Real Estate Market Thoughts | Q2-2016

We are a few days late going to press this quarter as a result of the time demands associated with the Second Closing of Fund III. Additionally, Fund II has two properties under contract to be sold, and we are hopeful that both will close by the end of October. And if all of that is not enough, Fund III has its second acquisition prospect under contract, and we are in the late stages of due diligence for that potential investment. Very busy indeed! We are extremely grateful for the confidence in our investment program shown by both existing and new partners by virtue of their participation in Fund III. We certainly believe that our approach to investing in value-add commercial real estate (CRE) is well structured, thoughtful and disciplined, and has proven to be successful over multiple CRE cycles. It is truly gratifying to see confirmation of our conviction through the ongoing enthusiastic commitment of our partners. As a quick reminder, Fund II concluded its investment period last December and is now well into its execution and investment realization stage. As mentioned above, we are expecting to harvest two of Fund II's ten investments prior to year-end, and will be returning that capital to Fund II's partners. Both sale contracts are still in the contingency phase, but as the contracts become firm, Fund II partners will receive more detailed information on those dispositions in upcoming correspondence.

Meanwhile, our investment team, which has recently grown by the addition of two new analysts, remains busy scouring our target markets for new investment opportunities. Readers will recall from previous Market Thoughts an analysis and observations of how distinct markets are frequently at different stages of the CRE cycle at any given point in time. Additionally, value-add investing is always primarily about the asset and plan for that asset, and therefore compelling opportunities can exist even in peaking markets. Accordingly, we are confident that there are still good opportunities in many of our target markets, and in fact we have identified one in Raleigh and placed it under contract. Fund III partners will be hearing more about that shortly if the due diligence is successfully concluded and the contract becomes firm.

CRE Market Conditions

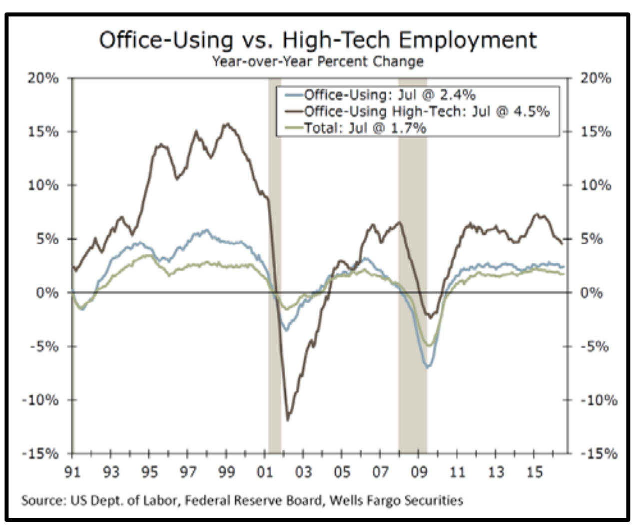
User Demand: Solid and steady with runway left

Supply: Continuing to grow but the pace of growth is decelerating……..for now

Rents: Still growing at rates above long term averages, but off cycle peaks attained in 2015

Capital Flows: Strong, but moderating – still lots of dry powder

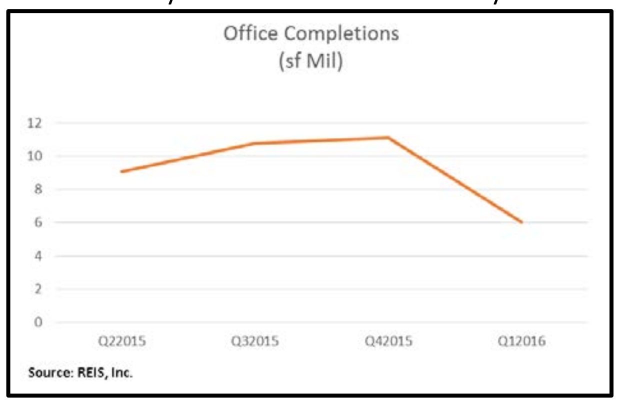
Pricing: Emerging from a period of price discovery in Q1 with the rate of pricing gains from 2015 beginning to moderate



