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capitas

US REAL ESTATE OUTLOOK
APPROACHING INVESTMENTS WITHIN AN IMPENDING CYCLE SHIFT

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KEY INSIGHTS:

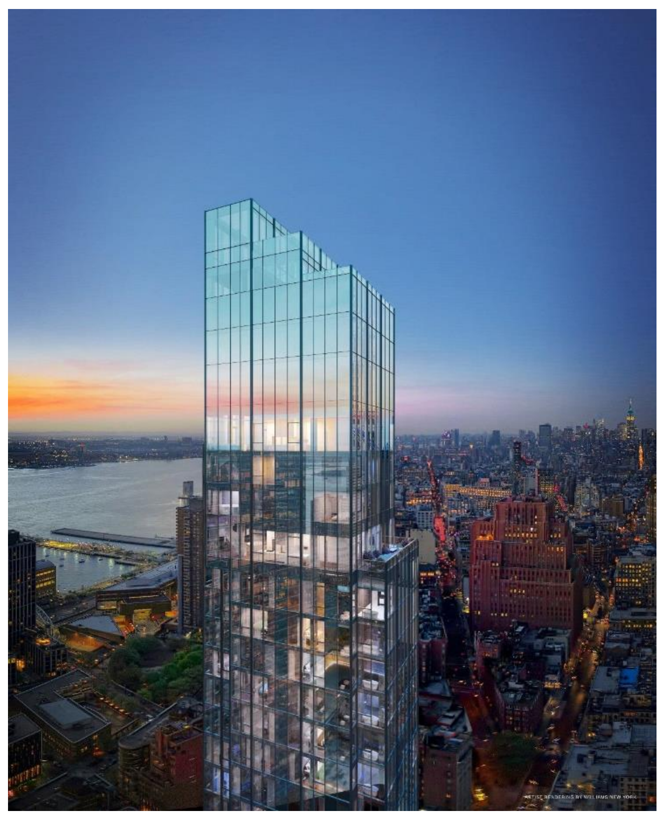
- **Targeted Sectors**: What sectors provide the most compelling opportunities in today's environment and why?
- **Equity vs. Debt:** Where should investors place themselves in the capital stack? Are capital gains still to be found for equity investments?
- **Tax Benefits:** What are the tax benefits for a properly structured debt investment?
- **Underwriting Criteria:** What are the key indicators to watch for while valuing investments?

With the US economy in the 2nd longest economic cycle in its history, savvy investors should turn to safer, current-income focused investments that would thrive, even during a potential downturn.

- Flexibility on hold periods, focus on current income and locking into long-term debt are key themes that will define successful investments in 2018
- Defensive sectors that provide a high degree of underwriting certainty, such as multifamily, NNN-leased office and industrial, and debt investments will be targeted by Capitas
- A supply/demand imbalance with local lenders has created a void that institutional investors are eager to fill, evidenced by 26% greater capital fundraising for CRE debt in 2017 vs. 2016[1]
- CRE debt investments provide tax benefits when structured correctly, resulting in an 17.5% boost to IRR when compared to a similar equity investment
- With greater amounts of capital chasing deals, deep origination expertise through relationships with asset managers is critical

Critical themes to follow

As the US continues its eighth consecutive year of economic expansion, the second highest in its history[2], investors have a critical question to tackle – aim for higher returns through riskier investments, most susceptible to an economic downturn, or shift to safer, stabilized investments that would protect wealth even in adverse conditions?



Capitas believes that the best of both worlds, strong returns and safety of investments, can be found by targeting core-plus and light value-add investments in highly targeted sectors and locations in the US. However, in order to maximize the potential of their investments, investors should keep a few guidelines in mind.

Focusing on current income driven returns, rather than significant exit value upside, is a key component of Capitas' investment strategy. Through this, investors do not need to rely on timing the market to realize value,

[1] Preqin
2 Bloomberg

but rather relying on an asset's overall ability to ride out a cycle shift while still generating measurable recurring cash flows. Investments with NNN-leases provide a high degree of underwriting confidence through stable fixed income with minimal variations due to nominal landlord operating costs. Multifamily, a long-standing favorite for defensive, yield-driven investors, is facing a growing wave of demand from Millennials while rising construction costs limit supply risk. Moreover, with recent interest rate hikes in place, and more likely on the horizon, a critical component of a smart real estate investment in 2018/19 would be to lock into fixed-rate long-term debt facilities to finance investments. Investors hedge their investments against higher interest rates in the future and would likely be able to ride out a shift in the economic cycle due to the longer term of the facility.

