INVESTCORP

INSIGHTS

MARCH 2019

US Real Estate Trends and Updates

Austin Skyline

US Market Overview

Midtown on Main, Arizona

Economy

2018 exhibited a healthy 2.9% annual rate of real GDP growth, extending an expansion (118 months) that is now approaching the longest in US history (120 months; 1991-2001)[1]. Most forecasters are predicting slower, but healthy growth over the course of 2019 and 2020, as the effects of the 2018 tax-cut and stepped-up government spending begin to fade.

Despite record-low unemployment throughout 2018, real (i.e. inflation-adjusted) wage growth has been relatively slow, which has constrained inflationary pressures. Wage growth is finally picking up, however, and will be closely watched for its impact on pricing and real estate operating expenses. Conversely, greater, but modest inflation could lead to greater rental growth.

The rise in US import tariffs on Chinese and other imported goods presents an interesting variable for 2019. Impacts could be positive (i.e. an increase in domestic production) or negative (i.e. increasing cost of goods and/or a meaningful curb in export demand resulting from retaliatory tariffs).

Given the strong fundamental economic growth, the Federal Reserve implemented four interest rate hikes during 2018. However, in January of 2019, the Fed signaled that it did not intend to raise rates again in the foreseeable future. Nonetheless, many economists predict that continued fundamental growth – along with core inflation projected to be at or above the 2% level next year – could prompt the Federal Reserve to increase rates to 3% or above by the end of 2019.

Continued increases in rates could contribute to higher costs of debt and decelerated foreign investment, respectively.

On balance, 2019 is expected to bring continued economic strength in the US, as we extend into the longest recorded expansion in US history. While inflation and geopolitical events pose tangible risks, the US economy's growth is expected to endure through the year as consumer and business confidence remains high.

Labor Markets

The 2018 US job market was strong with an average of 220,000 jobs added per month in 2018 (21% greater than 2017) with an additional 300,000 jobs added in January 2019[2]. Accordingly, year-end unemployment was very low at 3.9% (versus 4.4% in 2017)[3]. At these sustained levels, employers are experiencing increased difficulty in finding qualified employees. As noted above, we are starting to see this difficulty finally manifest itself in increasing real wages.

That said, increasing wages should support consumer spending (2.7% growth in 2018), in turn. Indeed, the US consumer remains quite optimistic: despite year-end stock market volatility, retail sales continue to grow at a healthy pace.

Real Estate Fundamentals

Given the present economic foundations – above average GDP growth, strong job growth, and tempered interest rate movement – commercial and residential properties remain on solid footing in the US That said, we expect occupancy and rental rates to experience slower, but steady rates of growth at this stage in the cycle.

In general, commercial tenant demand continues to meet the new supply in the industrial markets and the preponderance of the primary office markets. On the residential side, some segments – like Class B multifamily – have been largely unaffected by new deliveries, the bulk of which has been in the higher-end Class A segment of the marketplace.

Furthermore, the excessive financial leverage that characterized previous cycles is not in evidence in the current market. Therefore, most projects – including even speculative, development deals – have capital structures that should allow for patient, measured operating execution, as necessary.

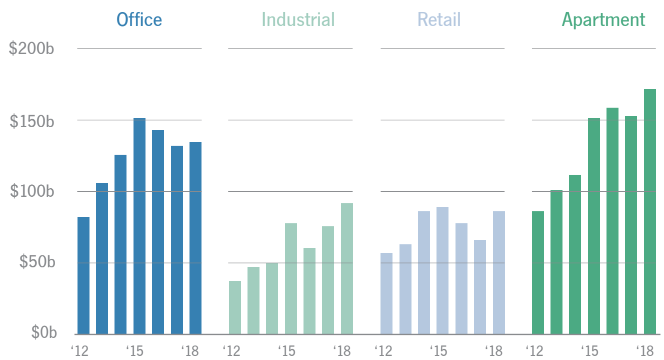
Transaction Activity

In 2018, commercial property transaction volume totaled $562 billion, the third-largest annual figure ever recorded (behind 2015 and 2007) and a 15% year-over-year volume change.[4] However,

1 Preliminary Estimate, US Bureau of Economic Analysis (February 2019)
2 Bureau of Labor Statistics, Employment, Hours, and Earnings from the Current Employment Statistics Survey (February 2019)
3 Bureau of Labor Statistics, Labor Force Statistics from the Current Population Survey (February 2019)

this near-record transaction activity was materially enhanced by the growing bulk of entity sales ($175 billion), a necessary approach for large investors seeking rapid scale in a market characterized by high prices and a limited supply of individual asset sales. If large entity sales are removed from the equation, single asset sales in 2018 increased 3% year-over-year.

