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Guggenheim Real Estate: Market Update

Chad W. Phillips | *Portfolio Manager, Managing Director*
C. Tyler Williams | *Acquisitions & Portfolio Management, Director*
Thomas S. Nielsen | *Acquisitions & Portfolio Management, Vice President*

Economic Outlook and Key Themes[1]

U.S growth remains robust but the economy is at risk of overheating

The fiscal boost from tax cuts and higher government spending has kept growth strong and should continue to do so over the next few quarters, in the 2.5-3.0% range. Real GDP growth above 2% could indicate that the economy is in an overheating stage, as demographic factors and slowing productivity growth have dragged supply-side sustainable growth down to 1.0-1.5%. Consumer confidence near cyclical highs and healthy household balance sheets bode well for near-term consumption, though rising rates are starting to have an impact on big ticket purchases such as automobiles. One area of weakness will continue to be housing, where high rate sensitivity and limited supply are holding back the sector.

At the same time, the trend rate of job growth should continue to slow. Even so, the unemployment rates should continue to fall for the next few quarters, likely below 3.5%. A tighter labor market and increasing worker shortages will put more upward pressure on wage growth, which has been held back by meager productivity gains. Core inflation is at the Fed's 2% target and should slowly trend higher due to a tight labor market and above-potential output growth. The strong dollar and lower oil prices will likely keep inflation gains subdued. The main near-term risk is further imposition of tariffs, which could spark higher prices that the Fed has no choice but to lean against with higher interest rates. Talks with China have proven to be more challenging than with other trading partners, thus creating further uncertainty.

Interest rate hikes will likely continue

The Fed will likely look to keep delivering rate hikes as inflation rises and the unemployment rate falls lower than expectations. Moreover, financial conditions are still accommodative, giving the Fed further room to raise rates. Meanwhile, fiscal stimulus is providing the economy with an additional boost that the Fed has as support. The Fed is increasingly signaling its intention to move rates beyond neutral and into restrictive territory (above 3%) to slow the economy. The warning signal from the flattening yield curve is being largely dismissed by the Fed so it may not slow the pace of hikes. With the Fed moving to increasingly tight policy, the economy may enter recession in 2020 as higher rates prove unsustainable, given record high corporate debt levels. Fiscal policy could also become a drag in 2020, further raising the risk of an economic downturn.

Growth cooling in Europe and China

Although eurozone growth momentum has slowed, inflation will likely head higher, reinforcing the European Central Bank's plans to end its quantitative easing policy by December. This sets the stage for a potential rate hike in the second half of 2019. One concern of note is that monetary policy normalization could exacerbate market strains in Italian sovereign debt as the Italian government bucks European Union guidance for lower fiscal deficits.

China's economic growth continues to cool as trade tensions mount. The focus on deleveraging and reducing risk in the financial system is weighing on output, leading policymakers to deploy fiscal and monetary stimulus. As trade tensions escalate, export growth will likely slow. Transitioning to Japan, where inflation remains well below the Bank of Japan's target, quantitative and qualitative easing policies should remain in place for the foreseeable future.

Real Estate Market Update[2]

Total returns remained relatively stable and primarily consisted of income return

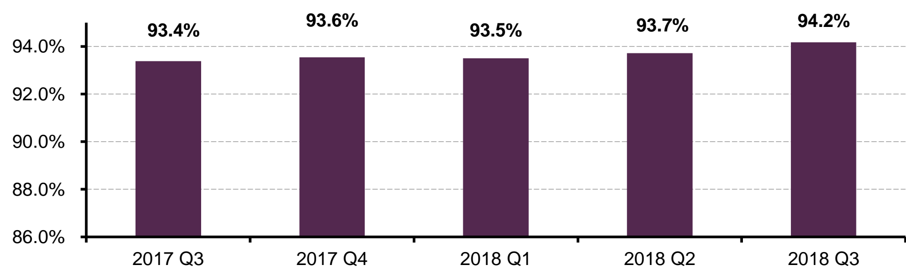
The NCREIF Property Index (NPI) unlevered total return for the third quarter 2018 was 1.7%, comprised of 1.1% income and 0.6% appreciation. On a trailing four quarter basis, the NPI was 7.2%. Total returns have moderated over the last several years, but the deceleration appeared to take a pause in the second quarter of 2017.