As the current cycle continues, investors must become flexible in their hold period and be prepared to hold on to an investment for longer than originally anticipated. Exiting at shorter term hold periods could prove to be detrimental to what may otherwise be a sound investment, underpinned by a high-quality asset. Accordingly, Capitas is stressing its underwriting scenarios to ensure that investments remain viable at 5, 7, and 10 year hold periods.

Opportunities in a compressed cap rate environment

Capitas views equity investments in the US real estate sector as a highly compelling option for investors who are willing to look beyond core investments in Gateway cities.

Capitas continues to target core-plus equity investments in the multifamily, industrial, suburban office, and data centers (with a preference on single let or low multi-let tenant profile) in growing non-Gateway markets. These provide a combination of high cash yields and low-to-mid teens IRR.

Within the industrial sector, Capitas targets acquisitions of headquarter facilities leased to strong private-credit tenants in 18-hour cities such as Orlando, Pittsburgh and Indianapolis. These cities feature higher cap rates than Gateway markets while staying highly attractive for industrial and logistics tenants due to their proximity to major MSAs. The higher rental rate growth and developing nature of these markets provides a greater potential for capital gains as well, making an equity investment a highly attractive option for investors.

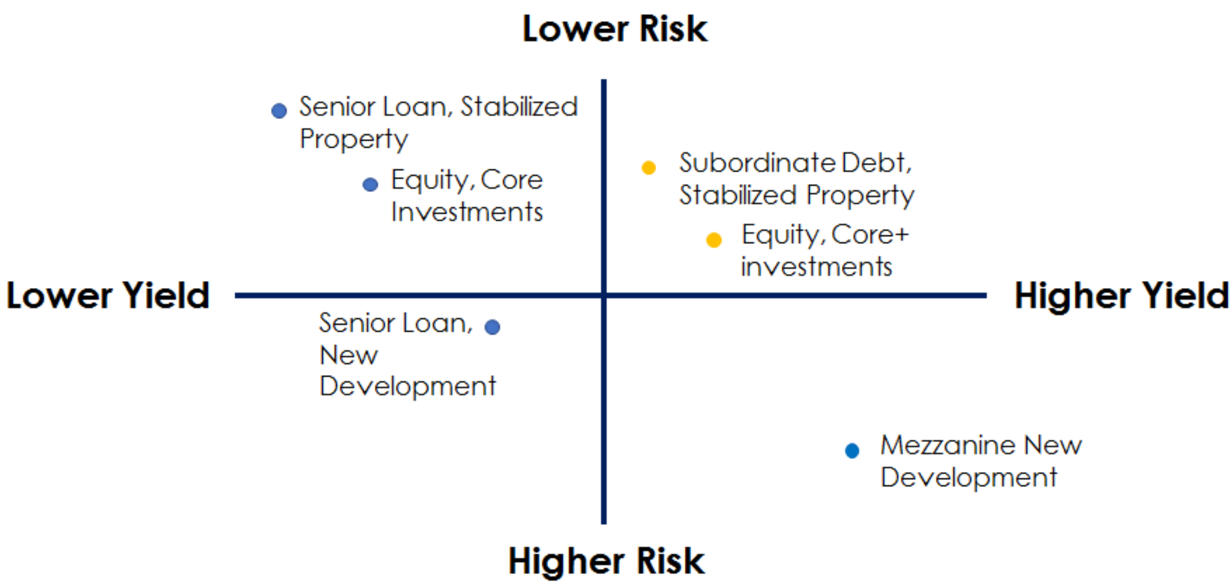
Within the multifamily sector, Capitas is focusing its acquisition efforts on light value-add opportunities, located in markets with solid demographic fundamentals such as the Sun Belt states. Cities such as Dallas, Houston, Las Vegas and Atlanta have experienced high growth in population and employment due to their lower cost of living in comparison to major cities in the US. 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.

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. Accordingly, Capitas targets acquisitions of Class A suburban office properties that are highly likely to benefit from the positive impact of decreasing vacancy and increased infrastructure spend during the investment period, leading to greater capital gains for equity investments.

Data centers are a rising phenomenon across the world, and especially in the US. As this is a nascent sector, investors could find opportunities for long-term net-leased data centers trading at cap rates approximately at150-200 bps higher than traditional industrial investments leased to the institutional tenants, a very compelling investment basis for secured cash flows. At the same time, Capitas believes that data centers are set to grow rapidly – billions of dollars are being invested by Amazon, Microsoft, Apple, Google and other tech giants looking for increased data storage. The growth of this sector and the resulting cap rate compression will drive capital gains for equity investments, while the long-term NNN leases locked in by high-quality tenants provides a strong basis for secured cash flows.

On the debt side, Capitas targets investments that are lower risk and provide an avenue to Gateway cities and higher-profile properties while not facing the issue of reduced capital gain potential as a result of the current compressed cap rates in the primary markets in the US.

