THE SMILING FACE OF MULTIFAMILY OPPORTUNITY IN THE USA

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THIS ISSUE COVERS:

- New drivers of US multifamily market led by Baby Boomers and Millennials
- Continued growth in 'Smile States' driven by strong market fundamentals
- Continued offshore investments in multifamily
- Smart money playing on the suburbs

Multifamily housing, the asset class credited with bringing the US real estate market out of recession, presents a multi-faceted investment opportunity

- Baby Boomers and Millennials increasingly favor renting highly amenitized urban and suburban community-led lifestyles, which underpins market potential and drives demand for rental units.
- Suburban communities are replacing metro hubs as renters look for highly amenitized, transit oriented and walkable environments outside of traditional city parameters.
- Strong multifamily sector performance in the US 'Smile States' markets in the last two years is set to continue due to low cost of doing business, low cost of living, and a vibrant and dynamic labor market.
- Major Smile States markets including Dallas, Houston, Atlanta and Austin are outpacing other metro markets in terms of demographic growth, net absorption and rental growth.

With nationwide supply issues at a forefront of investors' minds, rationalizing the local demand drivers at a sub-market level becomes even more critical.

- While other commercial real estate sectors witnessed a decline in investment activity of 10.7%, multifamily is the only sector to experience an increase in 2016 with investment totaling US$150.3 billion (up 4.3% from 2015).
- This underscores multifamily's potential as a defensive investment sector, providing both a good inflation hedge and a secure cash-flowing asset.
- Foreign capital inflow continues to diversify the multifamily investor base with overseas investors accounting for almost US$7.3 billion of 2016 acquisitions.

Investment Sales in US Multifamily 2016 (JLL)

$150.3 Bn	$7.3 Bn	4.3%	-9bps
Investment Sales 2016	Off-shore Investments	Investment Sales Growth	Average Cap Rate Change

THE CHANGING DEMOGRAPHICS

Declining home ownership across the US is being driven by changing lifestyle preferences as Millennials and Baby Boomers choose to go down the rental route

The high-level demographic shift propelling multifamily to the front of the asset class investment queue is centered on two classically opposing age groups – Baby Boomers and Millennials.

With around 75 million Baby Boomers heading towards retirement, a growing proportion of 51 to 69-year-olds are eschewing traditional family home living arrangements and relocating to highly amenitized urban and suburban communities; effectively driving demand for accessible units.

With 10,000 Baby Boomers joining the retiree ranks every day[i], older households are increasingly competing for appropriate community housing with the Millennial generation.

Harvard University research forecasts that rental demand is expected to remain robust over the next decade, as younger Millennials and 30 to 40-year-olds continue to struggle to get on the home ownership ladder.

These 83 million[ii] Millennials between the ages of 18 and 35 are also looking to multifamily housing communities for various reasons. Stymied by an unfavorable home loan market and the baggage of student debt, Millennials see renting as a more viable financial option. They are also delaying marriage and kids, thus requiring less living space, and increasingly adopting a more 'footloose' approach towards career development and social status.

THE HOME OWNERSHIP REALITY

Rental demand is surging as home ownership rates in the US hit a 50-year low in 2016, dropping to 63.7%, with a further forecasted decline to 60.8% by 2025

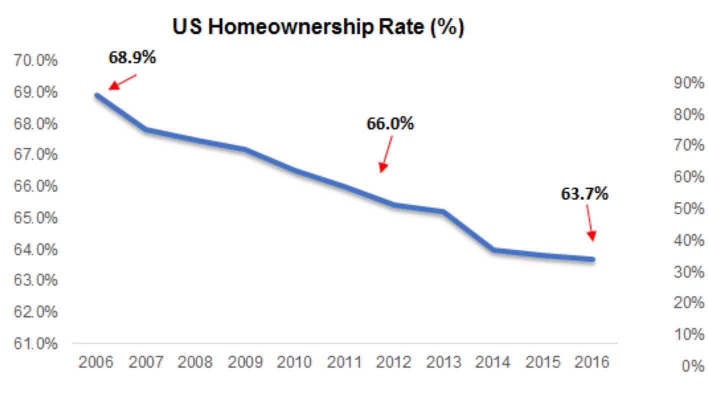
Home ownership statistics for 2016 continued a downward trend as per the US Census Bureau's February 2017 report release. The annual homeownership rate of 63.7%[iii] was the lowest measured rate in 50 years, and also the 12th year running in which home ownership rates were lower than the year prior.