The 4.5% annualized income yield represented a 1.4% premium to the 3.1% 10-year U.S. Treasury. Income continues to comprise the bulk of the total return, as appreciation remained moderately stable for the last six quarters. Income yields were the lowest levels since NPI began tracking in 1978. Fueled by consumer and government spending, the U.S. economy demonstrated strength with attractive GDP growth and low unemployment (lowest level since 1969). Third quarter earnings were mostly positive albeit revealed mixed signals regarding top line revenue data. Despite corporate tax cuts, business investment grew at only a modest rate, possibly indicating concerns related to the impact of tariffs on trade. Although the 10-year U.S. Treasury continued to rise, interest rates remained low compared to historical trends. Furthermore, periods of rising interest rates are not always correlated to rising real estate cap rates, as multiple factors influence cap rates. According to Green Street Advisors, unlevered real estate remains in-line with historical trends

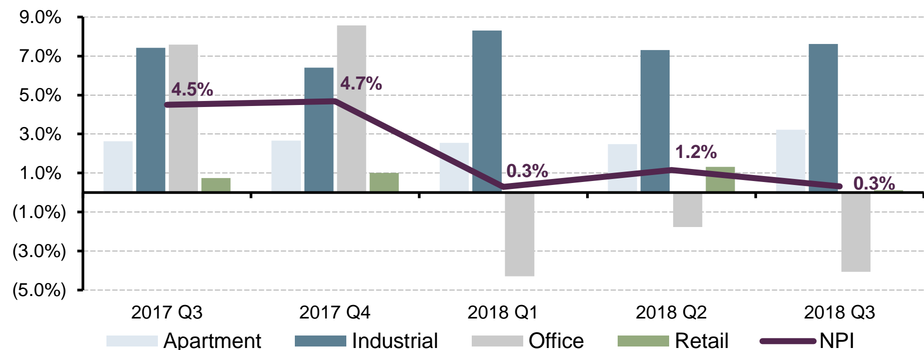
given that total returns of 5.9% fall between current yields on investment grade bonds of 5.2% and yields on high-yield bonds of 6.8%[3].

Occupancy rose to 94.2%, the highest since the fourth quarter of 2000. Industrial led property sector performance on a total return basis with office and apartments trailing, respectively. Retail continued to lag all sectors. The West region sustained outperformance, followed by the South region. Rolling four quarter same-store net operating income (NOI) growth for the index declined in the third quarter of 2018. While office and retail demonstrated large improvement from first quarter to second quarter, those sectors hindered the index in the third quarter. Industrial significantly outperformed with NOI growth of 7.6%. In addition, apartment growth exceeded the NPI index by 290 basis points.

Quarterly Occupancy (NCREIF)



Rolling Four Quarter Same-Store NOI Growth (NCREIF)

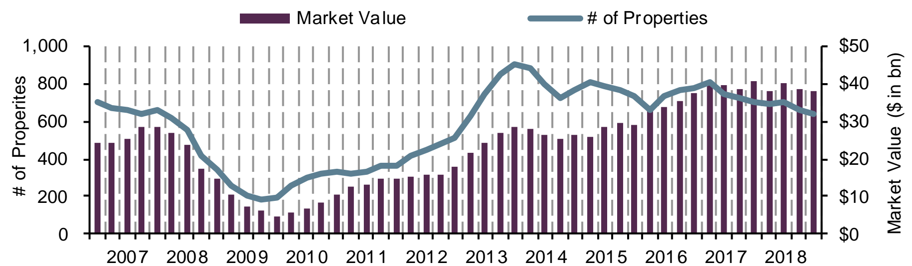


Transaction volume remains at historically elevated levels

Strong liquidity persisted for high-quality, well-located assets. As measured by NPI, the trailing four quarter volume slightly decreased from second quarter but remains at historically elevated levels. According to Real Capital Analytics (RCA), sales volume for the third quarter of 2018 grew 17.0% from the third quarter 2017. Year-over-year growth was significantly skewed by large portfolio deals and entity level transactions, however single asset sales were still healthy and remained the foundation of the market. Additionally, transaction volume growth was more robust in secondary and tertiary markets with year-over-year growth of 25.0% versus 5.0% in the six major metros. All property sectors demonstrated positive year-over-year growth except industrial and senior housing. Large transactions that drove third quarter volume included the $15.0 billion acquisition of GGP Inc. by Brookfield Property Partners LP. Education Realty Trust (NYSE: EDR) was also taken private

by a joint venture between Greystar Real Estate Partners and Blackstone Real Estate Income Trust (BREIT) for a value of $4.6 billion.

