BRIDGE
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Q2 2019 REAL ESTATE OUTLOOK

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Value-Add, Class B Multifamily Real Estate is a Durable Recession-Resistant Strategy.

With full acknowledgment of significant rent growth and cap rate compression since the global financial crisis (“GFC”), Bridge Investment Group (“Bridge”) sees extraordinary value in continued investment in Class B value add multifamily, particularly in strong secondary markets. Class B—characterized as 1980s-2000s vintage, 2-3 story garden-style apartments—is a differentiated product bolstered by strong, recession-resistant tailwinds and provides investors with current cash flow and capital appreciation.

The purpose of this paper is to review the current state of the market—supply, demand, valuation and projected returns—and provide some insights into how we expect the asset class to perform in a recessionary or inflationary climate. Below are some of the highlights we see as evidence supporting our value proposition:

- Multifamily benefits from robust fundamentals driven by strong demand matched with modest supply;
- Newly developed Class B assets are rare, as nearly 90% of new multifamily product is Class A luxury product;
- Rent growth of Class B Multifamily has consistently outpaced inflation through the expansion and is resilient through downturns;
- Carefully selected rapidly growing secondary markets have consistently outperformed the six Gateway markets; and
- Forward integration, now more than ever, is the key to create alpha generation, driving asset improvements and efficiencies that optimize NOI and occupancy.

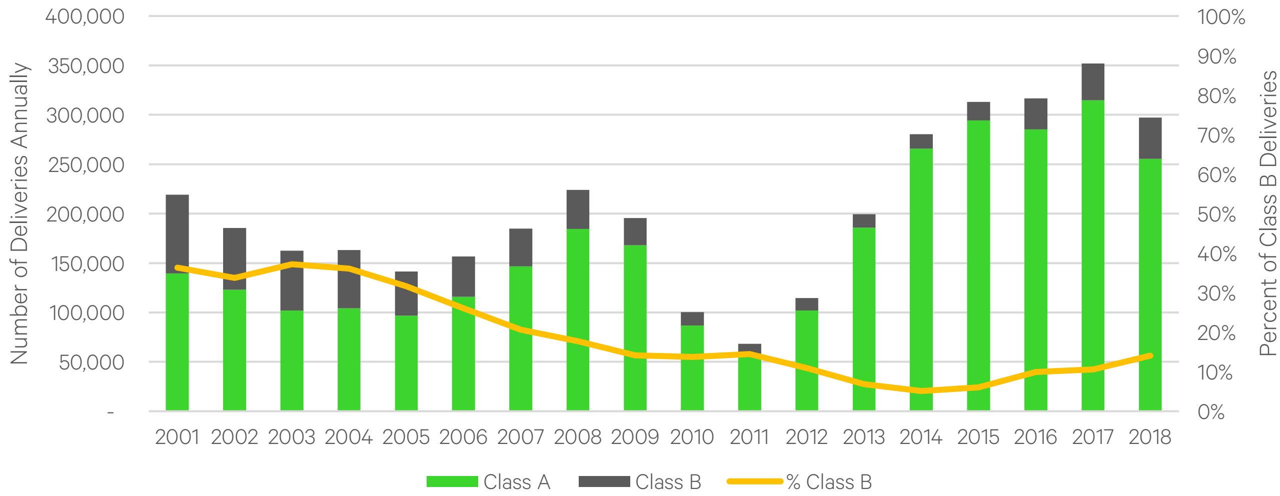
Private Multifamily Real Estate Offers a Flight-to-Quality Opportunity

Demographic tailwinds in multifamily will continue to provide uplift through the business cycle in comparison to other real estate sectors intricately linked to U.S. GDP. First, the fundamentals of the multifamily real estate market today remain strong. With homeownership rates declining from a peak of 69.4% in Q2 2004 to 64.4% in Q1 2019, during this period we have seen a 134% increase in the number of renter households relative to homeowners.[i] Renter demand drivers include a net growth of 185,000 18-34 year olds per year in America, and a net increase of over 250,000 65+ years old renter population.[ii] An additional interesting demographic explanation for the continued strong demand is the shift in household composition over the last 50 years. The more traditional homeownership households—married families with kids—has dropped from 41% of all households to 19%.[iii] When these numbers are added to a net immigration of over a million per year and some likely decoupling of the current 23 million millennials living in their parent’s home, Bridge derives a net demand of over 325,000 new multifamily units per year for at least the next five years. These long-term and growing demographic drivers of demand, as well as others, support that multifamily is a differentiated product in real estate assets.

