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capitas

US REAL ESTATE OUTLOOK
INVESTOR GUIDANCE FOR 2018 AND BEYOND

April 2018

KEY INSIGHTS:

- **Net-Leased Industrial:** The new darling of institutional capital. How should investors navigate through compressed cap rates to find the right deal?
- **Seniors Housing:** Providing unique opportunities for high yields. What is the best way to optimize operational efficiencies?
- **Multifamily:** One of the best choices for capital preservation. Is it overheated? Where are the best opportunities located?
- **Suburban Office:** Experiencing a resurgence from corporate relocations. Will it continue to grow? What markets should investors target?

As the US real estate market continues to support an extended economic expansion, Capitas has identified sectors that are poised to benefit from structural and demographic trends.

- The US is not slowing down – 2018 is expected to be one of strongest years of GDP growth so far[1] as the country continues to ride one of the longest economic expansions in its history.
- With the recent tax overhaul in the US significantly reducing corporate tax rates, investors have more reasons than ever to increase their allocation to US real estate.
- Amidst a rising interest rate environment, investors must be more targeted than ever in their approach to real estate investments to stay ahead of the curve.
- The Capitas Real Estate team has set its eye on the evolving fundamentals in the office, industrial, seniors housing and multifamily sectors, which will drive our investment strategy for 2018/19.
- The explosive growth of e-commerce, the demands of a dynamic Millennial population and the rising proportion of affluent, aging Baby Boomers are significant demographic trends that will underpin smart money investment decisions for the foreseeable future.

Looking Beyond Brand-Name Tenants in a Competitive Industrial Sector

Industrial real estate was 2017's strongest performing sector, with transaction volumes growing 23% from 2016 levels to reach $59.2 billion in 2017 and annual rental growth reaching 5.4%, highest among all sectors[2]. This momentum is not expected to slow down in 2018 as e-commerce companies demand distribution centers close to major metros. This demand will, in turn, drive growth in secondary markets that are within reach of these primary distribution hubs.

Nationwide vacancy in the industrial space ended 2017 at 7.3%[3] and is expected to have significantly lower vacancy levels from 2018-2022. The sector's strong performance has garnered increasing interest from institutional capital, leading to cap rate compression in major markets as well as in properties leased to institutional-credit tenants.

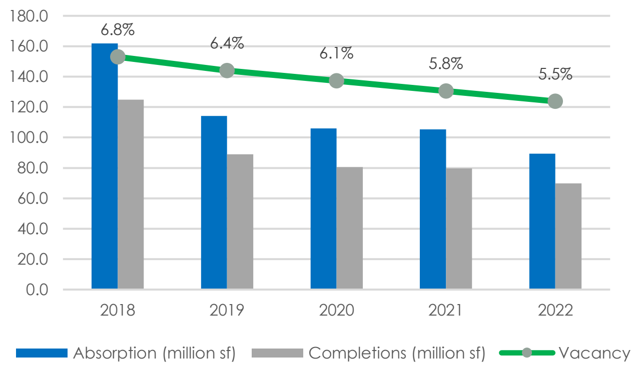
Capitas Underwriting Guidance – Industrial Sector

- **Strong Tenant Credit** – Rent coverage ratio over 4x, guarantee by parent company if applicable, historical revenue and EBITDA growth
- **Mission-Critical Facilities** – primary distribution/manufacturing facility with a long history of occupation by the tenant
- **Class A properties** – Clear heights above 28', significant capital investment by tenant into property
- **High-growth Markets** - rapidly growing secondary and tertiary markets that are within range of industrial hubs such as Chicago, Inland Empire and New Jersey
- **Long-term Net Lease** – NNN lease with unexpired lease term over 10 years
- **Contractual Rent Increases** – Adequate rental escalation to offset cap rate expansion

1 Cushman & Wakefield
2 JLL Industrial Report 2017
3 REIS

FIGURE 1

Demand to Consistently Outpace Supply across the US Industrial Space



Source: REIS

High demand for industrial assets is compelling investors to look beyond the brand name of a tenant and delving deeper into its financials. The recent cap rate compression trend provides opportunities to acquire properties that are leased to lower credit but financially sound, mid-market tenants at higher cap rates. Capitas maintains disciplined underwriting criteria that limits investments to well-capitalized tenants that have historically maintained Rent Coverage Ratios (EBITDA/Property Rent) over 4x, are projected to experience revenue and profitability growth over the hold period and have limited debt. These financial indicators are often more intuitive than reliance on a credit rating and provide the strongest assurance of the tenant's ability to service their rent payments over a typical 3-5 year hold period.