Figure 1. **US Deal Volume Across Major Sectors in 2018**



Source: Green Street Advisors

On average, sale pricing grew 6.2% from 2017 to 2018, higher interest rates notwithstanding. We are seeing a more limited seller pool at this stage of the cycle: many sellers have already realized gains in this cycle, and many recent buyers are not prepared yet to harvest their own gains. For some asset classes, like, for example, office in prime gateway markets, many asset-holders are long-term minded with plans to hold through the remainder of this cycle and well into the next one.

In any case, capital demand for US commercial real estate continues to be strong and growing. Significant "dry powder" (i.e. allocated but uninvested capital) exists within domestic closed-ended funds, foreign sovereigns, and domestic and international insurance companies. At the end of 2018, $73.4 billion of capital has been raised for closed-end funds targeting US real estate.[5]

Interest Rates and Cap Rates

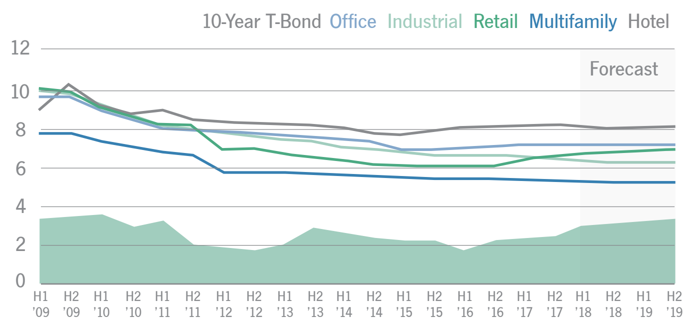
Cap rates are currently at historic lows across all asset classes, with the exception of some retail sectors, suburban office, and suburban hotels. Consequently, investor appetites are turning to secondary markets and/or secondary quality assets to maintain returns.

Accordingly, the spread between cap rates and the 10-year US Treasury yield (which peaked at around 3.15% in October 2018) has narrowed. Nonetheless, the spread is still sizeable.[6]

"Real estate fundamentals are solid, and Investcorp continues to believe that excellent investment opportunities exist in today's US real estate markets."

Jonathan Dracos
Managing Director,
Global Head of Real Estate

Figure 2. **CBRE Cap Rates, 10-Year Treasury Yield (%)**



Source: CBRE Cap Rate Survey, CBRE Research, US Federal Reserve Board, November 2018

Conclusion

With strong property-level fundamentals, active debt markets and compelling, albeit slower, growth prospects, most investors find US real estate to be relatively attractive on a risk-adjusted basis. Stock market volatility, low-yielding bonds, and complex geopolitical concerns make US real estate a consistent safe haven for domestic and foreign capital.

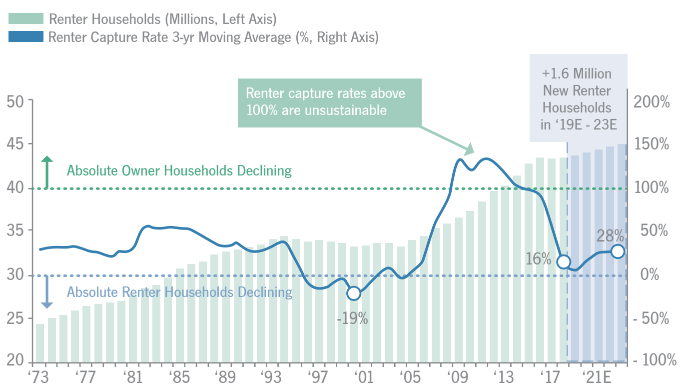
4 Real Capital Analytics, US Deal Activity Third-Highest on Record in 2018 (January 2019)
5 Preqin. (January 2019)
6 CBRE Research, US Real Estate Market Outlook 2019 (December 2018)

Multifamily

The multifamily sector's healthy surge during the current cycle has been driven by strong population and job growth, lagging real wage growth, and shifting lifestyle dynamics – delayed marriage and family planning – as well as a growing preference among certain cohorts to maintain liquidity and mobility. In particular, the renting lifestyle is propelled by a rising generation of millennials (80 million), as roughly 70% of 20-to-34-year-olds in the US are living in multifamily housing. Considering the population in this age group is expected to increase by 1.4 million over the next five years, the fundamentals for the multifamily sector are projected to remain strong.