Property Transaction Volume (Rolling Four Quarters)[2]



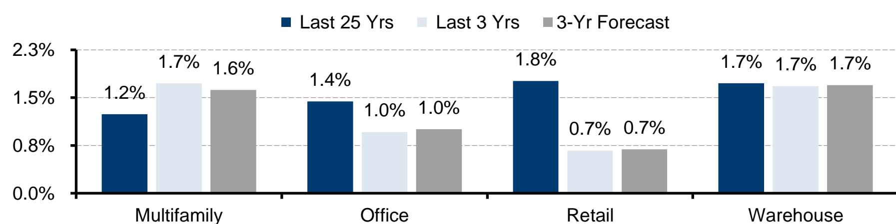
Debt financing is readily available, although interest rate increases persist

Leverage remained available at moderate levels and can be secured from a variety of sources (banks, insurance companies, CMBS, agency, etc.). Overall, accessibility to debt capital continued with rates that remain attractive by historical standards. Senior mortgages with fixed rates, 10-year terms and 60% loan-to-value on stabilized properties were available with interest rates in the mid-four percent range during the third quarter, based on a 130 to 150 basis point spread over 10-year U.S. Treasuries.[4]

Fundamentals support new construction activity

Supply growth neared long-term normalized levels, with heightened activity in the gateway markets. Office and retail are well below their long-term construction pace while multifamily and industrial development increased to keep pace with growing demand. While fundamentals of multifamily were bolstered by strong job growth, tax cuts and wage growth, there appeared no sign of new construction tapering. Industrial construction activity increased but is mostly well supported given the positive impact of e-commerce demand on absorption of new product.

Average Commercial Property Supply Growth[5]

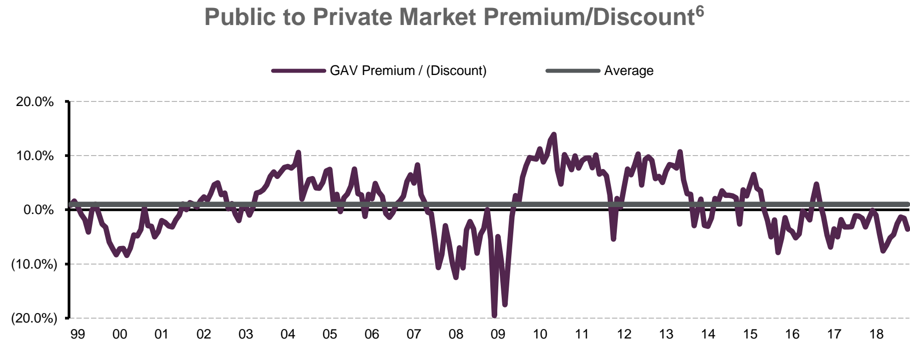


U.S. REITs traded at a discount to private market values, but improved from the beginning of the year

U.S. REIT performance, as measured by the FTSE NAREIT Equity REITs Index, resulted in a 0.8% total return for the third quarter 2018, hindered by negative performance in September. REIT returns fluctuated over the last several quarters with negative 8.2% in the first quarter and positive 10.0% in the second quarter. Year-to-date, the total return for the index remained positive at 1.8%. Fluctuations in returns over the last several quarters were caused by a mixture of factors including rising long-term rates, flattening of the long-end of the yield curve, attractive macroeconomic performance, robust merger & acquisition activity and concerns regarding trade. REITs were generally trading at a discount to private market values by the end of the quarter, with variations by property type. As of the third quarter, the implied unlevered public real estate market value traded at a 3.6% discount to

private values, just below the trailing 20-year average premium of 1.0% and within fair value range.[6]