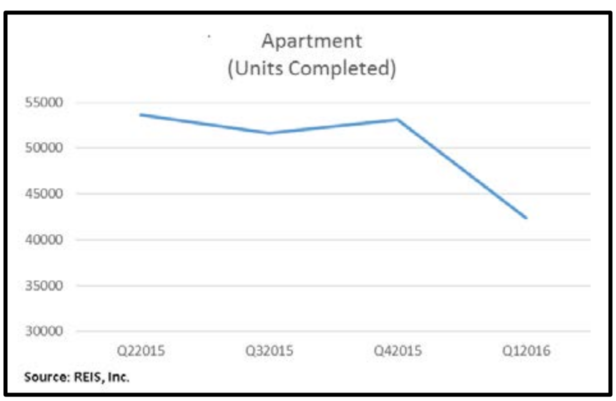
Both office and industrial fundamentals continued to show gradual improvement in Q2. As of June

30th, the office occupancy rate was at a high for this cycle of 89.4%, an improvement of 50 basis points (bps) from the prior year and just 0.3% shy of the previous cycle high water mark which occurred in Q4 of 2006. Two-thirds of office submarkets nationwide experienced quarter-over-quarter improvement in occupancy, and more than half of metro areas have occupancy rates above their 2006 and 2007 peaks. This fairly robust office demand is being driven by employment growth in office using jobs, which has averaged 2.4% over the previous year as compared to 1.7% for total employment. See chart on the previous page. One of the key drivers for office using job growth is high tech employment, which is showing signs of cooling but is still running warm at 4.5% year-over-year growth. Despite the growth in jobs, office demand is only expanding at a 1.3% annual rate, which is 50 bps slower than total employment expansion and most likely reflects the trend of office tenants moving to less space per employee.

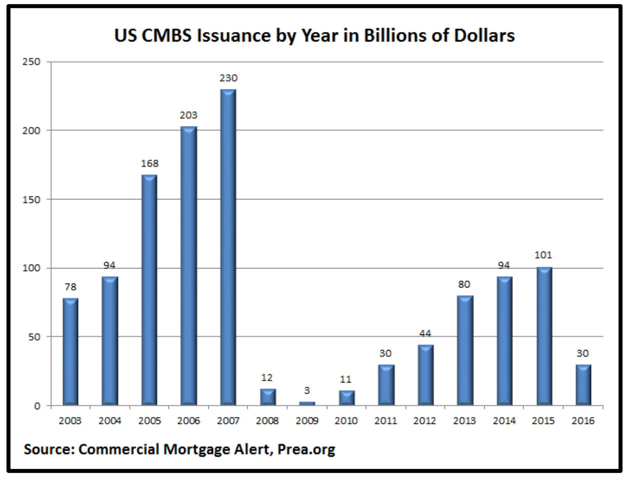
Nationally, the industrial market in Q2 2016 posted its 25th consecutive quarter of positive absorption, which is the longest stretch of positive quarters in more than 20 years. Industrial availability declined nationally to 8.7% at the end of Q2 2016 from 9.5% a year earlier, according to CBRE. Direct vacancy rates are in the 5% to6% range in most major industrial markets.