The urbanization of US cities is a major driver of increased demand in the industrial space. The current White House proposal for a **$200 billion spend in federal funds** is expected to result in major infrastructure upgrades in US cities[4]. As these upgrades are planned, demand for raw materials, as well as warehouses to store them, will grow.

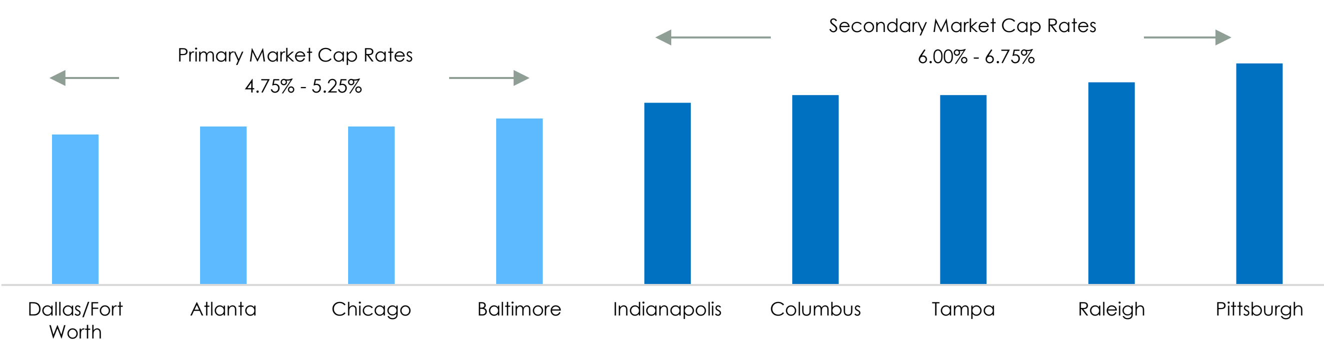
"Secondary markets close to established industrial MSAs are forecast to show over 3% annual rental growth while strong sub-investment grade credit tenants ensure a higher cap rate than brand-name tenants such as Amazon. Targeting these investments allows investors to benefit from exposure to growing markets and highly secure cash flows over 9% during the investment period." Alexander Rose, VP of Acquisitions, Capitas

In a compressing cap rate environment, Capitas is narrowing its focus to properties located in secondary markets that are close to major MSAs. Investments in these markets, rather than dense infill industrial markets, would provide higher entry cap rates and greater potential of a strong exit as these markets grow and mature during the investment period.

For tenants, the greater availability of land and lower rental rates within areas such as Orlando, Pittsburgh and Indianapolis provide a compelling solution for companies seeking to set up well-located, cost-

FIGURE 2

Growing Secondary Markets Provide Cap Rate Cushion for Class A Industrial Properties



Source: CBRE Cap Rate Survey 2017

4 New York Times, Feb 2018

effective distribution facilities. This lower rental rate, in turn, allows higher rental rate growth during the investment period. Two of Capitas' favored secondary cities within this strategy are Orlando and Pittsburgh with rental rate growth forecast at CAGR 3.9% and 3.2% respectively, between 2018-2022. In comparison, the more established neighbors of these markets, Miami and Philadelphia have rental rate growth forecast at 2.9%[5].

In addition, Capitas favors targeting sale-leasebacks of industrial facilities for investors seeking to tap into the significant potential of realizing fully-secured cash flows at above-market cap rates.

In the face of growing demand, many major logistics and manufacturing companies in the US have a need to free up cash to boost top-line growth. As a result, sale-leasebacks are, and will continue to be, an increasingly relevant option for businesses looking to shed illiquid assets from their balance sheet.