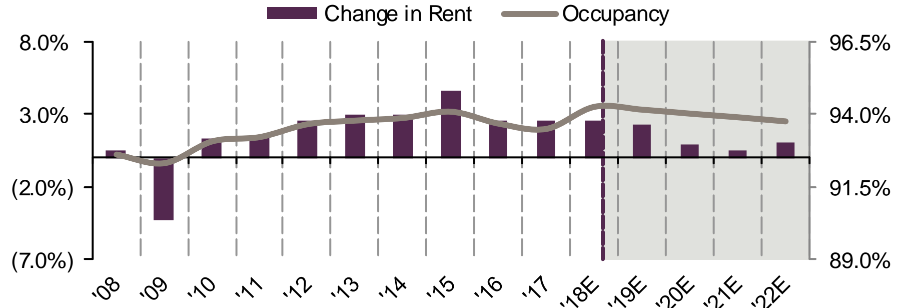
Public to Private Market Premium/Discount[6]



National Real Estate Market Update by Property Sector[7]

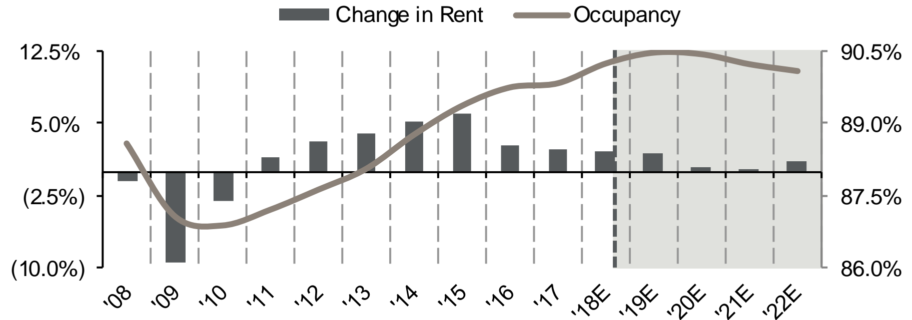
Multifamily

Apartment fundamentals remained intact with positive trends in absorption and stabilizing rental growth. Job growth continued to drive demand while tax cuts and wage growth helped to support rent growth. As the economy nears full-employment, job creation is expected to taper. A strong economic backdrop kept new supply elevated, only slightly helped by a shortage of construction labor. Fundamentals in the Sun Belt markets were pressured by new construction accelerating while general fundamentals for the East Coast improved. Third quarter occupancy was 94% and market rents averaged $1,306 per unit.



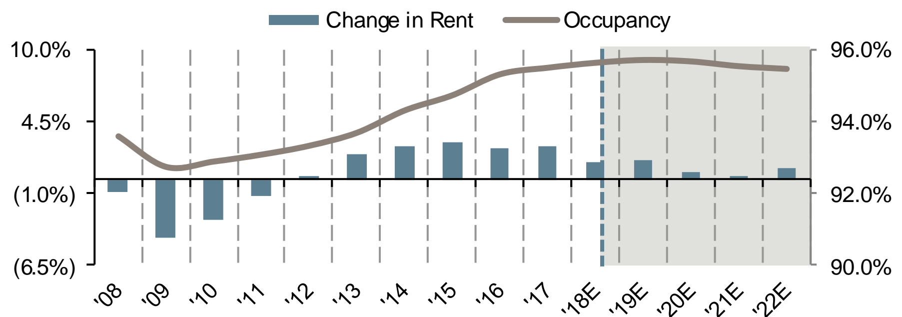
Office

Office fundamentals remained lackluster with high concessions and moderate demand. Recent tax reform policy didn't create immediate new demand but is expected to have a positive impact in the future. Fundamentals fared better in tech-oriented, West Coast markets and the Sun Belt while East Coast gateway markets were sluggish. Supply remained a concern in specific gateway markets (New York and D.C.) but appeared to be in control in most other markets. Areas with strong STEM (Science, Technology, Engineering and Math) exposure and vibrant urban cores continued to outperform. Nationally, third quarter occupancy was 90% and market rents averaged $32.22 per square foot.



