SECTOR ANALYSIS

Private Equity Real Estate

LEGACY PARTNERS

Strengths

- Very profitable for several investment styles
- Private: Not focused on share price, not required to report results
- Regulations based on private equity: Already well established
- Scalable

Weaknesses

- Reduced liquidity, typically locked in 5 to 10 years
- Limited accessibility, intended for accredited investors and institutions
- Exposure to all forms of business risk
- Dependent on potentially poor quality human capital

Opportunities

- Global market that is consistently growing
- Private: Can pursue returns superior to public market returns
- Innovative financial products in development
- Sub dividable: Can be sold or transferred relatively quickly

Threats

- Economic uncertainty in key regions (Europe)
- Heavy competition from other forms of private equity
- Vulnerable to real-estate bubbles
- Interest rate risk is unavoidable

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June 24th, 2015

Introduction

A Private Equity Real Estate (PERE) trust is best described as an actively managed asset class funded by both debt and equity. As indicated by the name, it is a combination of private equity and real estate assets. The purpose of these investments is to generate return through rental income, capital appreciation, or both. While similar to real estate investment trusts (REIT) in theory, private funds have distinct benefits over their publicly traded counterparts. For instance, the directors of a public firm are subject to market influences; their stock price, financial position, and exposure to economic trends creates hesitation that discourages managers from undertaking lucrative opportunities (Private Equity Council, 2007, p. 5).

Public firms are bound to shareholder contentment, while private enterprises are free to conduct the business necessary to be profitable. The ownership structure within a PERE trust typically takes the form of a limited liability partnership. The investment strategy is defined by a general partner who raises funds from investors who become limited partners (Kuzmicki & Simunac, 2008, p. 7). Limited partners have minimal involvement in the management process and are often locked-in for set periods of time. There is a holding period where fund managers will acquire or sell assets and temporarily open the fund for new entrants. Since these funds are closed-end and higher risk, they offer investors a superior return relative to traditional equity investments.

PERE does not represent a large proportion of real estate investments. In fact, their existence has been recognized as a product of low-interest rates (Kuzmicki & Simunac, 2008, p. 3). However, the primary investors are most commonly high-wealth individuals and institutions. Superior portfolio diversification along with inflation-adjusted rent agreements (used to hedge against inflation) creates an attractive product that draws-in accredited investors.

Industry Characteristics

Well over 50 years ago the REIT Act was signed into law. The law permitted small-time investors to buy into large income-producing real estate funds (Thomas, 2012, p. 2). While this was arguably the initiating factor that enabled real estate investment growth, the trend was not understood until many years later. After the market crash of the late 1980's there was an upsurge in private equity looking to undertake leveraged buyouts of well-founded companies (Linneman & Ross, 2002, pp. 5,6). Historically, credit was plentiful and preferable for asset financing, leaving equity undesirable (Linneman & Ross, 2002, p. 6). This changed when credit markets began to decline, thus, making debt more expensive and less attainable.

Since its inception, participants of the industry have divided themselves into groupings based on strategy and targeted internal rate of return. The information is well outlined in a report by (Kuzmicki & Simunac, 2008) and will be paraphrased below.

One of the most common structures is the core fund that targets an IRR of 7 to 9%. High degrees of diversity often characterize core funds in a standard book of assets that includes: office space, retail stores, industrial facilities, and multi-family properties. A core fund uses equity to fund purchases as opposed to debt. Although the return is lower, core funds provide a superior degree of safety for investors looking to simply diversify or minimize risk. Core-plus funds (IRR of 9-12%) employ a similar strategy but use debt-financing to further growth. Both Core and Core-Plus collect a significant portion of income from on-going revenue streams (rent payments and leases).

Value-Add funds attempt to generate returns by asset appreciation. By operating, releasing, and re-development, fund managers can influence appreciation. They have a target IRR of 12-16% and utilize significant leverage. Revenue streams represent a small portion of income, their fundamental goal is to create value from appreciation.

PERE funds can take aggressive positions; Opportunistic portfolios aim for over 16% IRR by engaging higher risk projects. Examples include re-positioning poorly managed assets and acquisition of existing portfolios of assets. Companies that undertake new-build developments fall into this category. Much like Value-Add projects, opportunistic funds rely on substantial leverage. Expansion into emerging markets is discussed later on, but it is another strategy employed by opportunists. An international focus exposes firms to more risk, thus requiring superior returns to attract investors.