These companies would be inclined to lock in to long-term net leases that would allow them to carry on their business without disruption. At the same time, investors benefit from cash flows that are fully secured for a long term. Nonetheless Capitas cautions investors not to be allured by attractive returns that may be generated by above-market rental rates. Although the selling tenant may be able to service the above market rental rate, in a tenant replacement scenario, rental revenues will drop to market rates.

In December 2017, Capitas tapped into this strategy with an off-market sale-leaseback acquisition of a Class A industrial property executed on behalf of an institutional investor in the Middle East. The tenant locked in a 20+ year net-lease on the property at market rental rates. Although the private tenant was not credit rated, the property achieved an appraised value that was significantly higher than its purchase price due to the quality of the asset and the growth within the submarket.

Seniors Housing Sector – Unlocking Strong Potential with the Right Partner Selection

By 2022, over 25% of the US population will be over the age of 65 years[6]. This is the Baby Boomer demographic, a cohort of approximately 76.5 million citizens who were born in the post-war era between 1946 and 1964[7]. This is **the wealthiest and currently largest generation in the US,** that is rapidly reaching retirement.

At the same time, families are less inclined to support this generation, with fewer family members projected to care for their elderly members. This has led to a surging demand for senior housing facilities. In 2010, there were more than 7 potential caregivers for every person over 80 years of age, a ratio of 7 to 1. By 2030, **this ratio is projected to decline by 43%**, evidencing a growing trend of caregivers not willing or able to take care of their aging elders[8]. As a consequence of these socio-economic realities, the senior housing market is set to continue to grow in the future.

Capitas Underwriting Guidance – Seniors Housing

- **Best-in-Class Operator and Asset Manager** – Local counterparties with excellent track record of managing facilities in the MSA and submarket
- **Continuum-of-care** – Facilities that feature multiple levels of care such as assisted living, independent living, memory care and skilled nursing
- **Proven Demand** – Facilities with track record of high occupancy and/or rapid lease-up
- **High-Income Qualified Adult Child** – Children of seniors with annual income >$100k and are over 5% of total population within 5-mile radius
- **Class A Properties** –Newly-built properties with high level of amenities appealing to Baby Boomers' more luxurious demand

Considering the significant demographic tailwinds, Capitas continues to remain bullish on investments in the seniors housing asset class. We will not be alone – 60% of investors want to increase their exposure to seniors housing assets in 2018[9].

5 REIS
6 US Census, 2017
7 US Census, 2016
8 AARP Public Policy Institute
9 CBRE

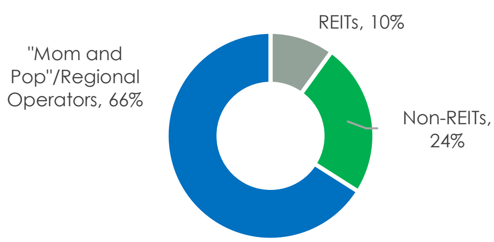
Unlike other real estate sectors, underwriting seniors housing assets requires a deep dive beyond the traditional real estate value drivers of location, tenancy, historical performance, etc. Seniors housing provides a unique opportunity to grow returns not just from the value of the real estate and its location, but from improving the facilities' profitability. Due to the operational intensiveness of seniors housing assets, the operators' capabilities and track record are of supreme importance to a successfully underwritten investment.

Accordingly, Capitas targets investments involving best-in-class seniors housing operators that are able to proffer a compelling business plan that optimizes net operating income within a facility by driving revenue growth, through strategic marketing efforts and rental rate increases, and maximizing cost efficiencies.

"A fragmented market combined with the largest generation in the US reaching retirement creates highly favorable conditions for investment within the seniors housing sector. By selecting the right partner, yields can be maximized through effective asset management within this operationally-intensive sector." Keith Parker, Head of International Real Estate, Capitas

FIGURE 3

Fragmented Seniors Housing Sector Provides Attractive Invesment Opportunities



Within the seniors housing sector, Capitas has targeted continuum-of-care facilities. These facilities offer various care levels for their residents, from senior apartments (minimal care provided) to memory care and skilled nursing (maximum care provided). This is highly beneficial for the seniors and their families as they would not be forced to relocate to another facility as their acuity of care increases. At the same time, investors benefit from a more stable resident base, consistent occupancy levels, and steady cash flows.