That said, home ownership did increase slightly (63.9% to 64.4%) in this past year.[7] The older millennials have, in some cases, migrated to home ownership. Nonetheless, rising home prices, higher mortgage rates, and a dearth of affordably priced homes continue to favor an increasing absolute number of renters. Furthermore, the 2017 federal tax legislation, which reduced some of the tax benefits of homeownership (i.e. deductibility of local real estate taxes and mortgage interest), may diminish any resurgent interest in homeownership.

Figure 3. **Renter Households**



*The percentage of net household growth generated from an increase in renters.

Source: Green Street Advisors

While fundamentals for multifamily demand remain strong, a lower rent growth rate is expected nationwide as the 2018 deliveries of new supply increased the overall, nationwide vacancy rate to 6%. Looking forward, deliveries, in aggregate, are projected to continue to slow down over the next two years. That said, some "Sun Belt" markets (i.e. Charlotte, Austin, Nashville) will continue to experience significant, continued supply pressure.

"Market fundamentals in the 'for rent' multifamily space remain quite healthy despite some nationwide deceleration of rent growth."

Michael O'Brien
Managing Director,
Head of Asset Management

Where there has been and/or continues to be new supply, the new apartments are Class A, higher-end, mostly urban in-fill product. Land and construction costs simply do not permit the new construction of affordable product

Consequently, the fundamentals of Class B/B+ apartments have remained relatively steady due to the continued, considerable rental rate gap between existing and new product. Most renters have been able to withstand continued Class B rent growth without ascending to a Class A price profile. Given the relative lack of wage growth in this economic cycle, these "renters by necessity" are paying an increasing portion of their income towards rent (from approximately 20% in 2006 to approximately 30%, presently)[8], but this seems to be manageable, especially as wage growth starts to accelerate.

Cap rates have been falling (values rising) for Class B assets, while cap rates for Class A assets – especially in markets that have seen significant new supply – are higher on average. In addition, some investors are adjusting as the cycle lengthens by shifting their focus to submarkets – often in more suburban locations – with limited exposure to high levels of new construction.

Investcorp continues to favor a multifamily strategy that focuses on Class B/B+ apartments with limited exposure to competitive new supply. As others shift their focus to similar strategies, we may experience cap rates compressing or flattening even in the context of higher interest rates. However, the strength of multifamily fundamentals will translate to ongoing attractive opportunities in select markets that continue to exhibit strong population and job growth.

[7] Green Street Advisors, US Apartment Outlook (January 2019)
[8] CBRE Research, US Real Estate Market Outlook 2019 (December 2018)

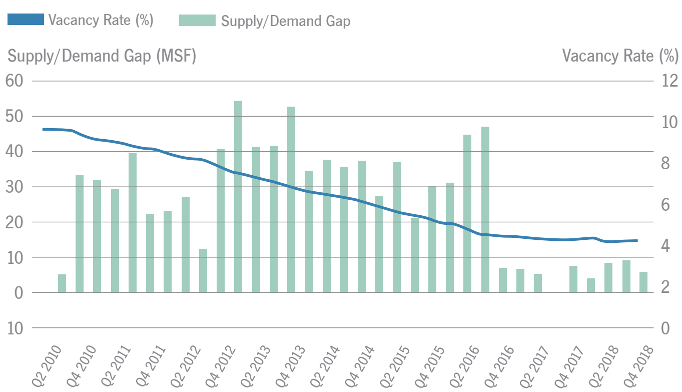
Amberly Place, Florida

Industrial

For a second straight year, CBRE ranked industrial as "institutional investors' most preferred asset class". While much of the industrial focus is on Amazon and the surging e-commerce retailer demand, there has also been significant net new demand from wholesalers and third-party logistics operators ("3PLs") who are expanding to meet the needs of the accelerating global supply chain. Given the growth in US consumer spending, increased business inventories, and expanded industrial production, tenant demand for warehouse and logistics space does not appear to show any signs of slowing.