Class A properties[3]. However, opportunities would exist in case there are no local sponsors in which case the only option would be to borrow from international sources.
A more readily available option for debt investments are mezzanine loans. While mezzanine loans would limit competition from local lenders, investors must be much more selective in their investments on account of the higher risk associated with the subordination of these investments. On a recently closed mezzanine facility for a development project, Capitas' successful execution was due to the project being close to completion in a Gateway city in the US and had generated an impressive amount of pre-sales. Thus, there would be a high likelihood that Capitas' place in the capital stack would be protected in a downside scenario.



When considering debt investments, the initial question for investors is where to place themselves in the capital stack. While senior loans are safer and backed by the property, mezzanine financing provides significantly higher yield.

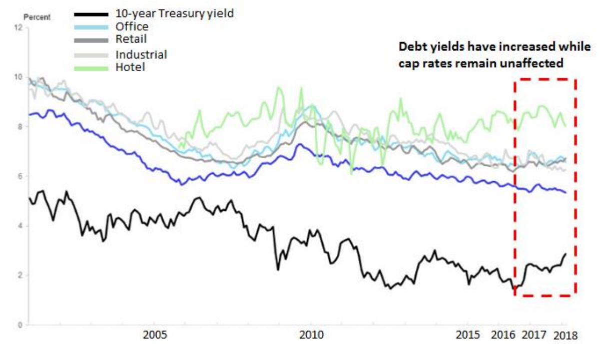
Senior loan investments carry lower risk, but opportunities would be harder to find as investors would compete with the aggressive rates provided by CMBS facilities and commercial banks in the US, who are willing to offer fixed rates of 4-5% and multi-year interest-only periods on

Going forward, Capitas' view is to focus on subordinate loans as the area with the greatest opportunity to match the yield requirements of foreign capital with the financing needs of local investors. Through its extensive network of best-in-class sponsors and diligent screening of transactions, Capitas has built a deep pipeline of risk-adjusted opportunities with strong yields within the CRE debt space.

3 Capitas Analysis

The rise of CRE debt investment

Institutional investors across the globe are beginning to take note of debt investments as a viable alternative to traditional core equity investments into US real estate. Aggregate capital raised for debt funds reached $33 billion as of January 2018, a 36% increase from 2015 levels[4]. The trend of rising interest rates combined with the lack of a corresponding increase in cap rates is beginning to shift the mentality of foreign investors to lower-risk debt investments.



Source: NREI

The rising interest rate environment in the US is one driven by years of economic growth as US unemployment rates reached new lows and median household income grew to the highest levels since 2000[5]. However, cap rates have been relatively unaffected, particularly for core real estate in Gateway markets. The continued expansion of the US economy along with the growth in e-commerce have improved real estate fundamentals, fueling a robust recovery in asset prices. However, there is a wide variance in pricing across the country – the spread between implied cap rates between Gateway markets vs. secondary markets is 90 bps[6].

While equity investments in secondary markets provide strong potential for capital appreciation and form a crux of Capitas' targeted equity investments for 2018/19, debt investments are a more compelling choice for investments in Gateway markets where capital appreciation is limited. At the same time, the US debt landscape is transforming to one with significant opportunities for private debt capital.

The US debt market has seen reduced leverage from traditional lenders due to more stringent regulations and capital requirements[7] post the fiscal crisis. Additionally, over $750 billion in CMBS, bank and life company loans that were made at the peak of the previous cycle are set to mature by 2020, which would likely require deleveraging to achieve a refinance with traditional lenders[8]. This supply/demand imbalance has created ideal conditions for private debt investments to step in and provide opportunities for foreign capital to realize strong yield-driven, low-risk returns.

Within the commercial real estate debt space, Capitas has identified office and net-leased industrial sectors as targets to execute transactions in 2018/19, while maintaining an opportunistic outlook towards developments and redevelopments in the US.

Central Business District ("CBD") offices in Gateway Cities provide an attractive avenue for senior or mezzanine financing. Properties located within the top 20 cities in the US are often too large for a simple two-tier capital stack to fulfil. At the same time, these investments provide other potential debt sources a high level of assurance of fulfiling future interest payments on account of their consistent demand from highly institutional tenancy, making them compelling opportunities for subordinate debt investments. The current compressed cap rates of these properties, at approximately 5.2% as of 2017[9], suggests limited potential for capital appreciation, so debt structures are ideal for investors looking to increase their exposure within this sector.