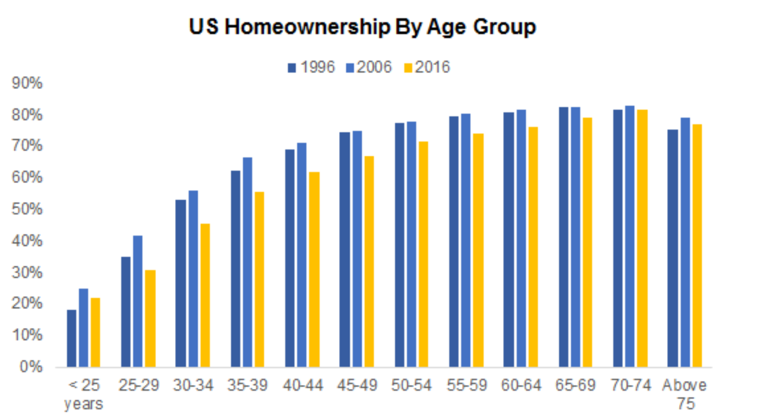
A Harvard University Joint Center for Housing Studies 2016 market report noted that the number of renter households rocketed to almost nine million between 2005 and 2015; the largest increase over any 10-year period on record.

A significant proportion of rental demand growth is directly attributable to middle-aged (30-44 years) households; US Census Bureau's data indicates that home ownership ratio in this age group fell from 65% in 2006 to 54% in 2016.

Many in this bracket were in their late 20's and early 30's when the recession hit. As the value of homes dropped owner's equity wiped out causing foreclosures and more owners became renters.

It is a similar story for Millennials, with Harvard University research indicating that two-thirds prefer the rental option for its lifestyle and career path choice flexibility.





Source: New Housing Vacancy Survey Annual Statistics by US Bureau of Census, Feb 2017

The erosion of easily available mortgage products, fast tracked credit approvals, and a consumer mindset geared towards home ownership as part of life's checklist, has been superseded by a surge in rental demand as a legacy of the real estate boom-and-bust scenario.

According to the ULI's *Q3 2016 Demographic Strategies for Real Estate* report, an excess of 12.5 million net new households created over the next decade will rent, including those who have never owned and those transitioning from owning to renting, as they grow older.

Renter households are growing at a much faster rate than owner households, reflecting growing confidence of those who were most likely impacted by the foreclosure crisis.

In fact, by 2025, home ownership is expected to decline to its lowest point since the 1950s, with the national rate anticipated at 60.8%. Bad news for single family and condominium developers, but good news for the multifamily investment space.

FOCUS ON THE SMILE STATES

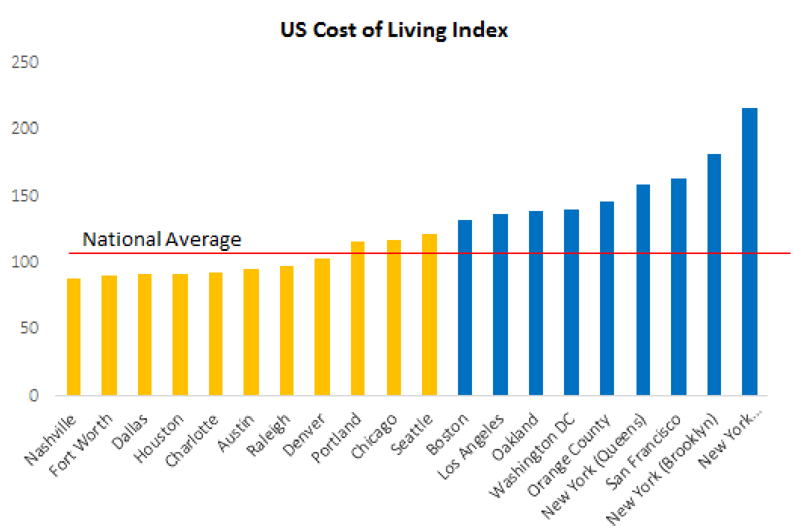
Gateway cities, with their high living and business costs, are being usurped by secondary cities offering diverse career opportunities, an affordable lifestyle, and lower costs of doing business