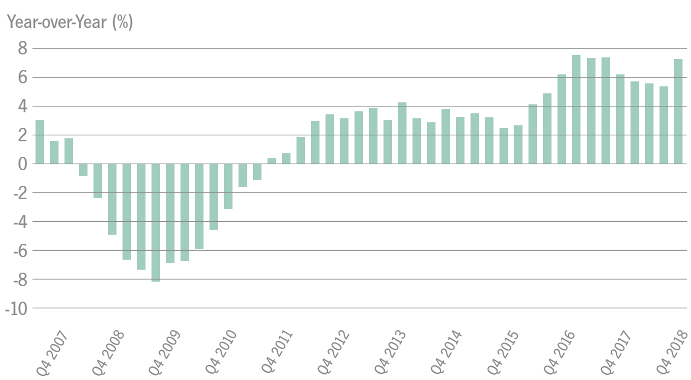
Consequently, demand for industrial space has consistently outpaced new supply in the marketplace (i.e. for thirty-two of the last thirty-three quarters), driving the year-end national vacancy rate to a historical low of 4.3% and increasing net asking rents by 7.4% year-over-year to a national average of $7.37 psf.[9]

Figure 4. **National Industrial Vacancy**



Source: CBRE Research

Figure 5. **National Industrial Rents**



Source: CBRE Research

While regional distributors' state-of-the-art "big box" logistics centers continue to grab headlines, smaller, "last-mile" facilities near population centers also receive considerable demand from omnichannel retail distributors and other service providers who value proximity to their customers. In fact, these in-fill locations are seeing a growing shift towards multi-story warehouse development due to a shortage of "last-mile" sites. Land costs, construction costs, and regulatory hurdles are simply too great to justify significant new industrial development in prime "last mile" locations.

Finally, as major grocers move more aggressively into e-commerce (i.e. Amazon-Whole Foods, Kroger-Ocado), demand for cold storage industrial space should increase. In 2017, online grocery sales represented only 3% of total grocery sales; however, by 2024, that share of the grocery sales is projected to rise to 13%, according to FMI/Nielsen.[10]

While concerns have risen around potential import tariffs and the impact on the industrial sector, the generally strong economy and supply/demand dynamic described above are expected to offset negative tariff effects.

Like many institutional investors, Investcorp finds industrial and logistics product to be extremely attractive given the strong fundamentals outlined above. We expect to buy quality industrial assets over the near term where both asset quality and current yield meet our standards.

"Industrial property has recently experienced significant construction levels offset by even greater levels of demand, resulting in all-time-high asking rental rates and rock-bottom vacancy rates."

Herbert Myers
Managing Director,
Head of Acquisitions

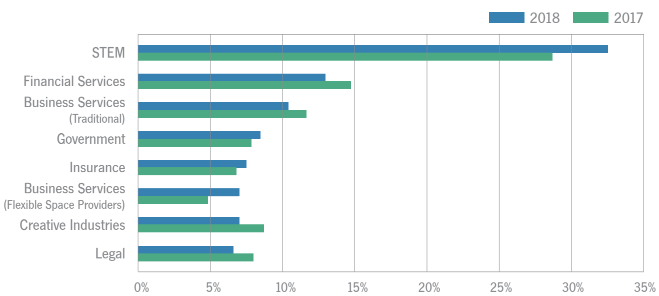
[9] CBRE Research, US Industrial & Logistics Figures Q4 2018 (January 2019)
[10] CBRE Research, US Real Estate Market Outlook 2019 (December 2018)

Office

Throughout the current expansion, office-using employment has remained solid, growing at a faster rate than overall employment. That said, as office-using employment growth confronts a tight labor market, US office tenant demand is projected to exhibit only moderate growth in the coming year. Further, this organic new job demand is expected to be offset by a variety of factors including market-specific new supply, increasing densification by users, requirements for more flexible (and more amenitized) workspace, a shift to urban office versus suburban, as well as trends in remote and shared-space work arrangements.

Currently, tenant demand is driven primarily by science, technology, engineering and math (STEM) industries –currently 25% of the total market – and flexible space providers (i.e. WeWork), whose leasing activity has increased over 700% since 2013.[11]

Figure 6. **National Industrial Vacancy: Overall Vacancy**



*Note: 2018 = YTD through Q3; data includes the 25 largest transactions by sq. ft. each quarter for each of the 54 markets tracked by CBRE Research. STEM includes high-tech and health care/life sciences leasing activity. Business services include s flexible space providers as well as accounting consultancy, employment services and real estate firms.