From a supply perspective, the balance between demand and supply is healthy and does not show overbuilding that is typical of late cycle activity. For example, the past two years has seen an annual average of 346,000 new institutional-grade multifamily units.[iv] Inclusive of obsolescence and neglected property management, Bridge estimates that net new supply may approach 275,000 new units over the past two years.[v] However, over the ten-year period following the GFC, deliveries and absorption have been in almost perfect balance with about 2.5 million of units of supply and demand leaving the overall market in a relatively stable occupancy position in the mid-90% range.

Current projections for deliveries show steady to slightly declining levels that should keep deliveries in the 300,000-unit range and maintain a supply/demand balance as we move into the next five years. That said, the reality of new construction costs makes it very difficult to build much needed Class B inventory, so we expect most built supply being Class A, which only reaches affordability to the top 20% of renter household incomes. Challenges facing new construction include rising construction costs, which have increased 81% since 2000,[vi] tightening underwriting standards and widening debt spreads, additional and complex regulations, and increasing land acquisition and assembly costs. While demand remains high and supports new supply, the Class A segment remains one of the few areas that is profitable for developers, and Class B is insulated from new supply competition.

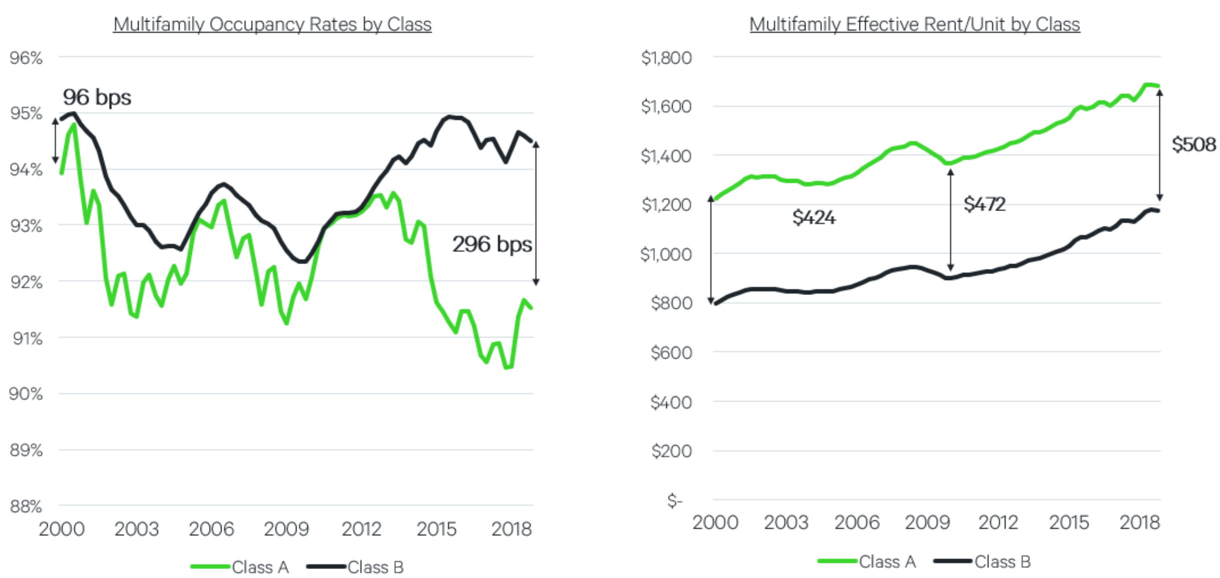
Figure 1: In the Early 2000s, Class B Units Accounted for More than Half of the Mix...Today, Class B Units Account for Less than 15% of A & B Deliveries.