The heartland of multifamily investment is being redrawn away from dominant tier one city hotspots to focus instead on opportunities in 18-hour cities and better connected suburban communities in the US 'Smile States'. As depicted in the image below, the Smile States run from East to West coast and across the southern tier of the USA. Major metro markets in these States are 18-hour cities which refers to a secondary real estate market that offers services, amenities and job opportunities on a scale of a large city such as New York, but does not operate on a 24-hour basis.

Traditional career-centric 24/7 powerhouse cities and areas where salaries are high, but the cost of living is prohibitive, are being spurned by employers and employees alike. In favor are second tier locations that offer job growth and career opportunities, a reduced cost of doing business, solid public transportation infrastructure and a more affordable lifestyle characterized by the wide availability of recreation and entertainment.

According to Mitch Roschelle, Partner and Co-Chair, Emerging Trends in Real Estate, PwC, lower cost cities are outpacing the rest of the US by two to one when it comes to job creation and, in turn, are offering better real estate investment, development, and homebuilding opportunities.

Dallas is an example of a vibrant 18-hour city experiencing sustained growth. The city has avoided the challenges of the slowdown in the energy sector and



Source: US Bureau of Census, 2010 Census Data. The average composite index for the nation is 100%, and each city's index is read as a percentage of the overall average.

declining oil prices, due to its commitment to successful economic diversification. This is underpinned by its highly attractive northern suburbs. Buoyed by a host of incentives including reduced cost of doing business and low occupancy costs, the area has become a magnet for companies looking to expand and relocate.

Most 18 hour cities experience moderate cap rate compression over the real estate cycle, ensuring property value stability in the medium to long term, resulting in strong yields.

The low cost of doing business in Dallas has seen major corporations such as Toyota North America, Liberty Mutual, FedEx, State Farm Insurance and JP Morgan Chase all relocate their headquarters/back office function to the area.

Houston, Austin, Orlando, Raleigh-Durham, Phoenix, Denver and Charlotte are the other major 18 hour cities to experience above 2% average annual population growth during the last five years. With the exception of Houston, all these markets were also among the top 10 employment growth markets among the 82 major metros across USA[iv].

BUILD IT AND THEY WILL RENT?

Major Smile State markets such as Dallas, Houston, Atlanta and Austin are outpacing other metro markets when it comes to demographic growth, net absorption and rental growth

The Smile States are leading the way when it comes to welcoming new stock. With combined net absorption of more than 46,000[v] multifamily apartment units in 2016, Dallas, Atlanta, Houston, Austin and Seattle were the top apartment rental markets across 82 major metros in the US. The net absorption in these markets accounted for approximately 23% of the total supply of 196,000 apartment units across the 82 major metros of the USA.

The major Smile States also recorded positive, though moderate, rental gains during 2016. Market data released by CBRE in Q4 2016[vi] indicate that Atlanta, Phoenix, Raleigh and Dallas/Ft Worth were among the top performing metros in terms of rental growth with year-on-year growth rate ranging between 4.1%-5.0%.