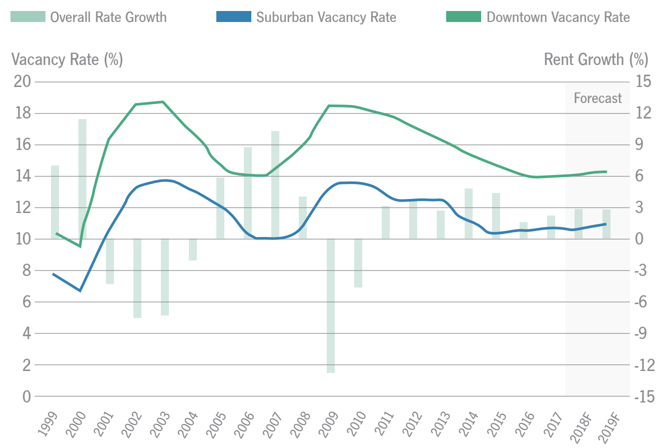
Source: CBRE Research

As supply outpaced net absorption in 2018, the vacancy rate in the US increased nominally by 30 basis points to 13.1%. This generally matches the lowest levels seen before the financial crisis but remains above the targeted 10-12% point of equilibrium.

10 Chandler Industrial Portfolio, Arizona

Meanwhile, the downtown vacancy rate decreased to 11.1% within major tech MSAs – including Seattle, Boston, New York, San Francisco, and Austin – which boast some of the lowest vacancy levels in the country. However, as the new supply is heavily concentrated in a handful of major markets (New York, Washington, D.C., Seattle, San Francisco, and San Jose), rent growth in suburban markets (3.0%) is actually expected to voutpace that of urban markets (1.9%) in 2019.[12]

Figure 7. **National Office Vacancy: Rates vs. Rent Growth**



Source: CBRE Research

While the dynamics within the office sector are evolving, opportunities will continue to exist with well-located urban and, in certain instances, suburban assets that offer proximity to public transit and extensive amenity offerings. However, unlike other asset classes, the office sector often requires high capital and leasing costs that reduce returns. Long-term value in the office-sector will be found in markets with deep, well-educated talent pools in the technology, medical and education sectors.

Retail

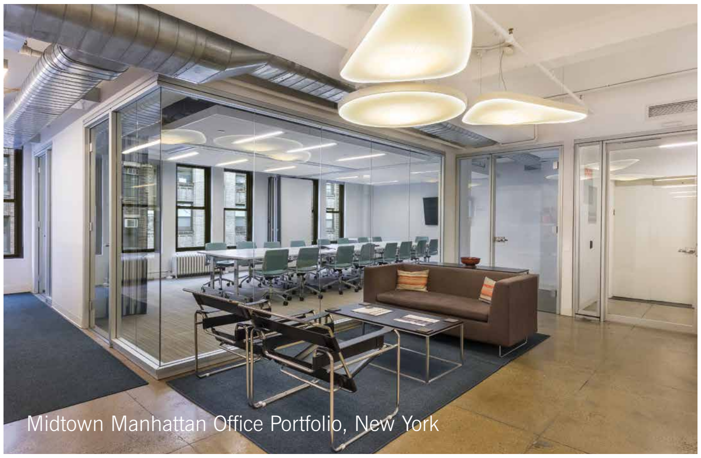
Over the last few years, retail sales have been growing at an accelerated pace, riding the high consumer confidence as a result of the US economy's strong job market, tax cuts, and ascendant (albeit rather slowly) wage growth. In 2018, these gains continued, as total retail sales increased by 6.1% year-over-year – the largest gain in six years.[13]

Nonetheless, in 2018, the retail industry continued to experience widespread store closings (i.e. Sears – 200 stores, JC Penney – 150 stores, Gymboree – 800 stores) as consumer buying habits shift towards e-commerce models.

The only major retailers expanding their footprint currently are leading value (i.e. Walmart) or service (i.e. restaurants and food) concepts that are more immune to e-commerce encroachment.