When studying a potential seniors housing investment, an important gauge of long term prospects of an asset is the number of Qualified Adult Children in the submarket. These are adults over 45 years of age, earning more than $100k annually and are the children of senior citizens. **Qualified Adult Children are key decision makers** – these individuals are involved in their parents' transition into a new setting 73% of the time[10]. As a result, prudent investors should target facilities that are surrounded by a healthy proportion of Qualified Adult Children, over 5% of the total population within a 5-mile radius of the facility. This ensures that the facility is adjacent to affluent decision makers that would drive future move-ins.

In line with its seniors housing strategy, Capitas added 7 seniors housing assets to its US portfolio in January 2017 through a co-investment with a specialist seniors housing fund. The portfolio featured continuum-of-care facilities that allowed its residents to avail higher levels of care as they aged in the facilities. In addition to a direct investment strategy, Capitas promotes programmatic co-investment strategies with its seniors housing asset manager partners to achieve scale.

[10] Reaching the Adult Children of Senior Living: The Next Gatekeepers

Honing-in on Multifamily Properties in High-Growth Markets

There is considerable debate as to whether the US multifamily sector is overheated. In Capitas' view multifamily remains to be among the best choices for capital preservation across all real estate sectors in the US. Historically, multifamily has been one of the top sectors for domestic and non-US institutional investors. In 2017, the US multifamily sector saw the second highest inflow of foreign capital driven by Asian sovereign wealth funds and pension funds increasing their exposure to the sector[11].

In 2018, Capitas will continue to target the US multifamily sector as it remains the best option for lower-risk investors seeking fixed income type returns. Multifamily has delivered the **second-highest risk-adjusted returns across all real estate classes from 1978-2016**[12], proving its value across multiple recessionary cycles. The sector will continue to provide stable cash yields, helped by preferential debt (typically 25 – 50 bps below debt terms in other sectors) as insurance companies and commercial banks compete with the lower cost agency debt providers, Freddie Mac and Fannie Mae.

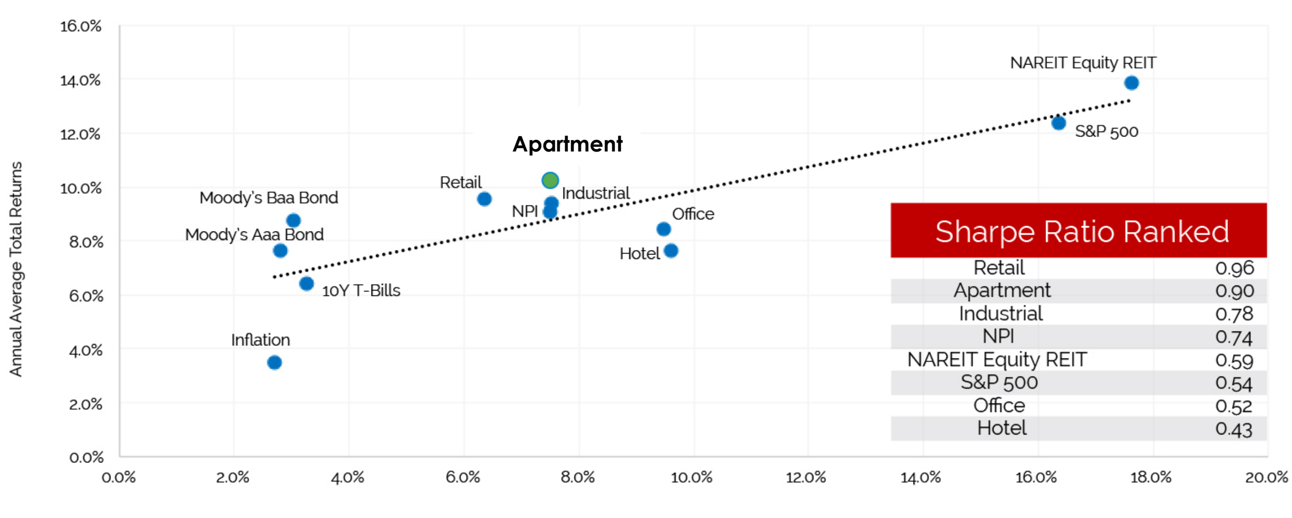
Capitas Underwriting Guidance – Multifamily Sector