A second aggressive strategy takes advantage of distressed debt and utilizes mezzanine lending. This technique will offer loans at terms more aggressive than traditional lenders. Moreover, they often acquire loans from other financiers at discounted prices. Dealing with lower quality borrowers requires them to pay carrying costs when loans default. While this method can be profitable, it carries substantial default risk and a higher likelihood of additional carrying expenses in the event of nonpayment.

Lastly, some companies do not invest directly in real estate assets but choose to invest in third party real estate funds instead. This strategy allows managers to diversify a portfolio by selecting from thousands of specialized funds. This method improves upon PERE availability to smaller investors as the buy-in costs tend to be lower than a full-fledged private equity firm.

Regardless of design, most firms use a compensation structure borrowed from the private equity industry. There is typically a management fee that varies from 1-2% of total capital committed to the fund (Kuzmicki & Simunac, 2008, p. 7). This fare is intended to cover management costs assumed by the firm. Management can receive additional compensation using a performance-based model. Most establish a hurdle rate, which is the expected return for participating investors. When yields surpass the hurdle, management may collect a bonus based on the degree of profitability. Hence, this model firmly aligns the goals of managers with the overall profitability of the firm.

The current global market is worth an estimated $12 trillion, representing a generous portion of global wealth (UBS Global Asset Management, 2012). One of the latest global trends has been the introduction of outcome-oriented funds. They are designed to yield returns that follow inflation while minimizing risk and volatility within a portfolio (Higgins, 2012). Their popularity is increasing because they state a clear and concise end-goal. The typical duration of a PERE is upwards of 12 years with few chances to liquidate. This fashions uncertainty among potential entrants as they are unsure if the opportunity cost of their capital is proportionate to the prospective gains of the fund. Outcome-oriented funds are not new to private equity; they are frequently used in retail-level financial management to connect financially illiterate clients to appropriate investment vehicles.

Potential investors must be prepared to tender substantial entry fees if they plan to enter this market. Typical payments start at $1 million but have the potential to rise to over $20 million during the fund's existence (Thomas, 2012, p. 3). Although the actual investment will depend upon the strategy, the amount of wealth required by PERE funds has effectively made the asset class unavailable to individual investors.

The Real Estate Advantage

The core advantage to using real estate assets is the level of diversification they offer. Figure 1[1] contains the correlation between major British asset classes. To provide an example of diversification: an investor's portfolio consisting of government bonds may acquire real estate assets to gain from the negative relationship. Moreover, an aggressive investor who holds British equities may add real estate to take advantage of the positive correlation. The larger application for this method includes a foreign investment variable that provides superior diversification than a solely domestic strategy. Figure 2[2] shows the relationships between four of the top real estate markets in the world. Although the data shows uniform movement in the global real estate market trends, the severity of that movement is independent of each market. An investor could use this information to select a better real estate market that compliments the assets in their portfolio. Applying the information in Figure 2, the theoretical UK bondholder may want to consider purchasing Eurozone real estate assets to diversify his bond position while keeping the portfolio's overall correlation as negative as possible.

	UK property	UK equities	UK govt bonds	UK inflation
UK property	1.00	0.62	-0.19	-0.11
UK equities		1.00	-0.34	-0.19
UK govt bonds			1.00	0.53
UK inflation				1.00

Figure 2 British market Correlations

	US	Eurozone	UK	Australia
US	1.00	0.68	0.62	0.90
Eurozone		1.00	0.41	0.62
UK			1.00	0.54
Australia				1.00

Figure 1 Correlations between global RE markets

Aside from diversification, private real estate investments are initiating growth in "secondary cities" that are classified as having inferior growth potential (EY Advisory, 2015, p. 13). The ideal markets for private equity investment are high-wealth cities like London, New York, Los Angeles, and Hong Kong. These metropolises have similar characteristics including high-wealth residents, top-tier industry, and steady population influx. A secondary city is not judged by economic success, but rather the potential for rental growth (EY Advisory, 2015, p. 13). Cities falling under this category include Chicago, Miami, Toronto, and Paris. Forward-looking fund managers are anticipating that secondary cities will experience increasing demand resulting from

[1] (UBS Global Asset Management, 2012, p. 4)
[2] (UBS Global Asset Management, 2012, p. 6)

industrial growth spurred by a slow recovery from the 2008 recession (PwC, Urban Land Institute, 2013, p. 1).