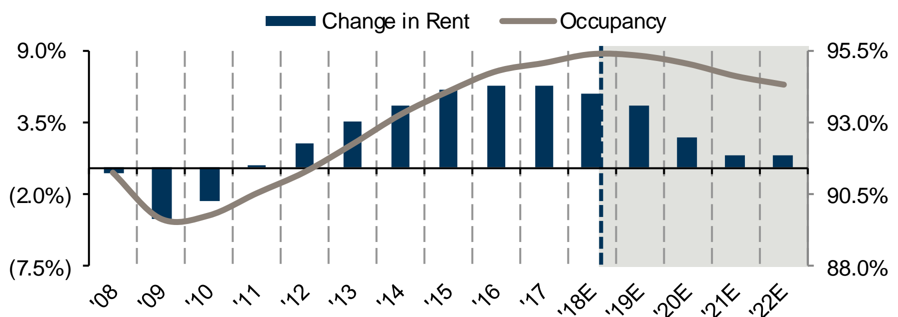
Retail

Higher quality retail centers that offer convenience and a unique shopping experience continued to be well-positioned. In addition, grocery-anchored centers remained strong and less impacted by e-commerce disruption, however there is a disparity in risk profiles between well-positioned grocers and weaker grocers. Occupancies remained stable and leasing activity was healthy, however rental pricing power remained in the control of tenants. The sector faced headwinds from changing consumer behavior, but new supply continued to be limited. Tenant disruption has moderated, although further store closures loom. Overall, third quarter occupancy was 96% and market rents averaged $20.91 per square foot.



Industrial

The industrial sector continued its outperformance with strong demand driven by e-commerce and a favorable U.S. economy. While potential trade war could have negative impacts on demand (especially West Coast markets), the bulk of absorption has been driven by consumption rather than trade. Occupancies remained high, driving rental pricing power for landlords. Generally, coastal locations with growing port activity and infill locations near large population centers continued to be strong performers. New supply increased, but strong absorption followed. Third quarter warehouse occupancy was 95% and rents averaged $8.24 per square foot.



Topic of Interest: What is the Opportunity in Opportunity Zones?

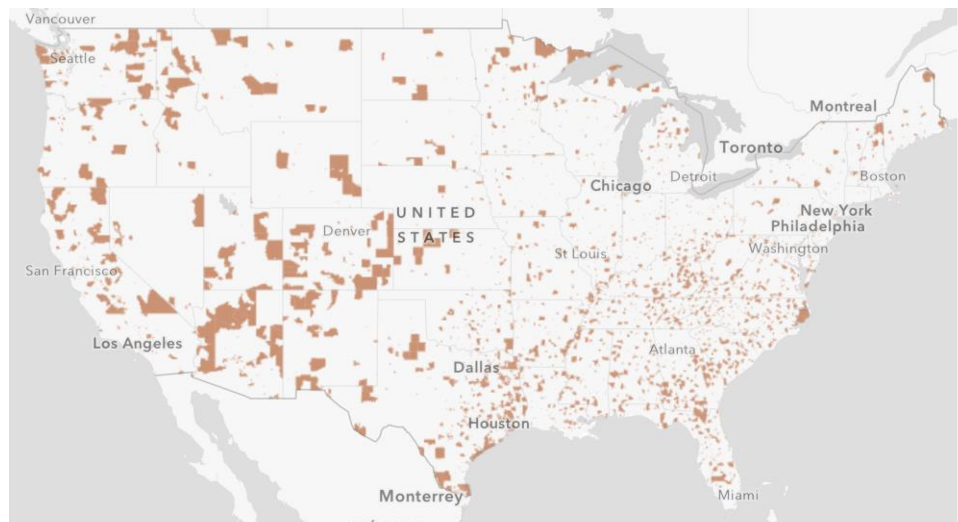
The Opportunity Zone program provides tax incentives for investors to deploy unrealized capital gains into low-income communities

As part of the Tax Cut and Jobs Act passed in late 2017, Congress established a new tax incentive program known as Opportunity Zones. The purpose of the program is to revitalize economically distressed communities using private investments instead of tax payer dollars. U.S. investors currently hold about $2.3 trillion in unrealized capital gains, which represents a material resource for capital redeployment.[8] The new incentive program provides taxpayers a deferral and reduction in capital gains taxes in exchange for investing the capital gains into Qualified Opportunity Funds (QOF). The QOFs are required to make investments in Opportunity Zones, which are designated census tracts comprised of qualifying communities that are generally economically distressed. The tax incentives are also tiered based on holding period to encourage patient, long-term investment into low-income areas.

Over 8,700 census tracts have been designated as Opportunity Zones across the U.S.

