for shareholders. While we won't have a scorecard for some time, we have no reason to question that assumption just yet.

As the rookie on the field, it may be premature to award EQC the same premium as industrial peers. This team will have to earn that premium through execution. But in time, as cash is deployed as the team builds out the portfolio, we believe that premium will be earned.

APPENDIX: INDUSTRIAL REIT OVERVIEW

Industrial REITs are a vital component of global logistics, storing, sorting, and facilitating the distribution of goods worldwide. Think massive, single-story, sprawling e-commerce fulfillment centers.

The sector remains highly fragmented, with Prologis and Blackstone the most aggressive acquirers over the past few years. Cheap money, coupled with solid fundamentals, has fueled transaction activity in the sector, as institutional capital has pushed property prices 70% above their prior peak. **High demand, limited supply, and low vacancies remain supportive of fundamentals.**



- **Ecommerce requires about three times the amount of space relative to physical retail for various reasons** (i.e., more inventory, more returns, more picking, packing, and sorting). While e-commerce growth has driven industrial development for years, demand surged last year. It will likely remain strong given increased adoption and new routines, even after the economy recovers from the pandemic.

- **Near-term demand will further benefit from inventory restocking,** following supply chain disruptions that brought inventories to all-time lows. In addition to this one-time benefit, supply chains are likely to see a structural shift away from "just-in-time" inventory, which should lead to higher inventory levels over time.

- **Rent growth is well supported by vacancy rates, which remain near all-time lows.** In the near term, accelerating economic growth should provide plenty of cover for rising rents.

- **Cumbersome entitlements, rising labor costs, and availability have constrained supply,** despite years of attractive returns and increasing demand for industrial real estate.

Bottom Line: Industrial supply growth is likely to lag continued demand driven by accelerating e-commerce adoption, driving strong rent growth for years to come.

ABOUT BROYHILL

Broyhill Asset Management is a boutique investment firm, initially established as a family office in 1980 and guided by a disciplined value orientation. Founded in the foothills of North Carolina's Blue Ridge Mountains, we operate outside of the fray and invest with a rational, objective, long-term perspective.

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