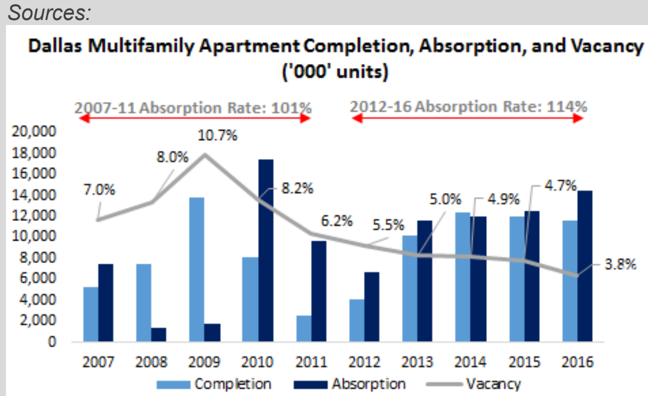
With the backdrop of a thriving Northern Texas economy, the Dallas-Ft Worth area has added nearly 100,000 new jobs to the economy in the last 12 months. A 2016 report from the Dallas Business Journal noted that the city is a popular relocation choice due to the fact that it has a high volume of jobs, a high ratio of jobs per candidate and a high number of available jobs (across a wide range of

DALLAS HIGHLIGHTS

1. Low cost of doing business[1]:
   a. 15% less than national average
   b. Energy costs 24% lower than national average
   c. State and local taxes 14% lower than national average
2. Fourth largest US metropolitan area in terms of population (as of 2010 census) and ranked second in US Census Bureau's (UCB) list of top 20 metros with largest numeric population increase between 2014 and 2015
3. First for the rate of job growth and second in the number of jobs added (trailing New York only) among the US' 12 largest metropolitan areas[2].
4. High-wage employment is increasing at triple the national pace. The unemployment rate is down to 3.6% - well below the national rate - with strong workforce growth[2].

The result is unprecedented growth in the multifamily housing market. As per REIS Inc., over the last five years the overall net absorption rate was 114% and the current metro level average vacancy stands at 3.8%.

Sources:



Source: Analysis Performed by Capitas on REIS Inc. data, Dec 2016

1) *Allen Community Profile by Allen Economic Development Corporation*

industry sectors) to its population – 252 jobs per 100,000 residents.

Rising construction costs, rapidly escalating land prices and labor costs, together with financing challenges that include mounting regulatory constraints and a new leverage norm of just 55-60% versus up to 80% in previous years, have resulted in project reins being tightened; and this augurs well for future absorption levels.

It's a similar story in Houston, where a 2017 US News survey places the city in the top 20 ranking of best places to live in the US this year; giving it high marks for affordable cost of living compared to the median annual salary. Houston is supported by strong job growth, as well as its position as another Texan metropolis, popular with young, well-educated Millennials and young families alike.

A Georgia success story, Atlanta experienced the highest population employment (4.2% CAGR) and apartment stock growth (3.7% CAGR) over the last five years out of 82 ranked metro cities across the US.

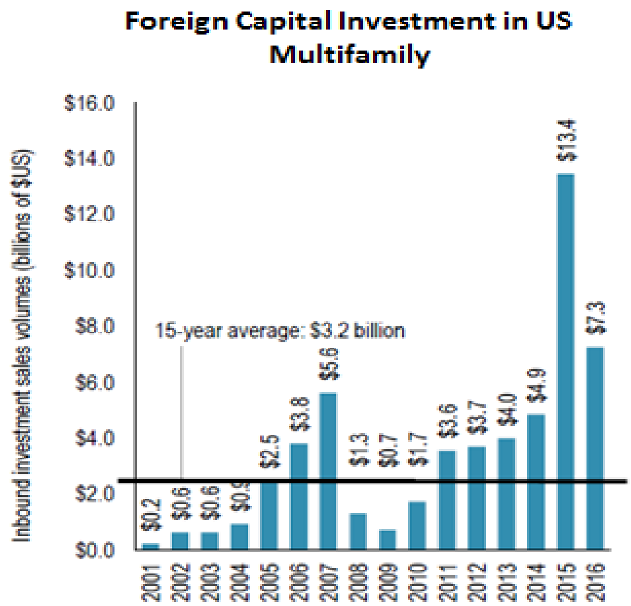
Austin added more than 8,300 apartment units in 2016, with North Carolina hotspot Charlotte adding more than 6,400 units. Austin, Charlotte, Seattle, Oakland, Portland, Denver, Nashville and Atlanta also outpaced other metro markets in terms of apartment rental growth.