Real Estate investments are an attractive asset class for foreign investors looking to enter non-domestic markets. As indicated above, many Europeans prefer to buy real estate due to declining bond returns and economic turmoil in Europe (EY Advisory, 2015, p. 15). Figure 3[3] provides a well-organized summary of the severity of the debt crisis in Europe. Government-issued debt has lost much of its appeal due to investor uncertainty and increased the likelihood of national governments becoming insolvent. For European investors, the alternative option is the equity market. Unfortunately, the volatility of equity along with mounting economic strain is concerning to investors with little risk tolerance, or who employ outcome-oriented approaches that are compromised by over-exposure to equities. As outlined in the previous section, real estate facilitates investment in active, passive, aggressive, and non-aggressive strategies. Foreign demand for PERE assets has inspired growth in specialty products. For example, recently launched Australian companies have targeted Asian investors to fund projects to upgrade the nation’s aging real estate (Rader, 2015). The Australian market has a strong banking sector with low and stable interest rates, making it a comparatively safer market to invest long-term. In the United Kingdom, the availability and use of real estate derivatives have allowed investors to buy and sell exposure to markets (UBS Global Asset Management, 2012, p. 4). The availability of these tools has led to the invention of subsequent financial products. For example, a new debt vehicle listed as a “Property Index

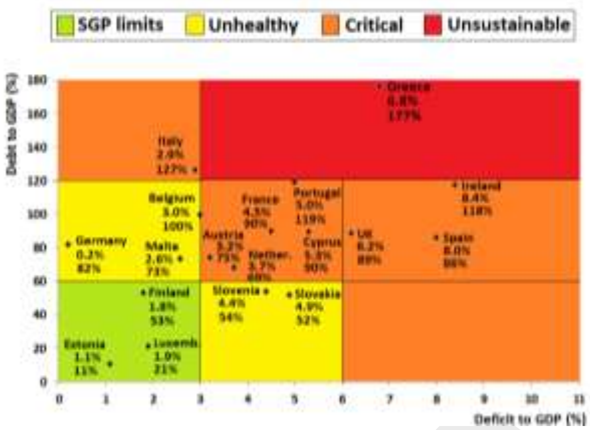

Figure 3 Gross Debt to GDP (Select European Nations)

[3] ("Danish Expert") – While this source is not official – the author has independently verified the data source using Eurostat data (Eurostat, 2014)

Certifications" provides rent income in the form of coupons, and a redemption value based on the change in the underlying asset's value at maturity (Barclays, 2015).

Scalability Advantage

While the bulk of this report focuses on the global market and large-scale businesses, the strategies applied by these firms can be easily replicated on a micro scale. Markets with large populations of low-income families and post-secondary students provide a phenomenal opportunity for private equity to generate sustainable revenues. Typical mortgage payments for homes under $400,000 CDN are affordable for low-income families. However, the 5 to 20% down payment precludes them from purchasing. Students represent a market that consists almost entirely of temporary occupants who typically only claim residency for the duration of their schooling.

As opposed to purchasing large apartment complexes or commercial facilities, a proportionately smaller group of investors could easily purchase residential homes or small multi-family units intended for use as low-income housing. Provided the target market has a healthy balance of supply and demand, the equilibrium rental price per room is simply a function of location, condition, and services provided. Overhead costs and a profit margin will already be factored in by market forces.

Challenges for Private Equity Real Estate

Challenges arise for both investors and trust managers. On a macro scale, the most notable problem is on-going economic turmoil in large markets. Launching new funds in Europe can be difficult as banks are still cautious after the 2008 recession (UBS Global Asset Management, 2012, p. 8). This, combined with the previously mentioned debt crisis, have failed to nurture an environment that encourages capital investment. On the other hand, American financial institutions have fewer reservations than their European counterparts, and investment is actively encouraged. As global markets stabilize, the appeal of Europe and other distressed markets will return to normal levels.

The dominant challenge for investors is a lack of liquidity along with slow purchase and sale processes (UBS Global Asset Management, 2012). Newly released products have attempted to improve an investor's access to liquidity, but the underlying constraint on real estate will always be salability. As a result, investors demand an illiquidity premium that should theoretically provide a greater return than a similar investment in a more liquid asset.

Trust managers face challenges stemming from human capital and its inevitable faults. The employees selected to manage properties are identified as a significant challenge for asset managers (EY Advisory, 2015, p. 6). A 2008 industry survey found that apartment management turnover is 36.1%, meaning 36.1% of employees leave their job every year (Anderson, 2012). High turnover can result in improper management that is likely to impact adversely the managing fund. For example; non-compliance with rent agreements, poor cash management, and inadequate insurance can result in fines or litigation that is expensive, time-consuming, and contrary to the goals of the investment trust.