Capitas is also closely monitoring debt investments in the logistics sector. NNN-leased logistics facilities provide bond-like returns backed by highly stable, long-term leases. With cap rates on high-quality NNN leased

[4] Preqin
[5] US Census Bureau
[6] NCREIF NPI
[7] PIMCO Whitepaper, 2017
[8] NREI, 2017
[9] CBRE Cap Rate Survey, H2 2017

industrial facilities well below 5%[10], capital gains are likely to be muted for these investments, while their bond-like returns provide a compelling option for senior or mezzanine lending with a high probability of debt repayment, backed by covenants drawn into the lease and by the tenant's credit.

Capitas also selectively analyzes opportunistic/special situation debt investments into development and redevelopment opportunities. Mezzanine investments into projects with institutional developers and in highly strategic locations in Gateway markets are opportunities that Capitas focuses on originating. The cost of construction in the US is rising rapidly, with prices up 5.8% in April 2018 compared to April 2017[11], which in turn increases the need for additional sources of financing from developers. However, considering the higher risk profile of development projects, Capitas only considers those that are ready for construction or in mid-construction, where the risk of delays or non-performance are reduced. Providing financing at this stage provides the benefits of flexibility as mezzanine financing can be structured to benefit both the lender through convertability and ownership options as well as benefitting from yields that would not be matched by other sectors.

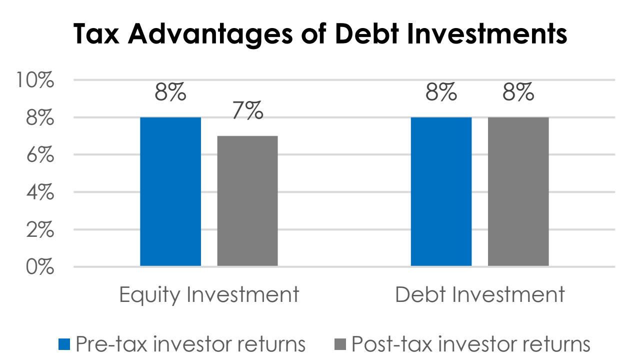
CAPITAS UNDERWRITING GUIDANCE

	Office	Industrial	Opportunistic/Development
Tenancy	Multi-tenant structure, publicly-listed institutional	Single-tenant, strong private or public credit	N/A. Focus on institutional developer
Location	Downtown Gateway/large non-gateway	18-hour cities	Gateway
Max LTV	Max 75%	Max 85%	Max 70%
Local Sponsor Equity Contribution	20-25%	15-25%	30%
Type	Mezzanine	Senior/Mezzanine	Mezzanine
Target Yield	7%	6-7%	15%

Tax Benefits of Debt Investments

With the current tax regime in the US growing more favorable to foreign real estate investment (see here for our insight into the impact of tax reforms on international investment), debt provides a relatively straightforward avenue for real estate investments compared to equity.

FIRPTA withholding tax entails a 15% withholding on dispositions, impacting potential capital gains from equity investments[12]. Lenders to real estate investments are however exempt from FIRPTA taxation, even when the loan is secured by the subject property. This is a significant benefit for senior loans provided by international institutions or mezzanine loans that are not convertible to equity shares in the property. Additionally, mezzanine loans provided for development projects in the US can avail the portfolio interest exemption in sections 871(h) and 882(c) of the US tax code which would eliminate any taxation applicable on interest payments. These factors allow debt investments for international investors to generate a higher IRR than an equivalent equity investment if the property were sold at 17.5% premium to its cost[13].



[10] CBRE Cap Rate Survey, H2 2017
[11] US Bureau of Labor Statistics
[12] IRS

[13] Capitas Analysis based on a 5% dividend rate for the Equity Investment and 8% coupon for the Debt Investment and a hold period of 5 years

The recent supply/demand imbalance for CRE debt interest rates in the US and stricter lending from US banks, has created a void that international institutions are quickly filling.

Institutions in South Korea have increased their allocation towards debt investments in the US, with South Korea currently representing a significant 21% of the total CRE debt investments into the US as of April 2018[14]. This trend of deploying debt capital into safe-haven markets such as the US will likely be followed by investors in other countries.

Some of the notable transactions from international investors include a $475 million refinancing of 285 Madison Avenue a $220 million loan for 787 7th Avenue by South Korean investors[15]. While these investments are primarily focused on office properties, savvy international investors are increasingly turning to the industrial sector, drawn by the higher return potential and stable tenant fundamentals.

NOTABLE TRANSACTIONS

Name	Size	Type	Date	Investor
33 South Sixth St	$320m	Equity	Jun-18	Samsung SRA Asset Management
Chrysler Building	$300m	Senior debt	Mar-17	National Bank of Abu Dhabi
Marriott Times Square	$300m	Mezz debt	Apr-18	Hana Alternative Asset Management
Woodies Building	$204m	Senior debt	Jan-17	IGIS Asset Management

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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[14] Preqin

[15] Wall Street Journal, April 2018