Multifamily development follows job growth. Therefore, metros with high job growth (like Dallas and Austin) should be the top choices when it comes to selecting a location for investment.

INVESTMENT CAPITAL IS TRENDING UP

Offshore demand, mainly from Canadian and Middle Eastern investors, continued to rise steadily in 2016, recording the second highest year of inbound acquisition in history

The multifamily investment landscape reached yet another year of record-setting investment sales volume in 2016, totaling $152.3 billion[vii], an increase of almost 4.3% over 2015 levels. Following this trend, foreign capital continued to flow into the multifamily product with $7.3 billion[viii] total acquisitions in 2016. Canadian and Middle Eastern investors remain the most active, with select Asian sources of capital also emerging.



Source: JLL Multifamily Investment Outlook Q4, 2016

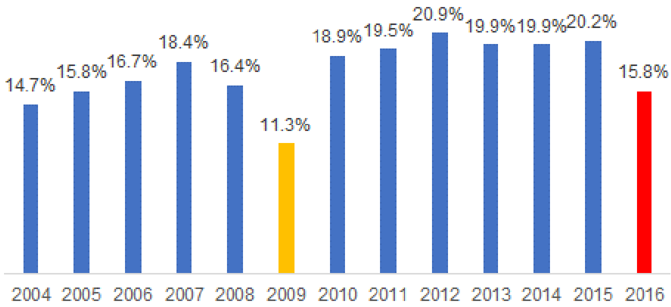
THE SMART MONEY'S ON THE SUBURBS

Investment capital is diversifying into suburbs and away from central locations, with CBD (Central Business District) sales coming in five percentage points lower than five years ago

The hot markets for multifamily housing have traditionally been rooted in CBDs and major urban hubs, but the suburbs are fast gaining ground as developers and renters turn their attention to the attraction of living in highly amenitized, well connected and walkable environments that step outside of city parameters.

JLL's *Multifamily Investment Outlook Q4 2016* revealed deeper diversification into the suburbs in 2016 as CBD annual transaction volume dropped to 15.8% of total multifamily transactions, down from 19.5% of total multifamily transactions in the prior five years.

Share of CBDs in Total Investment Sales (%)



Source: JLL's Multifamily Investment Outlook Q4 2016

CATEGORISING MULTIFAMILY – RISK AND REWARD

While value-add opportunities in the multifamily sector are making waves, Core-Plus opportunities in secondary markets provide attractive cash returns

The triumvirate of US multifamily investment opportunities includes **Core** (Class A) product; essentially central 'top drawer' amenitized locations in very strong markets such as New York, Washington DC, or Boston. It ticks all the boxes, and naturally attracts a more affluent renter base.

A virtually stabilized asset, but with a slightly higher risk profile, **Core Plus** encompasses both new buildings in secondary markets or older but still highly amenitized buildings in core markets. The defensive play here comes from having an investment associated with a product that will remain attractive to the rental audience for a sustained period of time.

Value-Add is also currently making market waves, particularly in relation to workforce housing provision. This Class B/C type of product invariably dates back to the 70s or 80s, with low amenitization, but is a supremely effective defensive play.

This rental stock caters to the average electrician, plumber or other blue collar worker who can't afford to buy his or her own home and will always be in the market for affordable rental options.

One effective strategy used by building owners/sellers is to renovate a percentage of the total units, for example, 10%, to demonstrate to prospective buyers the potential rental increase they will be able to achieve on the remaining 90%.

Even the low-income end of the multifamily housing bracket displays strong defensive potential, which, with government subsidization commitment, is a growth area.

News of the Trump administration's recent decision not to proceed with a planned Obama administration reduction in Federal Housing Administration (FHA) fees –part of a government program aimed to stimulate increased home purchase spend through lender subsidization – will also undoubtedly keep low income families tied to the rental market.

In a January 2017 *Brevitas Bulletin* piece, columnist Walker Fitch highlighted the rental affordability dilemma, especially in markets with high rates of job growth. He flagged moves by local and national government to incentivize the development of inclusionary properties that provide housing options for lower and middle-income renters, citing Atlanta, Nashville and Portland as live examples.