Source: CoStar Group as of Q1 2019. Bridge Investment Group Research.

The dearth of affordable supply will continue to bode well for owner-operators of Class B who can improve those assets and make them more competitive, without having to compete with newly built inventory. The lack of supply for Class B product has resulted in a significant widening of the occupancy gap between A and B apartment inventory. Furthermore, the need to achieve a return on more costly new Class A product has widened the spread between Class A and B rents, which stands at approximately $500 per month and creates a strong opportunity for improvement-based rent growth in Class B. This is an incredibly supportive environment for Value-Add B assets.

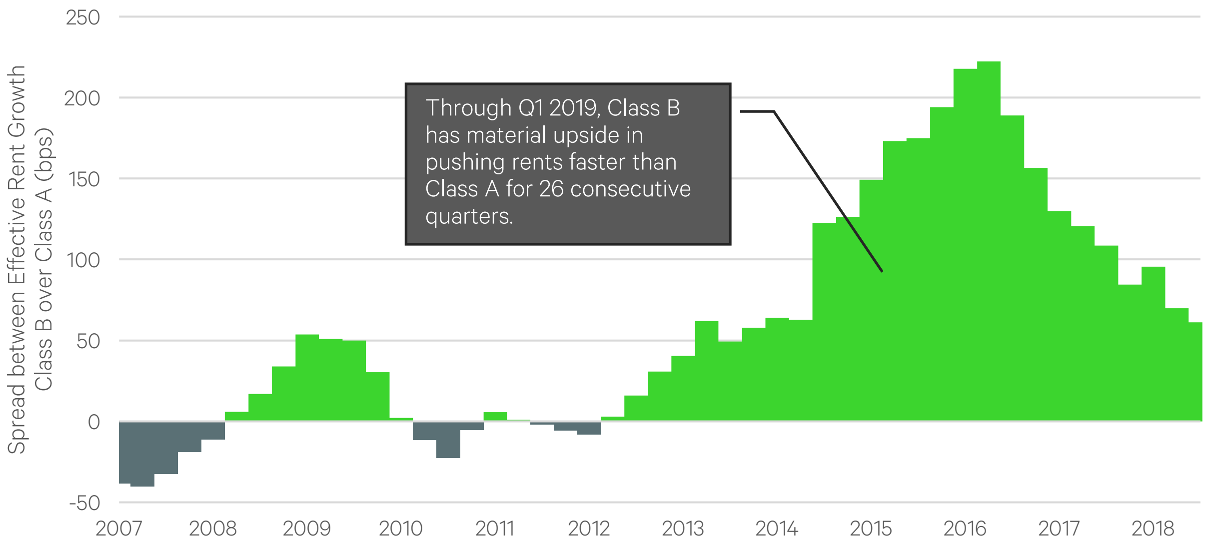
Figure 2: Class B Apartments Have Experienced Higher, More Stable Occupancy Rates than Their Class A Counterparts & The Occupancy Gap Has Widened During the Current Expansion Due to Increasing Class A Deliveries



Sources: CoStar Analytics, as of Q-4 2018; Bridge Investment Group Research.