- **Sun Belt Metros** – Properties located in high-growth MSAs in the Sun Belt such as Houston, Atlanta, Dallas etc.
- **Strong Location** – Close proximity to key employment clusters, public transportation and retail/entertainment offerings
- **Newer Vintage Properties** –Newly-built properties with high level of amenities and lower capex requirements
- **Revenue Uplift Potential** – Lease-up or rental growth potential to grow revenues during the hold period through light/organic value-add strategies

Additionally, the post-recession multifamily sector remains one of the strongest performers in the real estate market, with occupancy and rental rates continuing to grow, despite construction remaining near cyclical highs. 2018 is expected to be the second-highest in the cycle in terms of number of completions, with 258,000 units expected to activate, approximately 10% below the levels seen in 2017. However, this supply is expected to have minimal impact on occupancy going forward, with 2022 occupancy expected to remain steady at

FIGURE 4

VARIOUS INDICES: 1978-2016 ANNUAL AVERAGE TOTAL RETURN AND VOLATILITY (RISK)



Source: Axiometrics

11 JLL, September 2017

12 Axiometrics

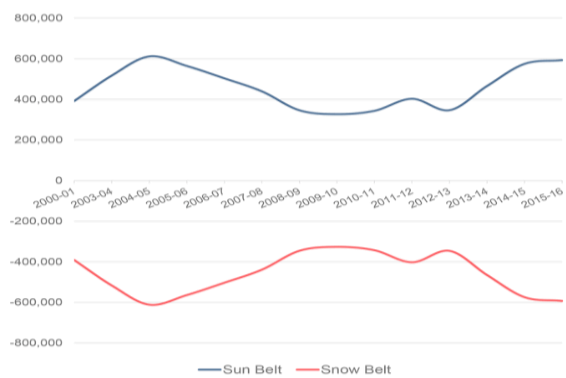
94.7%. Additionally, rental rate growth is still projected to be robust, with annual effective rent growth not dropping below 2.0% during the same period[13].

Not all multifamily is the same. **Within the multifamily sector, Capitas is focusing its acquisition efforts on light value-add opportunities, located in markets with solid demographic fundamentals such as the Sun Belt states**. Cities such as Dallas, Houston, Las Vegas and Atlanta have experienced high growth in population and employment due to their lower cost of living in comparison to major cities in the US.

FIGURE 5

US Domestic Migration

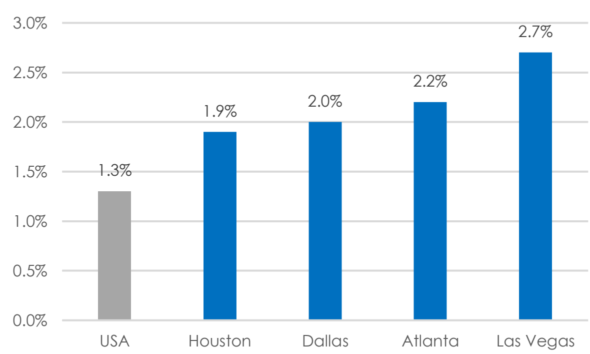
Snow Belt to Sun Belt Region, 2000-2016



Source: US Census Bureau, Brookings Institute

FIGURE 6

Strong Household Growth Projected for Sun Belt Metros (2018-2022 CAGR)



Source: REIS

The business-friendly environment within these MSAs has also driven large-scale relocations from employers to follow employees - a fundamental shift in the real estate dynamic. This has, in turn, created robust demand for housing space.