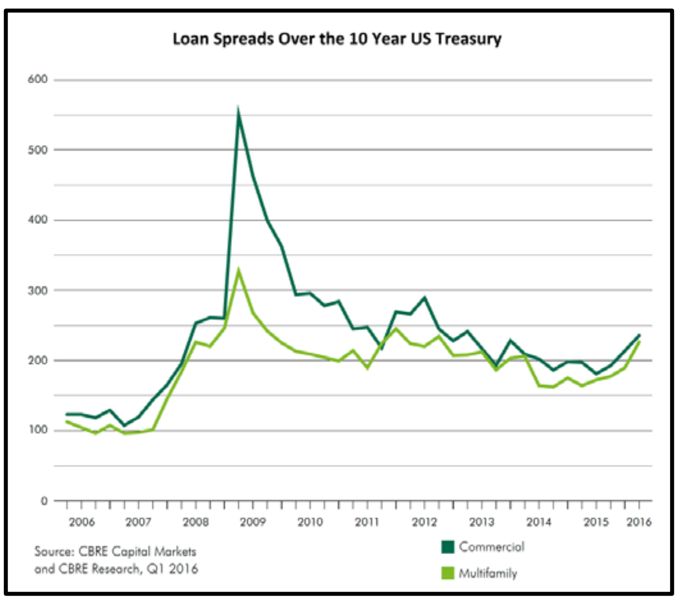
Generally, and with a few notable exceptions, most US office markets are seeing a gradual deceleration in the rate of new office supply. Additions to supply across all property types are expected to be more limited across the board, with only modest supply growth in a few segments such as multi-family, student and senior housing, and single-tenant industrial, which is adjusting to the rapid growth of e-commerce by building regional and micro-nodal distribution centers in order to gain better efficiencies for the last mile of delivery. A significant contributing factor to the tapering of new construction activity has been increasing regulatory scrutiny of construction loans at banks. Many of our banking relationships have indicated that the focus of their origination objectives are loans on existing income producing properties rather than construction loans. Many banks were already cautious about funding new construction during the first few years after the recession, and now that caution is resurfacing as regulatory pressure is increasing, bank reserve requirements from Basel III are requiring more capital set aside for construction loans, and new risk retention requirements for commercial mortgage–backed securities (CMBS) constrain the availability of take-out financing which allows construction lenders to exit at completion. More on that in our capital flow comments below. Further indication that lending constraints are a large contributing factor to the recent decline in deliveries can be found in the forecasts by several market experts that deliveries will fall in 2017 but rise again in 2018 as market volatility eases and the banks and CMBS issuers adjust to the changes in their regulatory environment.



Year-over-year, office rents nationwide are up a very healthy 3.9%, but that is down from a peak this cycle of 4.4% in Q4 2015. Industrial rents are up 4.6% year-over-year, also above the long term average but down from a 2015 cycle peak of 5.4%. This moderation of effective rent growth in Q2 was evident nationwide. High-tech markets continued to experience the strongest growth, but even that pace of growth has slowed as one would expect from observing the employment data described above.