Additional challenges are present for the fund-level managers. Most notable is a lack of confidence in property managers and the inability to provide oversight on individual assets (UBS Global Asset Management, 2012, p. 6). Unfortunately, distrust of staff results in the attention of upper-level managers being diverted to mundane operational tasks. Maintaining a sound investment strategy represents a second challenge. Shifting economic conditions may require managers to rethink the fund's core strategy, conversely any alterations are sure to impact the overall dynamic, for better or worst.

Notes on Regulatory Requirements

The regulatory requirements follow the same set of rules in place for private equity and venture capital. The United States Securities and Exchange Commission requires private equity funds to register as investment advisors if their holdings exceed $150 million (Kirchheimer, Manganelli, & Humphrey, 2012, p. 1). Moreover, they must institute a compliance program as per standard regulation. Some of the notable features that must be established are (1) a chief compliance officer and annual compliance reports, (2) disclosure of compensation agreements, (3) restricted handling of material information, (4) a clear and concise policy for the treatment of secondary funds.

Canadian regulations apply a similar set of requirements. For funds operating out of Canada, the director must register with regulators as an investment fund manager (Gowlings, 2011). The firm is also required to file an offering memorandum that contains any information presented to an investor regarding the offer. Companies can avoid filing a prospectus if they are dealing exclusively with accredited investors. However, they are still required to report this strategy to regulators (Gowlings, 2011). Additionally, individuals who sell securities must be registered as advisors and firms shall be recorded as dealers.

Future Prospects and Profitability

A recent report issued by PwC has forecasted institutional grade real estate to expand by 55% over the next five years (PwC, 2014). The report suggests that sustainability will be increasingly important. Cities will experience mass inward migration, and urbanization will continue to occur. Prospects for the real estate market should focus on demographics for the future population. With an aging population, there will be growing demand for retirement homes, nursing homes, and other medical facilities. These services can generate a stable cash flow with relatively low default risk.

Migration of the population to the cities will require real-estate to be built vertically rather than horizontally. Condominiums and apartments are already a favorable source of income due to consistent rent payments paired with skyrocketing property values in urban locations. Integration of sustainable practices represents great opportunity and risk. Being “green” currently carries a premium for tenants, but if sustainable practices become regulation then many buildings will likely suffer a “brown discount”, representing the loss of value and potential investment required to retrofit.

Rural areas represent an opportunity for PERE given the above forecasts. An increasing population needs more agricultural land to provide a sustainable food source, and as people leave the rural areas, the population density falls. Opportunities exist for private equity to purchase rural land for conversion to farmland, providing a stable income with minimal expenses. Renting land is a common and preferred practice in the agricultural industry as it allows farmers to dedicate capital towards equipment rather than property.

Measuring real profitability is challenging because different fund structures have different targets. However, a survey conducted by EY found real returns to be 8 to 10% (EY Advisory). In comparison to the fund structures and targeted IRRs mentioned in the industry overview, the surveyed returns represent a sensible estimate of the profitability of private equity real estate. A further report analyzing public pension fund earnings stated real-estate generated a 6.7% return over 10-years (Private Equity Growth Captial Council, 2013, p. 5).

Notable Risks and Potential Resolutions

For funds that operate using leverage, the availability of credit presents a substantial risk. The general economic environment can impact how much a lender is willing to provide to a conceivably high-risk borrower. If the fund is unable to expand, it will likely hurt overall strategy. Having adequate cash on hand, or immediate access to equity capital, are two applicable options in desperate situations. However credit market impairment likely results from adverse macroeconomic conditions, making it difficult to prevent.

Credit availability extends to interest and financing risk. While many firms attempt to stagger the maturities of debt portfolios, there is still an element of risk present. In the event a fund cannot refinance debt on terms acceptable to management, the resulting agreement may not be beneficial for investors. In terms of interest rate: it is dependent on the bank rate that can be manipulated by monetary policy. Even a small increase in this percentage can have an enormous impact on a fund that is heavily leveraged. An interest rate swap agreement could be used to hedge this risk.

The design of the business is oriented around collecting rents from tenants, so PERE trusts are subject to customer credit risk. Although many firms mitigate this risk by performing credit checks and verifying income, there is no guarantee they will receive payments. This is especially relevant for funds that own larger commercial assets. If a high rent customer defaults, the fund will lose a substantial revenue stream and be forced to cover property expenses out of pocket. Requiring deposits from tenants and ensuring property managers understand the rights of both tenants and landlords can help lessen the severity of this risk.