> *"With projected household growth 100 bps higher than the US average and cap rates around 75 bps higher than primary markets, multifamily investments in Sun Belt metros will provide strong cash yields backed by solid demographic growth." Omer Maqsood, Head of Underwriting, Capitas*

Within these markets, Capitas targets multifamily properties in transformative neighborhoods – areas that have a high rate of infrastructure, retail and office construction that would be fully built during the investment period. This evolution of the property's surroundings results in significant value creation and potential for strong capital appreciation at exit.

Newly-built multifamily properties offer compelling opportunities to complete for light value-add by completing lease-ups, switching property management from the developers to dedicated operators and cost optimization.

Capitas has also targeted Sun belt MSAs as Class A multifamily properties in these markets feature cap rates that are, on average, 50-100 bps higher than fully matured markets[14].

In line with its multifamily strategy, Capitas added a Class A multifamily property in Houston in 2017 to its US portfolio, which is expected to average approximately 7% cash yield and 11% IRR net to investors over a 3-year investment period.

13 REIS

14 CBRE Q2 2017 Cap Rate Survey

Suburban Office – A High-Growth Sector with Double-Digit CoC Yield Potential

The trend of major corporate relocations into Sun Belt states has resulted in large office campuses being set up on the fringes of these fast-growing metros. Capitas believes that this trend, coupled with the rapid growth of infrastructure to transform these areas into "Live-Work-Play" communities will drive demand of the suburban office sector across the country.

In terms of absorption of office space in 2017 across the US – suburbs finished the 12-month period ending mid-year 2017 with 30.5 million sf of absorption, while downtown markets ended with 2.4 million of negative absorption during the same period[15]. **With positive absorption for 27 consecutive quarters**, the sector has steadily, quietly continued to improve[16].

Going forward, Class A office properties located in Sun Belt metros will benefit from the growing demand for Class A space from large companies. Reputable companies, notably Deloitte, Ford, Toyota, State Farm, GE and UPS have either relocated their headquarters, or expanded their presence within cities such as Atlanta, Orlando and Dallas.

Orlando, for example, has had the greatest drop in vacancy among suburban office markets in the US, recording a **490 bps drop** from Q4 2015 – Q4 2016. It is of little coincidence that this metro is experiencing significant infrastructure improvements. **$9.3 billion** of infrastructure investment is underway, expanding roadways, airports and public transportation.

Capitas Underwriting Guidance – Office

- **Suburban Offices** – Offices located 15-20 minutes away from downtown areas
- **Class A Properties** – Newly-built or recently renovated properties that cater to institutional tenants
- **Limited Tenants** – Less than 10 tenants in the property, limiting tenancy loss and re-leasing risk
- **Blend & Extend** – 4-6-year WAULT, providing stability of income over the hold period and potential to extend leases ahead of exit
- **Growing Markets** – Properties located in Sun Belt metros that are the subject of high demand from institutions looking to relocate headquarters
- **Strong Location –** Close proximity to national highways, public transportation and entertainment

Investments in Sun Belt metros such as this are highly likely to benefit from the positive impact of decreasing vacancy and increased infrastructure spend.

With the current cap rates for suburban offices sitting in the range of 7-8%, risk-adjusted cash-on-cash returns in the double-digit range may be achieved with moderate leverage. At the same time, the growing popularity of Sun Belt metros and Class A offices within their suburbs stands to mute cap rate expansion, increasing the probability of capital appreciation over typical hold periods.

By focusing on well-situated assets in high-growth markets, investments within this sector can provide a rare combination of secured high current income yields and strong capital gains on exit.

Data Center Growth - A Key Trend to Watch

Data centers are generating significant demand from small-to-large-scale users driven by the increasing consumption of data.

From self-driving vehicles, to networked homes, to advancement in virtual reality, there is an ever-increasing demand for data consumption and consequently, data storage. This is evidenced by traffic growth in US cloud data centers, at **27% CAGR from 2015-20**[17], primarily driven by demand from Amazon, Oracle, Microsoft, Apple etc. as these companies require additional infrastructure to support their rapid growth. Hyperscale technology solved a critical issue facing the data center sector – as data centers got bigger, the corresponding growth in output was smaller.