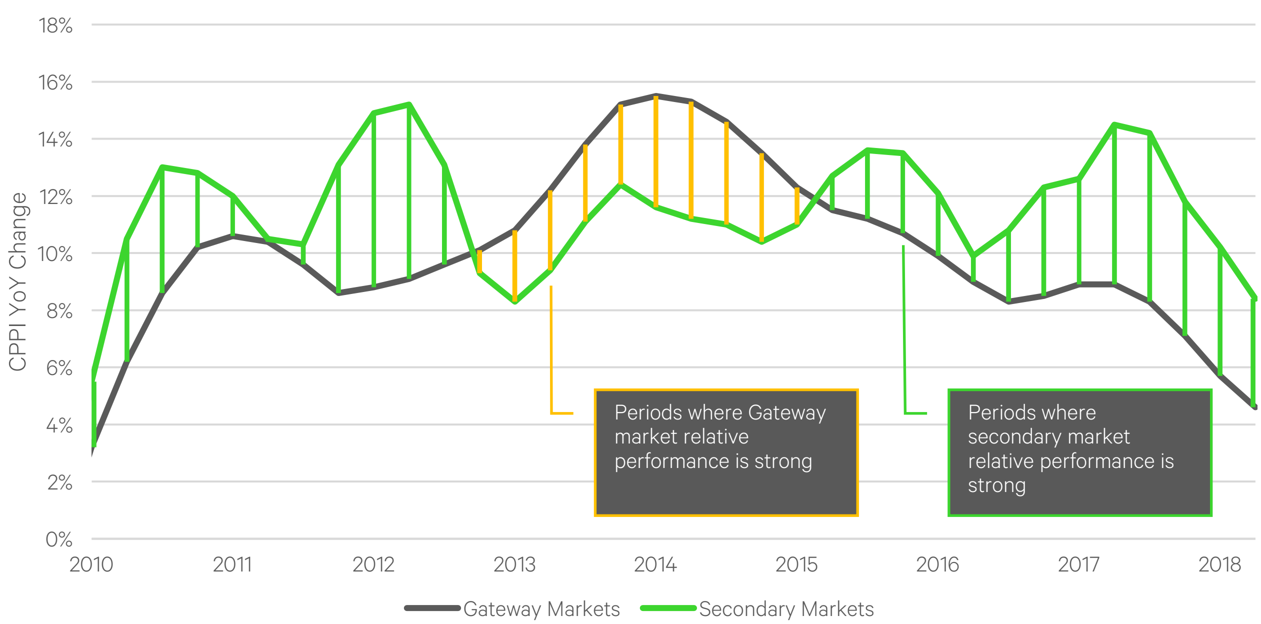
Throughout the current expansion, Class B new deliveries consistently remain below 15% of overall new product.[vii] New multifamily product is simply out of reach for most U.S. households, with 83% of units under construction requiring incomes over $75,000—in urban cores this figure jumps to 93%.[viii] Combining this supply-demand mismatch with the observable rent and occupancy growth advantage over Class A, Value-Add Class B strategies continue to offer investors added upside. Forward integrated investment managers, where best-in-class property management is embedded into the firm's operational capabilities, are further advantaged in their ability to execute on improving assets, to create strong and thriving communities, and thus to command higher rents and occupancy. For illustrative purposes, an average Value-Add investment of $7,500 in a 1990s vintage asset could result in $1,200 of additional annual revenue; at a conservative secondary market cap rate of 5.5%, the value and profit per unit are $21,818 and $14,318, respectively.[ix] Or, for every 100 units, there is an additional $1.4 million of upside in operational alpha achieved in addition to market rent growth over the investment hold.

Figure 3: Since the GFC, Class B Multifamily Has Materially Outperformed Class A in Effective Rent Growth



Source: CoStar Group as of Q1 2019. Class A and B are defined as 4 & 5 Star and 3 Star properties, respectively. Bridge Investment Group Research.

Figure 4: Multifamily Performance in Secondary Markets Has Exceeded the Six Gateway Markets in 24 out of the Past 34 Quarters