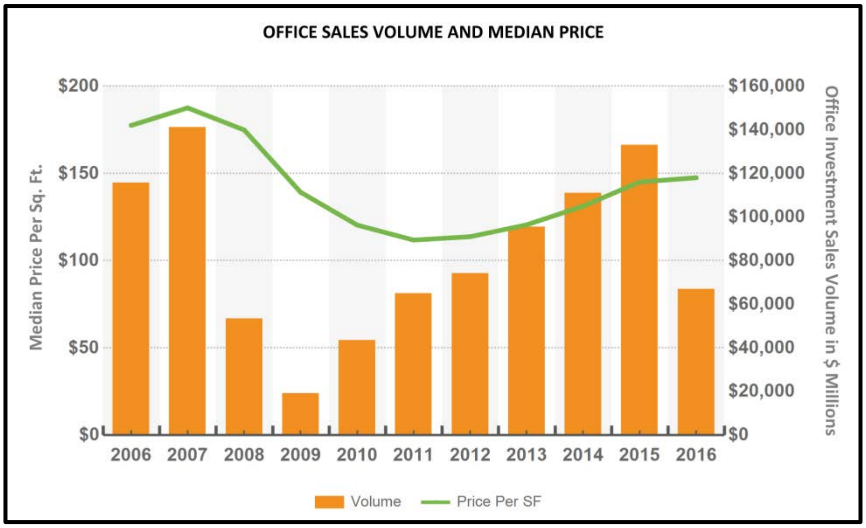


Capital flows into CRE remain healthy, but the volume of transactions has declined slightly. As we have previously reported, regulatory changes had a significant impact on CMBS originations in the first half of 2016, and coupled with market volatility have resulted in dramatically reduced CMBS offerings, off roughly 40% through June on an annualized basis. See nearby chart. Life insurance companies and debt funds have picked up some of the slack in CRE debt markets created by lower CMBS originations. Banks have also capitalized on the opening. Total CRE debt outstanding at US banks through the end of July was up 11.1% year-over-year, standing at $1.9 trillion. The rate of growth for CRE bank loans has been creeping up over the past two years from a range of 6% to 7% in 2014. Anything north of 10% in a low growth low inflation world is running hot, and the current elevated rate is probably a factor in the rising regulatory scrutiny the banks are experiencing. Lender spreads have stabilized in a consistent range but remain wider than one year ago. It is worth noting that loan spreads, except for a brief period early in 2014, have remained throughout this cycle at levels more than two times their narrowest levels during the peak of the previous cycle in 2006 and 2007, indicating a reasonable healthy pricing of risk. See nearby chart. Taken as a whole, debt continues to be widely available for CRE at compelling interest rates that remain close to all time lows.



Inbound cross-border investment activity in the US rose in Q2 2016 compared to Q1, crossing the tape at $96.4 billion; however, that figure is still below its Q4 2015 cycle high. The point of origin with the largest falloff was Europe, as the lead up to the Brexit vote elevated uncertainty for CRE investors. It remains to be seen what the longer term impact on CRE capital flows from Brexit will be, but logic would dictate that US markets should get a share of any reduction in CRE investment in UK assets.

Through the first two quarters of 2016 there has been a notable decline in transaction volumes as measured by the aggregate value of sales. Office sales are down about 20% from a year earlier (see chart on the next page), and industrial sales are down almost 31% in the first half of 2016 as compared to the same period in 2015. Broadly speaking, Houston and certain tech oriented markets have seen some of the more significant transaction volume declines. Based on our data, Houston transaction volume is off about 75% in 2016. Notwithstanding the diminished transaction volumes, pricing metrics continue to show modest upward trends over the prior year. CoStar reports that its repeat office sales metric is up by 3% from one year earlier. The commercial property price index (CPPI) published by Real Capital Analytics for US office bounced back in Q2, recovering all of its fairly steep 3% loss in Q1. Supporting the rebound in values, cap rates compressed slightly for all property types, except office, in Q2 versus Q1, with slightly more notable declines in industrial properties, down approximately 40 bps. However, the spread between cap rates and the U.S. 10 year Treasury yield, remains well above long term averages. The outperformance of the six major markets as compared to the non-major markets, a theme we have elaborated on in the past, continued apace. Similarly, the pricing metrics of office properties in central business districts (CBD) persist in displaying premiums to suburban office properties.

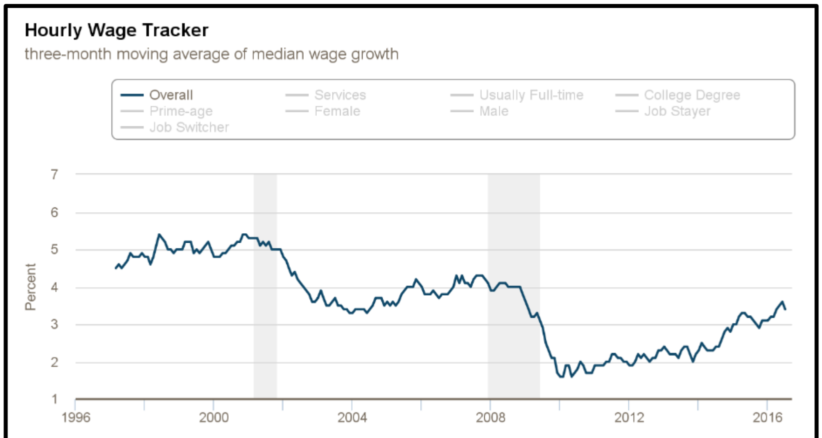


As our Fund II partners know, we have two properties currently in the market for sale, and we have had discussions with investment sales professionals about the prospects for selling a couple of others and the likely valuations. In those discussions, a common theme has been that valuations are stable to rising slightly, but the buyer pool has become smaller, resulting in fewer bids and backup bids.