11 CBRE Research, US Real Estate Market Outlook 2019 (December 2018)
12 CBRE Research, US Real Estate Market Outlook 2019 (December 2018)
13 CBRE Research, US Real Estate Market Outlook 2019 (December 2018)

BüroCampus, Germany

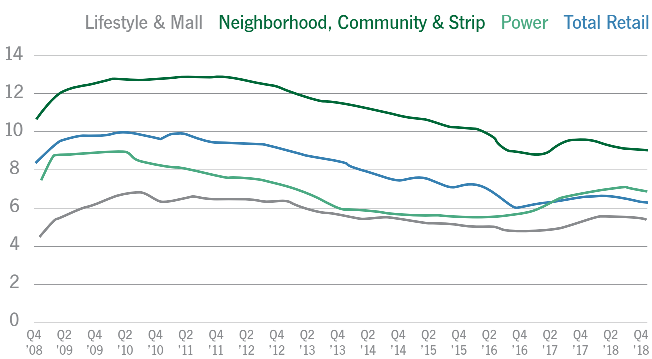


Midtown Manhattan Office Portfolio, New York

Department stores and traditional malls have been hit the hardest by the changing retail dynamics with some mall repositioning their assets towards alternative uses (food halls, hotels, co-working spaces, fitness and sports facilities, entertainment venues, etc.).

Though store closures in 2018 affected all retail property types, the concentration of vacancy was found in Class B and C assets and locations, as super prime properties retained relatively high retailer demand and continued low vacancies. National availability rates are low (6-7% per most sources) thanks to limited new construction as well as new demand from certain sectors including off-price and discount retailers and restaurants, as well as non-retail service, medical, personal service, and entertainment uses.

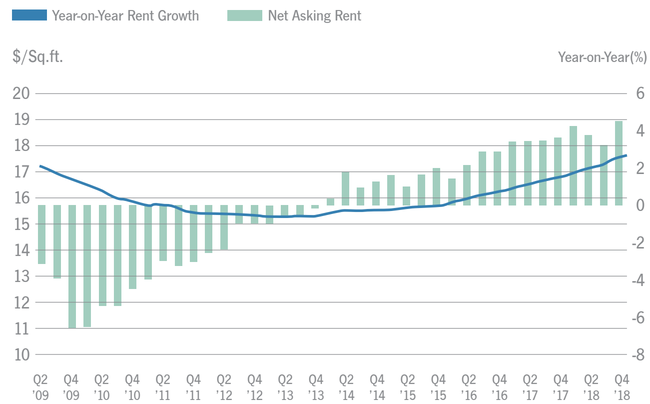
Figure 8. **National Retail Availability Rates**



Source: CBRE Research

In the right locations, many retailers re-investing in their physical stores to enhance the value of the omnichannel offerings to the consumer. Stores are becoming pick-up and drop-off points for online orders and returns, thereby reducing shipping costs. Further, where retailers can create unique experiences for their customers, higher-margin in-store sales can be cultivated.

Figure 9. **National Retail Rents**



Source: CBRE Research

Well-located retail centers, including urban retail, with proper tenant mixes and active programming (often involving creative landlord-tenant partnerships) should continue to thrive in our strong economy. However, lease terms will shorten, in this context, average tenant-credit quality will decline, and landlord capital contributions to tenant spaces will increase. In order to drive foot traffic, landlords will focus on restaurant and beverage tenants (e-commerce's least impregnable retail segment), and long-term true credit leases will become increasingly scarce.

While retail investment is currently not a top priority, Investcorp is always looking for specific investment opportunities that could be attractive to investors.

"Long-term performance in the office sector will be found in those markets with deep, well-educated talent pools in the technology, medical, and education sectors."

Brian Kelley
Managing Director,
Head of Managed Accounts

Raleigh Student Housing, North Carolina

Student Housing

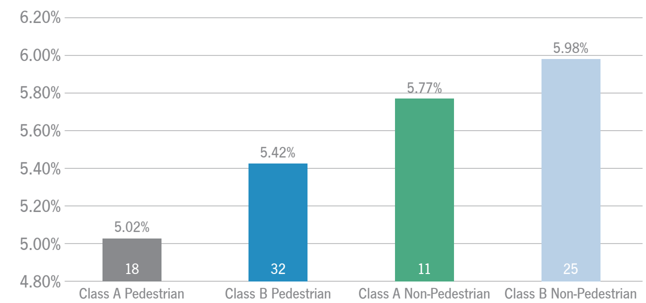
Despite steeper pricing and concerns regarding supply in specific markets, investment within student housing continues to grow at an accelerated pace, with transaction volume increasing 700% from 2010 to the record $10 billion achieved in 2018.[14] Investment activity has been spurred by many favorable market dynamics that include the growing disparity between the on-campus housing inventory and the rising college student population (i.e. roughly a 1:5 bed-to-student ratio),[15] the widest historical earnings gap between high-school and college graduates (1.7x),[16] and the strong occupancy and rent growth experienced in the cycle despite surges in supply.