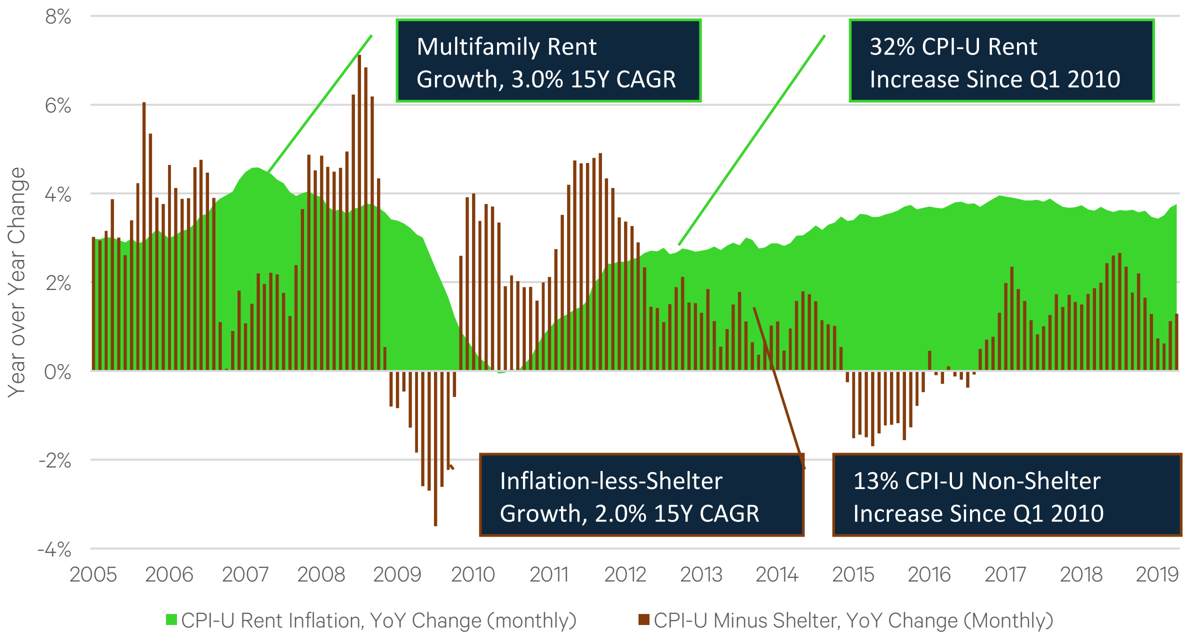


Source: Real Capital Analytics as of Q1 2019. Gateway markets include Boston, Chicago, D.C. Metro, LA Metro, NYC Metro, and SF Metro. RCA CPPI (Commericla Property Price Index) is based upon repreat-sales regression methods. Bridge Investment Group Research.

Multifamily has performed extremely well in the post-GFC period, and to the extent we continue to have steady growth with moderate inflation and an accommodative lending environment, we expect to see attractive returns. Cumulative price appreciation since 2010 has been 34.3% more in Secondary markets at 163.3% versus 129.1% in Gateway markets.[x]

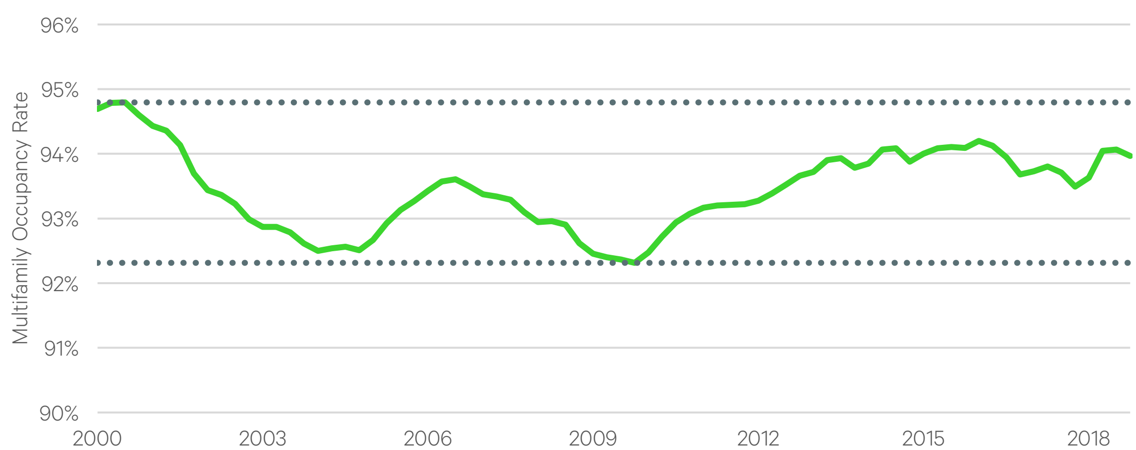
While fundamentals remain supportive of Value-Add Multifamily, the question on many investors' minds is how will multifamily stack up against other investments in either a recessionary or an inflationary environment? In a recessionary environment, Bridge believes multifamily, particularly Class B multifamily, will distinguish itself from other investments due to the structural supply-demand fueled stability in rents and occupancy, which should allow cash flow from operations to continue solidly through the downturn. Apartment rents weather economic downturns and supply a hedge against inflation (see Figure 5 below). Additionally, debt service on floating rate debt will come down, offsetting a reduction in scheduled income, and in the case of class B, new renters will move down from the A product to the B assets to save rent, which more than offsets any resident loss from the B class assets to C assets making occupancy very stable (see Figure 6 below). In addition, during the expansion, rent growth has increased 32% compared to 13% for all other components of inflation.