On top of rents, PERE trusts are heavily exposed to the real estate market and economic conditions on both micro and macro scales. Micro conditions, like changing demographics, industry stoppage, or layoffs are all factors that could poorly impact property values or the firm's ability to collect rents. Macro conditions include deflation of real estate prices and popping housing bubbles. For example, many analysts believe the Canadian market is nearing the breaking point of its bubble (Safalow, 2015). Further macro conditions relate to the overall health of the economy. If the market enters another recession, the resulting interruption to the credit market will increase the difficulty of obtaining a mortgage. Thus, decreasing demand for homes and causing prices to fall.

PERE trusts are subject to numerous federal, provincial (state), and municipal laws that govern everything from environmental issues to social well-being. Funds purchasing real-estate must be cautious of assets that could generate liabilities later on. Litigation is expensive and time-consuming and diverts the management team from executing the strategy. Well-being laws often side with the tenant, so non-payers and squatters are a risk to the profitability of the business. An asset occupied by a delinquent tenant is an immediate liability.

Additional regulatory risks come from taxation, more specifically for multinational firms. For example, a firm operating in Canada and the US may be adversely impacted by withholding tax; subsequent coupon and dividend payments may be double taxed in certain scenarios. Tax laws are continuously under the review by legislators who evaluate and amend interpretations of tax law. The effect of these interpretations is unknown, and could be detrimental to a private fund.

Strategic Analysis: Five Force Model

Threat of New Entrants

New entrants represent a moderate threat due to the regulatory registrations and memberships required to start and maintain a trust. Moreover, the amount of equity needed to fund a PERE trust is enough to deter new entrants that are not familiar with the business. For firms that have the correct licensing and access to accredited investors, this industry is very enticing. Thus, most competition will come from established companies and managers who have experience in private equity investments.

Threat of Substitute Products or Services

Substitution is dependent upon region. For example, in Europe the risk is fairly small because the substitutable products are not in demand (due to poor economic conditions). However, North America has ample opportunities for investment in both traditional and alternative vehicles that have the potential to yield similar risks, returns, and diversification benefits as real estate. It is wise to follow an outcome-oriented approach to investment strategy by establishing the intent to achieve an objective by developing a strong competitive advantage.

Bargaining Power of Buyers

In the general and limited partnership structure, buyers have little bargaining power. Strategy and direction are typically decided by the general partner who handles operating the firm. Buyers are locked in for a specified term and may not see an opportunity to liquidate until the strategy expires. Investor involvement is intended to be passive while general partners actively manage the portfolio.

Bargaining Power of Suppliers

Two components of supply can be analyzed. First is the typical amount of capital obtained through banks. The bank has total control over its lending policies and is permitted to assign the borrower debt covenants as per their agreement. Moreover, the bank has no obligation to lend to a prospective borrower, and only faces the opportunity cost of the investment when denying a loan. The second supplier is the real-estate asset broker. The seller has final say to who may purchase the asset, and may refuse any offer for any reason. Provided the broker has interest from several parties, there is no cost to ending one negotiation and starting a new one.

Intensity of Competitive Rivalry

Competition within the real-estate industry is moderate as investors are sourced through networks of investment professionals. Given that most trusts operate in a closed system, the management team will put less effort into securing equity until the fund expiration approaches. By the time this occurs, competing funds will likely be in the process of executing their strategies rather than raising more capital. Thoughtful competition is most likely to come from alternative investments. Private equity firms operating in separate industries like power generation, natural resources, or venture capital are more likely to provide a competitive advantage or apply a more aggressive strategy.

Strategic Analysis: SWOT

Strengths	Weaknesses
• Very profitable for several investment styles • Private: Not focused on share price, not required to report results • Regulations based on private equity: Already well established • Scalable	• Reduced liquidity, typically locked in 5-10 years • Limited accessibility, intended for accredited investors and institutions • Exposure to all forms of business risk • Dependent on potentially poor quality human capital
Opportunities	**Threats**
• Global market that is consistently growing • Private: Can pursue returns superior to public market returns • Innovative financial products in development • Sub dividable: Can be sold or transferred relatively quickly	• Economic uncertainty in key regions (Europe) • Heavy competition from other forms of private equity • Vulnerable to real-estate bubbles • Interest rate risk is unavoidable

Summary

The future prospects for private equity are vast and can be easily attained by forward-thinking managers. Additionally, scalability is present and often overlooked in favor of heftier rents from large-scale apartment buildings and commercial facilities. In closing, Private Equity Real Estate Trusts are an extremely adaptable investment vehicle that can provide superior results for enlightened investors.

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