15 Avison Young
16 CBRE Spring 2017 Office Report
17 Cisco Cloud Global Index

These diminishing marginal returns were a roadblock to large data center users as it did not allow them to scale effectively. Hyperscale data centers have replaced legacy technology, opening the doors for large-scale facilities to be constructed efficiently. This has generated significant interest from large technology companies, who are locking in long-term NNN leases on build-to-suit hyperscale data centers in key markets with lower-cost energy output such as Loudoun County, VA.

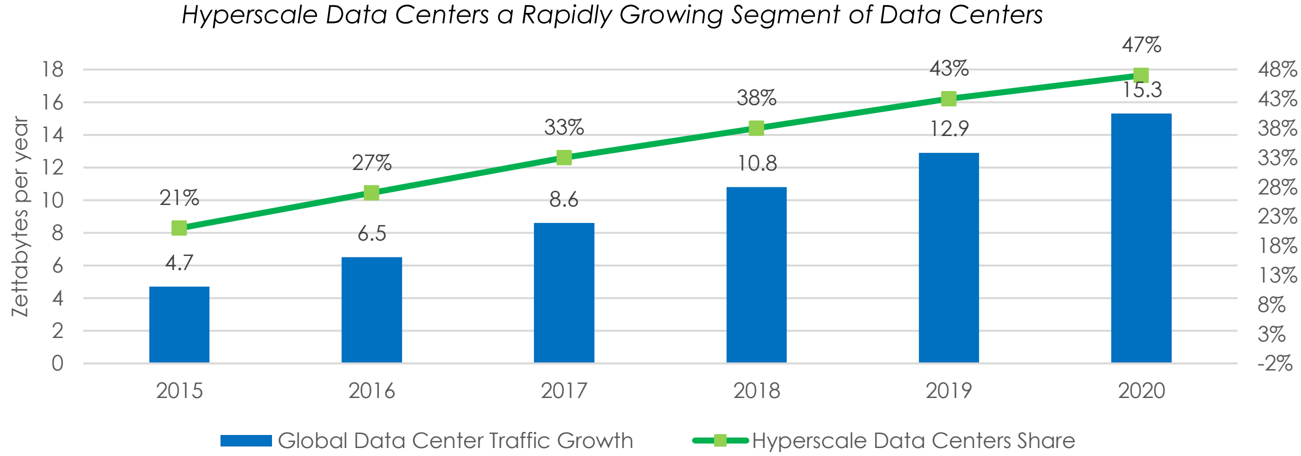
With 27% CAGR forecast for hyperscale data centers, and the billions of dollars invested by Amazon, Microsoft, Apple, Google and other tech giants, it is clear the demand for data centers is present and growing.

Because this is a nascent sector, investors could find opportunities for long-term net-leased data centers trading at cap rates around 150-200 bps higher than traditional industrial investments leased to the same tenant, a very compelling investment basis for secured cash flows.

In 2017, **$75 billion** was spent by hyperscale users such as Google, Microsoft, Facebook and Amazon to build and expand their bespoke data center infrastructure, a **19% growth** in capex from 2016, according to Synergy Research Group. This significant level of capital expenditure provides assurance of these companies' commitment towards long-term occupation of hyperscale data centers.

FIGURE 7

Hyperscale Data Centers a Rapidly Growing Segment of Data Centers



Source: Cisco Global Cloud Index

About Capitas

Capitas (DIFC) Limited ("Capitas") is regulated by the Dubai Financial Services Authority. Capitas accesses international capital markets to acquire quality real estate assets in the US and Europe for its capital partners in the GCC, Asia, Europe and North Africa.

Through co-investments with US asset managers, Capitas transacted on 9 real estate assets in the US with a combined value of $237 million for its capital partners in 2017. These assets are located across the US and encompass 500 senior housing units, 370 Class A multifamily apartments and 464,000 sf of NNN single-tenant industrial/logistics facilities.

Together with its development projects in the GCC, Capitas' real estate advisory portfolio has grown to $500 million in the span of 18 months.

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