Macro-Economic Conditions

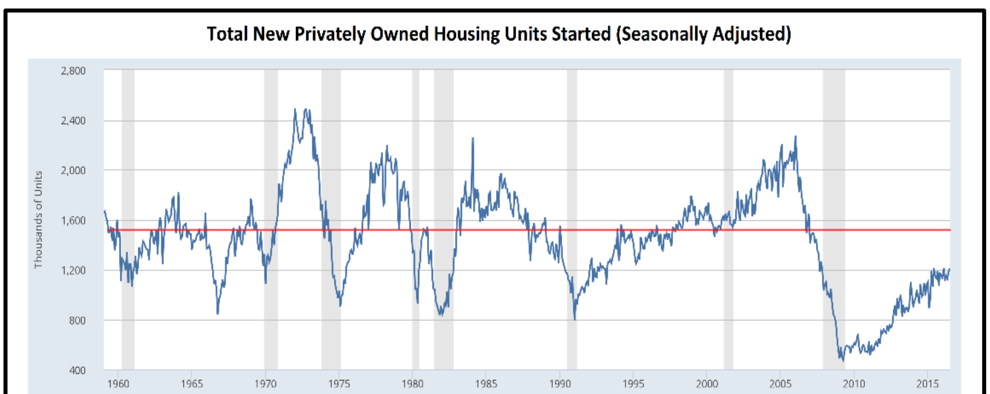
The US economy displayed mixed signals during the second quarter and into the summer. Not much has changed over the past two years. Monthly job growth, while steady at an average of about 186,000 per month, has declined about 20% from the levels of 2015 but remains sufficient enough to have pushed the labor market close to full employment. The rising intensity of the debate about what constitutes full employment and whether or not the US has arrived there is evidence that we must be getting close. Many economists argue, as part of that debate, that with the primary unemployment measure consistently below 5%, it should not be surprising that the rate of monthly net new jobs added would decrease as there are fewer workers available to fill open positions. The counter argument is that labor force participation rates remain at generational lows, providing plenty of slack and excess labor capacity. Participation rates peaked in the late 1990's at about 67% of the population and have since declined to about 63%. Economists at Wells Fargo recently made the case against the likelihood of recovery in the rate due primarily to long term demographic trends that were in place even before the past recession. Those trends include an aging population, declining demand for low- and middle-skilled workers and stronger social safety nets, which have significantly impacted the participation rate for prime-age workers, both male and female. As such, Wells Fargo is forecasting the labor force participation rate to "trend sideways over the next few years."

While both sides of the debate have merit, one possible approach to gauge who is more correct is to observe the price signals in the labor market. On that score, the nearing full employment crowd is making hay. Meaningful and consistent wage growth is finally appearing, albeit slowly, as job openings continue to climb. See nearby chart. Job and wage gains are translating into a healthy consumer environment. Consumption increased by a vigorous 4.2% annualized rate in Q2, a print that is the best gain in any quarter since early 2014. Because consumption is the largest component of GDP, rising consumption should yield solid economic growth. Retail sales during the first half of 2016 were up 3.1% from the year prior.