Opportunity Zones are located throughout the 50 states, the District of Columbia and five other territories. Governors in each state were able to select up to 25% of that state's eligible low-income census tracts to become Opportunity Zones. Criteria for the opportunity zone designation included having a census tract with at least a 20% poverty rate and a median household income that did not exceed 80% of the metro or state median income. In addition, up to 5% of each state's Opportunity Zones could be non-qualifying tracts that are contiguous with qualifying tracts if the median income is less than 125% of the area median. In June 2018, the U.S. Treasury certified more than 8,700 tracts as Opportunity Zones, representing 12% of all census tracts in the U.S. Essentially all of Puerto Rico was designated as an Opportunity Zone. In totality, the designated areas are home to nearly 35 million Americans and have an average poverty rate of 32%.[9]

National Map of Opportunity Zones



No limitations exist for the number of Qualified Opportunity Funds

The Opportunity Zone program is less restrictive, less costly and less reliant upon government agencies than existing programs. Alternative community-based tax incentives like the Enterprise Zones, Enterprise Communities, Renewal Communities and the New Markets Tax Credit have been part of the federal tax system for 25 years. However, these programs can be overly complex, limited in supply of tax credits and subject to annual congressional approval and/or tax credit allocation authority. No limitation currently exists on the number of Opportunity Funds available. In addition, the funds are managed entirely by the private market with the administration of the funds at the discretion of fund managers rather than government agencies. Each fund is responsible for abiding by the guidelines of the Opportunity Program to receive the tax benefits.[9]

Tax benefits include the deferral and reduction of capital gains taxes based on length of the investment period

Unlike a 1031 exchange program that allows sellers of real estate to defer capital gains by reinvesting proceeds into "like-kind" properties, the eligible capital gains for a QOF include proceeds from multiple investment sources, including real estate, stocks, securities and business interests. Investors are only eligible for the tax benefits if capital gains are invested into an Opportunity Fund within 180 days from the realization of the capital gains. The Opportunity Zone program includes the following tax benefits based on the length of investment period in a qualified fund:

- **Fewer than 5 years:** deferred capital gains tax until sooner of December 31, 2026 or Opportunity Zone Fund investment is sold or exchanged
- **Greater than 5 years and less than 7 years:** deferred capital gains tax until December 31, 2026 and the capital gains tax owed on the initial investment is reduced by 10%
- **Greater than 7 years:** deferred capital gains tax until December 31, 2026 and the capital gains tax owed on the initial investment is reduced by 15%
- **Greater than 10 years:** no capital gains tax on new gains generated by investments in the Qualified Opportunity Fund (investors still pay deferred capital gains tax on their initial investment pursuant to holding periods above and the exclusion of new capital gains only applies to rolled-over capital gains invested in the fund, not any new capital invested)[10]

QOFs may be structured as limited liability corporations, can self-certify and can utilize third-party debt to finance investments

A Qualified Opportunity Fund is a U.S. partnership or corporation that intends to invest at least 90% of its holdings in one or more qualified Opportunity Zone. QOFs are not subject to IRS approval and can self-certify to the U.S. Treasury Department. A QOF may be owned by a single individual, by a partnership, or by a large pool of investors operating with a professional fund manager. Structures for a QOF can include REITs and limited liability corporations. Qualified investments within the QOF include either businesses that primarily operate in Opportunity Zones or real estate located within an Opportunity Zone. Opportunity fund investments are limited to equity investments only, therefore loans or debt investments are not eligible for the tax incentives. However, recent rules clarified that third-party debt can be placed on the properties.[11] Additional preferences in federal loan and grant funding are also being considered that could further benefit Opportunity Zone investments.