Looking forward, the attractive supply and demand imbalance for student housing is projected to endure and drive opportunities for strong returns within the sector. Per the National Center for Education Statistics, the US student population is projected to grow consistently at an average rate of 1.2% per annum through 2025.[17] Meanwhile, the supply of new purpose-built student housing is projected to decrease substantially (52%) over the next five years compared to the last five years.[18] Considering high school graduates are now enrolling in college at a record level (69.7%), the ongoing strong demand is expected to propel occupancy above 95% over the next five years.[19]

Furthermore, as the current cycle matures, student housing poses an additional attraction to investors: the sector's resilience with respect to recession dynamics. Historically, during the last six economic downturns, student enrollment has consistently increased as higher education's appeal rose in the face of weakening job markets.[20] Accordingly, student housing REITs were the only REIT asset sector that experienced positive NOI growth (7.4%) during the Global Financial Crisis (2006 to 2009).[21]

Given these positive fundamentals and the influx of institutional capital, student housing cap rates have compressed considerably during this cycle. However, the compression was driven largely by newer Class A product situated within walking distance to campus (i.e. less than 0.5 miles). For instance, Class A pedestrian product (~5%) traded roughly 100 basis points tighter than Class B (~6%) non-pedestrian during 2018.[22]

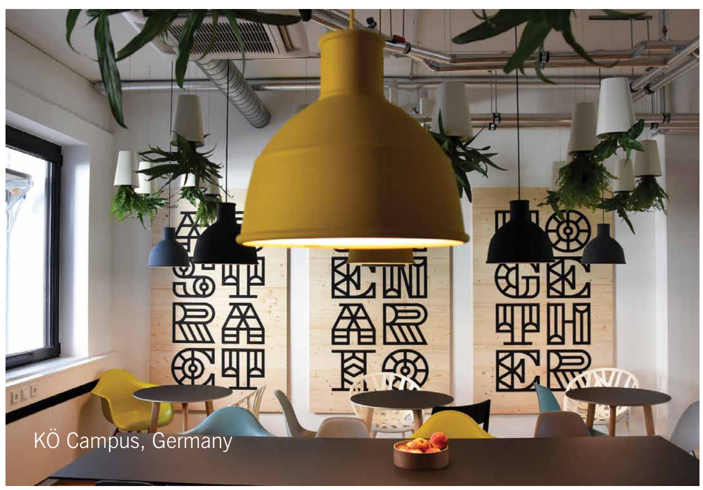
Figure 10. **Student Housing Cap Rates**



*For the pupose of this chart "Pedestrian" is defined as a walking distance of 0.5 miles or less to commute

Source: CBRE National Student Housing

Investcorp remains very positive on the student housing market and its favorable enrollment and housing dynamics. Investcorp will continue to target investment opportunities in off-campus, purpose-built student housing within 5 miles of 4-year public universities with greater than 10,000 undergraduate students.



KÖ Campus, Germany

[14] CBRE National Student Housing, Mid-Year 2018 Student Housing Market Overview (2018)
[15] Axiometrics, National Student Housing Supply & Demand Model (2018)
[16] Bureau of Labor Statistics, Unemployment Rates and Earnings by Educational Attainment (March 2018)
[17] National Center of Education Statistics, Projections of Education Statistics to 2025, Forty-Fourth Edition (September 2017)
[18] Axiometrics, National Student Housing Supply & Demand Model (2018)
[19] Axiometrics, National Student Housing Supply & Demand Model (2018)
[20] National Center of Education Statistics, Projections of Education Statistics to 2025, Forty-Fourth Edition (September 2017)
[21] Green Street Advisors, Student Housing Sector Report (February 2016)
[22] CBRE National Student Housing, Mid-Year 2018 Student Housing Market Overview (2018)

> **“Capital flows into the US are expected to continue to remain strong because the US is seen as a safe haven relative to other countries.”**

Babak Sultani
Managing Director,
Real Estate Specialist

Conclusion

Job growth, population growth, consumer spending and even real wage growth continue to move in a consistent positive direction in the US The US economy is strong, and rest of the world is generally experiencing synchronous growth. Accordingly, real estate fundamentals are solid, and Investcorp continues to believe that excellent investment opportunities exist in today's US real estate markets.

That said, cap rates do not seem likely to go much lower in 2019. (Though it is worth iterating that despite rising interest rates and our expectations to the contrary, cap rates in some of our favorite spaces – Class B/B+ multifamily and industrial/logistics – did actually drop slightly in 2018.)