Source: Federal Reserve Bank of Atlanta

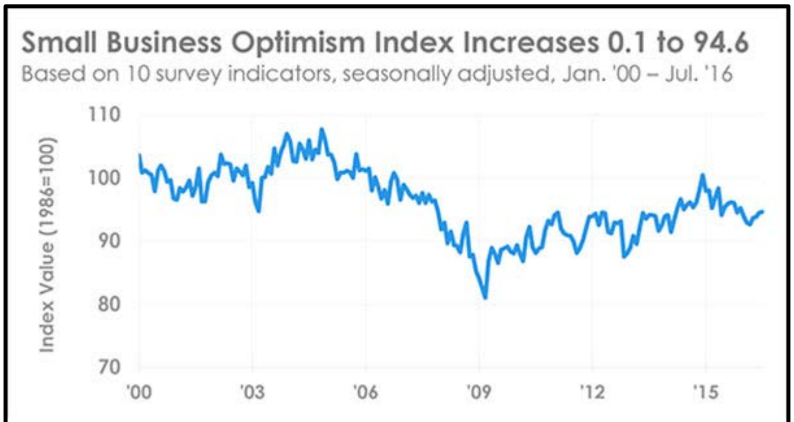
Not surprisingly given improving consumer conditions, the multi-quarter trend of expansion in the housing market continued during Q2. Following strong existing and new home sales activity during July, housing starts delivered an upside surprise, rising 2.1%. The increase was largely concentrated in the multifamily sector, but single-family also eked out a positive reading. While the data on housing is encouraging, the overall housing market has yet to return to its long term average as can be seen in the nearby chart of housing starts going all the way back to 1960. Nonetheless, a strong positive trend persists off a low base at the end of the last recession.



Source: US Bureau of the Census, St. Louis Fed

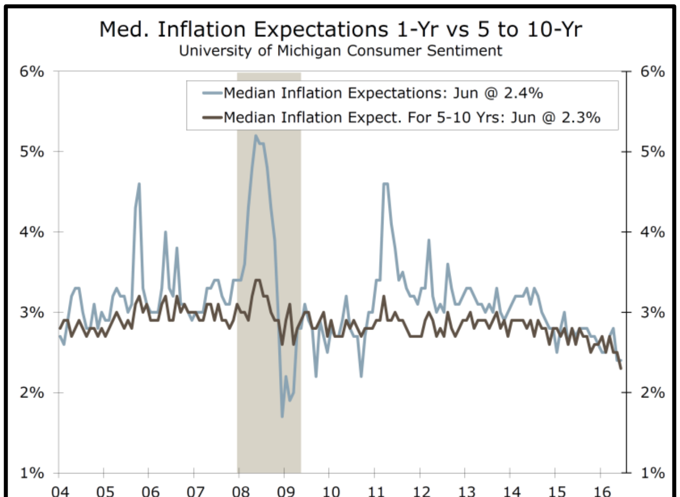
In contrast to conditions in the consumer portions of the economy, business spending and investment remains near recessionary levels. Corporate profits have not grown much for well over a year, and therefore have consistently declined as a share of GDP. Political uncertainty both domestically and abroad (read Brexit) is elevated and no doubt a contributing factor, and significant reductions in investment outlays in the energy exploration industry are a drag on the aggregate measures. Continuing regulatory creep in financial services is also an impediment to business investment.

There has been much discussion of late on the topic of small business, its impact on the economy and job growth, and the conditions currently facing small business owners. The National Federation of Independent Business (NFIB) is one of the leading small business advocacy groups nationally. The NFIB produces monthly its Index of Small Business Optimism, which rose one-tenth of a point in July to 94.6. See nearby chart. NFIB describes the index change as: "a meager increase showing no real enthusiasm for expansion, expected sales, and making capital outlays." A statement from NFIB Chief Economist, Bill Dunkelberg, said: "Small business optimism was pretty much unchanged during the month of July and small businesses continue to be in maintenance mode" He continued, "Uncertainty is high, expectations for better business conditions are low, and future business investments look weak. Our data indicates that there is little hope for a surge in the small business sector anytime soon." At 94.6, the Index remains well below the 42-year average of 98, and more owners still expect future conditions to be worse than expect improvement. The rate of new business formation remains near 40-year lows, and some analysts cite rising barriers to entry associated with federal and state regulation as being partially responsible.