Figure 5: For the Past 6 Years, Multifamily Rent Inflation Has Significantly Outpaced Inflation for All Other Goods and Services Making Real Estate an Attractive Play for Investors to Hedge against Inflation



Source: Federal Reserve Bank of St. Louis Economic Research Division. Bridge Investment Group Research.

Figure 6: Multifamily Occupancy Has Been Extremely Stable Over the Past Two Decades... Recent Occupancy Decreases Are Likely Due to Absorption Lags as Deliveries Have Substantially Increased

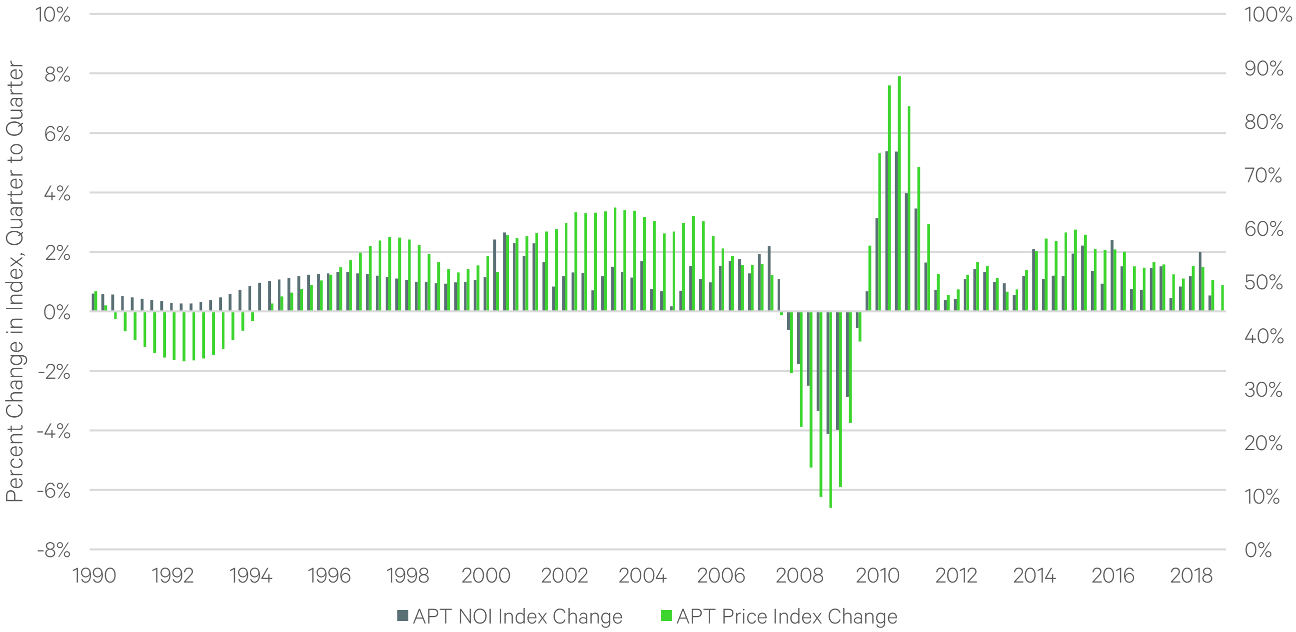


Source: CoStar Group as of Q1 2019. Bridge Investment Group Research.