Given a flattening of cap rates, income growth will likely be the most important driver of property appreciation in the coming years. And, at this stage in the cycle, many investors will emphasize steady current income returns as the basis of their US real estate investment strategy.

Through its upcoming real estate investments, Investcorp will remain committed to its investment strategy which includes the following:

- Emphasis on assets that generate strong cash flow. While value accretion is always a part of our strategy, return generated from cash flow is expected to represent the majority of the overall return generated from our investments.
- Investment in assets with diversified rent roll profiles. Reduced concentration of individual tenant risks at the portfolio/ placement level.
- Moderate leverage of 60%-69% loan-to-value for most transactions and 50%-60% loan-to-value for longer-term hold transactions in urban environments.
- Investment in select US metro area markets that are ranked in the top 30-40 for total population size and/or rank as top college towns with large and growing public universities.
- Within these metro areas, emphasis on markets that have solid population, employment, and GMP growth, as well as significant, consistent capital markets demand (i.e. liquidity). Although, due to geographic desirability of certain Midwest markets to the industrial sector, we may seek industrial opportunities in metro areas wherein the overall economic growth prospects are more modest.
- Modest value-add programs (i.e. no opportunistic or major development type programs).
- Local operating partners with proven track records.

Please feel free to reach out to your relationship manager, should you have any questions about your account, or should you require any additional information.

About Investcorp

Investcorp is a leading global manager of alternative investments. Led by a new vision, Investcorp has embarked on an ambitious, albeit prudent, growth strategy. The Firm continues to focus on generating value through a disciplined investment approach in four lines of business: private equity, real estate, absolute return investments and credit management.

As at December 31, 2018, the Investcorp Group had US$ 22.5 billion in total AUM, including assets managed by third party managers and assets subject to a non-discretionary advisory mandate where Investcorp receives fees calculated on the basis of AUM.

Since its inception in 1982, Investcorp has made over 185 Private Equity deals in the US, Europe, the Middle East and North Africa region and Asia, across a range of sectors including retail and consumer products, technology, business services and industrials, and more than 600 commercial and residential real estate investments in the US and Europe, for in excess of US $59 billion in transaction value.

Investcorp employs approximately 400 people across its offices in Bahrain, New York, London, Abu Dhabi, Riyadh, Doha, Mumbai and Singapore. For further information, including our most recent periodic financial statements, which details our assets under management, please visit: www.investcorp.com

INVESTCORP

www.investcorp.com
@investcorp

INVESTCORP BANK B.S.C.

Investcorp House
P.O. Box 5340
Manama
Kingdom of Bahrain
T: +973 17 532 000
F: +973 17 530 816

INVESTCORP INTERNATIONAL LTD.

Investcorp House
48 Grosvenor Street
London W1K 3HW
United Kingdom
T: +44 (0)20 7629 6600
F: +44 (0)20 7499 0371

INVESTCORP INTERNATIONAL INC.

280 Park Avenue
New York
New York 10017
United States of America
T: +1 212 599 4700
F: +1 212 983 7073

INVESTCORP SAUDI ARABIA FINANCIAL INVESTMENTS CO.

Al Faisaliah Tower
29th Floor
P.O. Box 61992
Riyadh 11575
Kingdom of Saudi Arabia
T: +966 11 484 7600
F: +966 11 273 0771

INVESTCORP BANK B.S.C. – ABU DHABI

Al Sila Tower – 8th Floor
Abu Dhabi Global Market Square
Al Maryah Island
P.O. Box 36961
Abu Dhabi
United Arab Emirates
T: +971 2 501 8900
F: +971 2 644 1566

INVESTCORP INVESTMENTS LLC

Qatar Financial Centre
Tower 1
West Bay Area
P.O. Box 24995
Doha
State of Qatar
T: +974 4496 7966
F: +974 4496 7960

INVESTCORP ASIA SERVICES PTE LTD.

Level 24-01, CapitaGreen
138 Market Street
Singapore 048946
T: +65 6679 6032
F: +65 6697 6097

INVESTCORP INDIA ASSET MANAGERS PRIVATE LIMITED

7th floor, Tower 1C, One Indiabulls Centre
Senapati Bapat Marg,
Elphinstone Road (W)
Mumbai 400013, India
T: +91 22 4222 2155
F: +91 22 2421 0114