In a working paper on *Household Projections 2015-35*, the University's Joint Center for Housing Studies also highlighted projected growth in minority-headed households, which it says will account for almost 75% of net new households formed in the next 10 years. With historically low home ownership rates, this adds further weight to the multifamily opportunity.

ON THE DEFENSIVE

The demographic driven demand and strong interest from capital players, both domestic and foreign, makes multifamily a 'defensive' asset class

Cap rate compression is part and parcel of the defensive nature of this asset class, with Wall Street's nose for demographic shifts fueling investment and the capital value increases seen over the last six to seven years.

The latest figures from the JLL *Q4 2016 Multifamily Investment Outlook* confirm stable cap rates despite volume gains across primary and secondary markets nationally, with an average cap rate of 4.4% (across the different investment categories).

This is where the asset class delivers additional inflation hedging benefits.

Compared to a classic office building scenario, which invariably comes with an average five-year fixed term lease and zero recourse against economic uncertainty, the short-term nature of multifamily housing rental contracts allows for a much higher degree of flexibility and fast response to changing market and inflationary conditions.

Core Plus opportunity investment, with its moderately augmented risk profile, generally offers a cap rate of 5-6% versus the 3.5-5% seen with **Core**.

Drilling down to the all-important cash-on-cash implications, and taking into account the scaled-down multifamily dynamic, **Core** product delivers 4-6% cash-on-cash returns and an internal rate of return (IRR) of 7-9%.

For **Core Plus**, this translates to cash-on-cash returns of 6-8% and an IRR of 9-11%.

The third profile, **Value-Add**, which has enhanced associated risk due to required investment in capital improvements and renovations, delivers a blended cash-on-cash return of 7-9% and IRR of 12-14%.

Last, but not least, if **Opportunistic** investment and building from the ground up is a portfolio acquisition strategy, a total IRR of 14+% is expected.

CONCLUSION

The intrinsic appeal of multifamily housing lies in its defensive investment nature. Historically, as well as in the current market cycle, it is a great inflation hedge. A proven cash-flowing asset with stable rental income is probably the most secure investment out there today, especially when compared to the inherent risk in investing to build new inventory.

In comparison to other commercial real estate, where sector acquisitions fell by 10.7% in 2016, multifamily delivers a compelling investment thesis, especially in the highly attractive suburbs of these all-important Smile States.

Multifamily attractiveness over the next five years is charting upward as investors look to capitalize on steady economic growth, strong demographic outlook, and buoyant growth opportunities in secondary cities with strong market fundamentals.

About Capitas

Capitas is a specialized real estate investment firm based out of Dubai, UAE that serves as an adviser and partner to a select group of institutional investors, sovereigns, royal and family offices, and government ministries. Backed by an experienced team of real estate experts, Capitas currently manages 3 million square meters of development in the GCC and provides real estate acquisition and strategic cross border transaction advisory to its clients and partners with a particular focus on US and UK real estate transactions. Additional information about Capitas can be found at www.capitas.me.

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REFERENCES:

1 CBRE Q4 2016 US Multifamily Marketview Snapshot
2 Jones Lang LaSalle (JLL) research
3 The only years with a US home ownership rate lower than 63.7% were 1967-8 and 1985, at, 63.5%, 63.6% and 63.5% respectively.
4 The average composite index for the nation is 100%, and each city's index is read as a percentage of the overall average.

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[i] *The Counselors of Real Estate (CRE) 2016/17 Market Report*
[ii] *PwC/Urban Land Institute (ULI) 2017 Emerging Trends in Real Estate report*
[iii] *US Bureau of Census, Feb 2017*
[iv] *Demographic data compiled by REIS Inc. Q4, 2016*
[v] *REIS Inc. data Q4 2016*
[vi] *The CBRE Marketview Snapshot Q4 2016*
[vii] *JLL's Multifamily Investment Outlook Q4 2016*
[viii] *JLL's Multifamily Investment Outlook Q4 2016*