Class B Multifamily Provides Material Opportunity to Achieve Above-Market Returns and Drive Alpha at the Asset Level

Investment managers can derive alpha through acquisitions and asset management. From an acquisitions perspective, this means buying the right asset in the right market and submarket at the right price. Investment managers can capture more asymmetric information through access to data and analytics. As pricing competition increases, select markets will rise above others given positive demand characteristics. On a go forward basis, positive screens for market selection will rely on effective and thoughtful analysis of demographic and employment trends and forecasts. Negative screens could include overexposure to cyclical risk; to illustrate this point, markets with diverse industry composition will have defensive positions against secular downturns. As it relates to asset management, purchasing existing assets at a significant discount to replacement cost and efficiently repositioning them to drive improvements and tenant satisfaction provides the opportunity to "create alpha" at the asset level and deliver recurring substantial returns. For both acquisitions and asset management, given the accretive environment for Value-Add, owner-operators with a forward integrated business model that aligns vision and execution have a distinct competitive advantage to source, diligence, and optimize attractive assets.

Figure 7: Since 1990, Apartment Prices & NOI Increased by a Compound Annual Growth Rate of 5.2% & 4.1%



Source: CoStar Group as of Q1 2019. Bridge Investment Group Research.

The result of these factors makes multifamily a lower beta investment, with steady and durable cashflows. The short-term nature of leases enables multifamily to respond to growth in an inflationary period, making multifamily one of the more attractive investments to hold during a recession while exposing investors to market upside in growth cycles. Short term valuation and pricing drops are recovered quickly, and over time rents and value maintain a reliable and attractive growth rate. Since the current strong demographic fundamentals of the multifamily market, particularly the Class B Secondary market, show no signs of deterioration, we do not expect a real estate cycle to occur. Consequently, whether we continue with slow and steady growth or if we hit a recession or expansionary period, Bridge makes the case for overweight exposure to multifamily in a portfolio.

In summary, Bridge expects the Class B segment of Multifamily real estate to deliver strong performance for the real estate investor. The segment not only demonstrates resilience through periods of economic distress, but there are material opportunities for investment managers to derive alpha. Specifically, select assets acquired through a data-driven, top-down investment process offer market alpha. Likewise, forward integration offers operational alpha through targeted, return-enhancing capital improvements and hands-on efficient execution. Multifamily thus offers an attractive combination of strong and growing cash flows and capital appreciation with lower beta, stacking up favorably on a risk-adjusted basis versus both other real estate and broader global markets.

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References

[i] Moody's Analytics as of Q1 2019. Bridge Investment Group Research.
[ii] U.S. Census Bureau, 2017 National Population Projections - September 6, 2018 Revisions.
[iii] U.S. Census Bureau, Current Population Survey, March and Annual Social and Economic Supplements, 2018 and earlier, *Families by Presence of Own Children*; Bridge Investment Group Research
[iv] Institutional-grade multifamily units are defined as apartment buildings with more than 5 units. U.S. Census Bureau and U.S. Department of Housing and Urban Development, New Residential Construction, April 19, 2019.
[v] Obsolescence rates based on a conservative analysis based using a 200-year product lifecycle. This equates to the 0.5% annual loss rate estimated in a recent study from the National Multifamily Housing Council (NMHC), *US Apartment Demand – A Forward Look*, May 2017. Prepared by Hoyt Advisory Services, Dinn Focused Marketing, Inc. and Whitegate Real Estate Advisors, LLC.
[vi] RSMeans *Historical Cost Indexes* from the National 30 City Average index. Bridge Investment Group Research.
[vii] CoStar Group as of Q1 2019. Analysis by Bridge Investment Group Research.
[viii] CoStar Group. CoStar Portfolio Strategy, *Winners and Losers in the Age of Peak Supply,* 2017 NMHC Research Forum.
[ix] Bridge Property Management.
[x] Real Capital Analytics as of Q1 2019.