Source: National Federation of Independent Business

The differing outlook between US consumers and businesses, coupled with regulatory and political uncertainty, should continue to produce constraints on the potential growth rate for US GDP. In spite of occasional rhetoric to the contrary, the Fed has been quite dovish since the December 2015 rate increase of 25 bps and is likely to remain so until either global economic uncertainty or tepid inflation expectations (see nearby chart) show a reversal of trend. Most analysts expect a 25 bps increase in the Fed Funds rate before year's end, particularly if labor market conditions continue to tighten. We think that is at most a 50% probability.

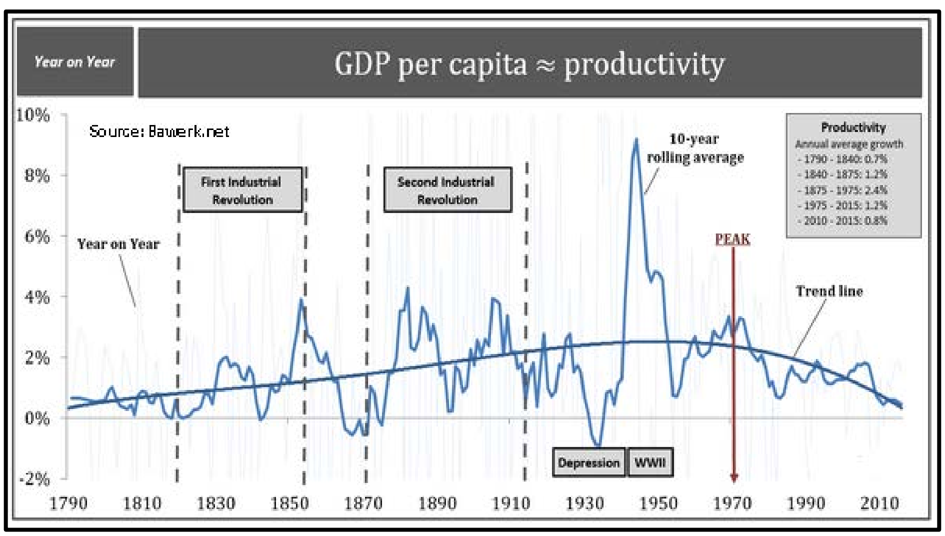


Source: Bloomberg LP, Federal Reserve Board, University of Michigan and Wells Fargo Securities

Outside the US, global economic conditions in the major developed economies remain weak. Europe appears to have stabilized but at a level around 1% annual growth. China, to the extent one can draw conclusions from the official statistics, also appears stabilized at just under 7% annual rate of growth; however, many observers are pessimistic about whether China can avoid further deceleration or outright contraction given the gross inefficiencies of the state-owned-enterprises (SOEs) and the policy limitations inherent in pushing the economy more towards consumption and services and away from dominance by export driven manufacturing. We have previously highlighted the concern about excessive debt levels in China and the diminishing returns from each incremental unit of new debt, but it is unlikely that a debt fueled implosion will occur in the near or intermediate term. In fact, recent stability in the exchange rate and the balance or foreign reserves (see nearby chart) is an indication that the capital flight seen in 2015 has tapered off, and Chinese economy is likely to muddle through for the time being. However, the misallocation of capital into inefficient companies or industries, particularly by the SOEs and to a lesser extent in property markets, is an ongoing concern that will be politically difficult to correct and will therefore most likely cause slower growth over time.