Qualified property investments must include new construction or significant renovation to be completed within 30 months

With respect to properties, Opportunity Funds can only invest in (1) the construction of new buildings or (2) the substantial rehabilitation of existing buildings. The rehabilitation investments require a capital improvement greater than or equal to the cost of the existing improvements (land cost excluded). For both new constructions and rehabilitation, the development and capital investment must be completed within 30 months of acquisition and the fund must have a written schedule and detailed plan for the expenditures. Underlying properties must have been acquired by the fund after December 31, 2017 and the ability to make the full step-up in tax basis is preserved through December 31, 2047 to prevent flooding the market with sales at the end of the 10-year holding period.[10,11]

O-Zone New Construction

O-Zone Rehabilitation

Over 43 funds are actively raising capital for Opportunity Zone investments

Investors and real estate fund managers are actively in the process of evaluating options, setting up funds and conducting due diligence. Pressure exists to move quickly as investments must be made by the end of 2019 to receive the full 15% tax basis “step-up” from a seven-year investment. Goldman Sachs invested $70 million into Opportunity Zones in 2018 and has a pipeline of transactions over $1billion. Bank of America, Wells Fargo and other wealth managers are also investigating how to offer investments to affluent clients. Sales activity has increased in opportunity zones throughout the country as investors have studied maps and purchased property anticipating that prices would rise when the new funds began to deploy capital. According to RCA, sales of development sites in Opportunity Zones nationwide increased 80% in the first three quarters of 2018 compared with the same period last year. Primary targets have included Oakland, San Diego, Phoenix, Atlanta, Portland and other growing cities where real estate speculation has been growing even before the program was announced. Many brokerage firms are now highlighting opportunity zones in marketing packages. As of mid-November, at least 43 funds were seeking to raise a total of $8.9 billion and Treasury Secretary Steven Mnuchin expects that figure could grow up to $100 billion.[12]

Additional investment guidelines and regulatory clarifications are expected by year-end 2018

Ultimately, the Opportunity Zone program is intended to spur broad-based job creation and benefit the businesses, entrepreneurs, and residents in low-income communities. However, some critics are concerned that the program provides large tax breaks to projects that would have happened anyway and that the program may result in further gentrification and displacement of low-income households in those communities. Others are concerned that capital investment into Opportunity Zones may not be as large as anticipated due to the risks of investing in low-income submarkets which may more than offset any benefit from the tax incentive.

Furthermore, additional questions remain outstanding regarding the regulation, particularly with respect to how carried interest is taxed within the fund, what happens when the capital improvements are delayed due to unforeseeable circumstances and what constitutes a “reasonable period” for funds to reinvest proceeds from the sale of qualifying assets. Nevertheless, the magnitude in which investors are actively creating funds and pursuing properties is a strong indication that the Opportunity Zone program may help drive significant capital into underserved markets. The Treasury and the White House have indicated that additional guidance will be provided before the end of 2018.

Footnotes

1 Guggenheim Partners Economic Outlook and Key Themes as of 11/14/2018.
2 Data sourced from the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index Quarterly Detail Report and Trends Report for the third quarter 2018. As of 9/30/2018, the NCREIF Property Index (“NPI”) included 7,786 investment-grade, income producing properties with a market value of $592 billion. Occupancy calculation is based on leased square footage. NOI Growth reflects the change in NOI from quarter to quarter for properties that are in the index at the beginning and end of the respective quarter.
3 Green Street Advisors Real Estate Securities Monthly November 1, 2018.
4 Commercial Mortgage Alert newsletter as of 10/5/2018. Based on 10-year U.S. Treasury Yield of 3.1% for 3Q 2018.
5 Based on the average of 2Q18 Dodge and 3Q18 CoStar supply growth data.
6 Source: Green Street Advisors; GAV = Gross Asset Value.
7 Analysis based on data sourced from CoStar 3Q18 and Green Street Advisors. Shading represents forecasted period.
8 WSJ, “Big Stock Windfall? New Rule Defers Taxes With Real Estate Investment”, Oct. 2, 2018.
9 GlobeSt, “Everything You Need To Know About Opportunity Zones”, July 16, 2018.
10 Hunton Andres Kurth, “Client Alert: Investors Should Consider the Benefits of A Qualified Opportunity Zone Investment Authorized by the Tax Cuts and Jobs Act”, July 2018.
11 Hunton Andres Kurth, “Client Alert: Opportunity Zone Update”, October 2018.
12 WSJ, “Rich Investors Eye Tax-Favored Development Funds”, Nov. 14, 2018.

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Contact Information

Barry A. Ziering, PhD
Business Development
212.518.5385
barry.ziering@guggenheimpartners.com

Kevin M. Harrell
Business Development
704.805.1002
kevin.harrell@guggenheimpartners.com

Kevin E. Bishop, CFA
Investor Relations
617.859.4602
kevin.bishop@guggenheimpartners.com

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