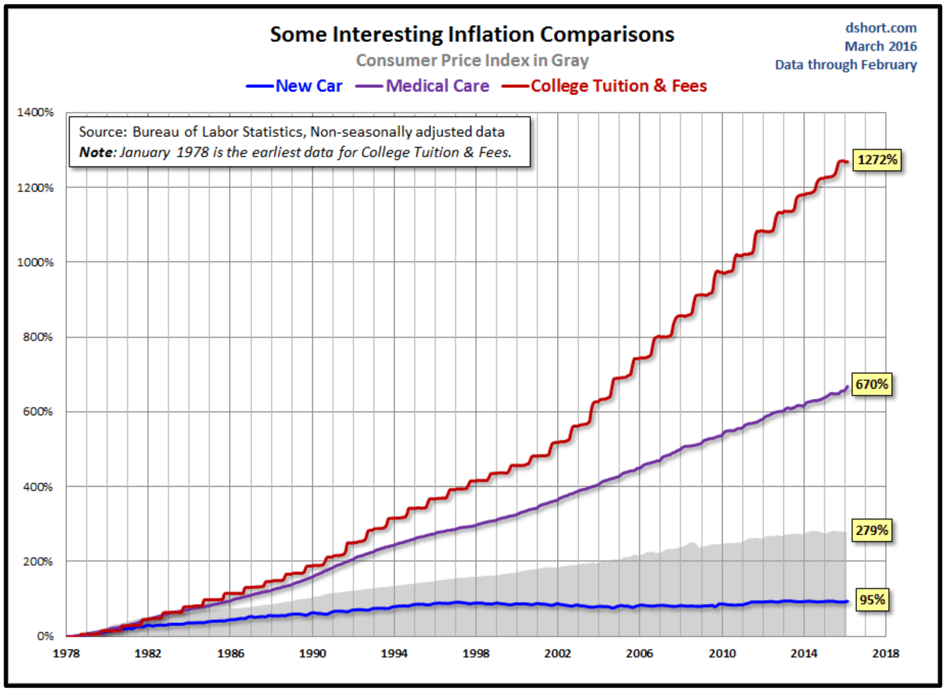
As if to wrap all of that in a bow, the Organization for Economic Cooperation and Development (OECD), revised slightly downward its forecast for global GDP growth in 2017 to 3.3% which would be the sixth consecutive year in which global output has grown below its long-run average of 3.5% per annum.

One of the biggest economic issues facing both the US and the other large developed economies is the secular decline in productivity growth, which has been particularly pronounced in the current economic cycle beginning with the Global Financial Crisis (GFC) through the recovery to today. Productivity is the most important long run factor to increases in standards of living and overall prosperity, and as such, the current extended weak trend in productivity growth raises serious questions and concerns for the long-term economic outlook. There are several different ways of measuring productivity, including a) GDP/per capita which is a general measure, b) GDP/hour worked which is a measure of labor productivity, and c) the Non-farm Payroll Productivity index produced by the BLS, also a measure of labor productivity, which posted a negative 2.1% print for Q2. That means productivity actually retreated by 2.1% in the second quarter. Not good! The other measures were also negative with output per worker hour declining for the third straight quarter, falling 0.5% in Q2 and down 0.4% on a yearly basis. The longer term secular trend can be observed in the nearby chart. There are many contributing factors including shifting demographics and rapidly changing technology contributing to the long term trend, and there are not any easy ways to "fix" the problem, but political



leaders worldwide would be wise to focus on productivity when formulating their policy mix.

Relative changes in market prices for goods and services over time can be a rough proxy for the impact of longer term changes in productivity within industries. By looking at the nearby chart of inflation comparisons, it is easy to see that productivity gains in the auto industry have been strong between 1978 and 2015 as the total cost of a new car has increased only 95% during that period compared to 279% for consumer prices as a whole (CPI). Medical care has been much less successful at driving productivity gains through the system as costs are up 670% over that same 37 year period. But wait, what is that red squiggly line on the chart……college tuition, up 1,272% over the same period. Ugh! At the risk of upending society's firm convictions on the matter, perhaps we should at least ask if that outlier trend is a potential drag on economic efficiency. We are pretty confident that any of our readers shouldering the burden of college tuition would like to see a reversal of that trend!



In the intermediate term, we believe that the secular decline in productivity growth will continue to be a significant factor in the witches brew of conditions that will constrain growth to below its historical trend and thereby contribute to an interest rate environment that is lower for longer.