BRIDGE INVESTMENT GROUP

Q3 2019

Office Outlook:

Investing in the Path of Progress

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Office Investing Through the Cycle: Attractive Yields and Risk-Adjusted Returns

A robust investment opportunity for value-add office in supply-constrained, knowledge-based markets has been one of Bridge Investment Group's key investment themes this cycle, consistent since the trough of the GFC. In 2017, when many market participants were concerned the long recovery had overextended its welcome, Bridge Investment Group ("Bridge") released a white paper called *Why Office Now?* This report presented our thesis that the significant value-add opportunity in office we had captured to date through the cycle endured, regardless of whether market bulls or pundits were correct. Two years later, the dynamics laid out in our paper have not only proven in-line, but in fact have significantly beaten our projections.

The question today, in a market environment that combines the now longest recovery on record with a highly volatile equities market, a yield curve at or near the point of inversion, and low-to-negative global interest rates. is whether the case for value-add office still stands? Bridge Investment Group asserts that it does.

Macroeconomic, supply-demand, and institutional factors continue to bolster the strong investment case for office. Market participants had previously called for a decline in absorption, which did not come to fruition; today, absorption remains highly supportive in knowledge-based markets. The earlier and current prophecies also failed to differentiate between supply-rich and supply-constrained markets; the supply gap in high-growth US markets continues to provide a significant rent growth tailwind, and, importantly, downside protection. Finally, many capital allocators (as distinct from owner-operators) continue to invest with a static, core-centric approach that misses the significant opportunity to proactively amenitize technologically savvy workspace and capitalize on the shifting landscape of tenant requirements. We show why in today's yield-starved and inverted environment, US value-add office in high net in-migration markets presents one of the strongest risk-adjusted opportunities within global asset allocation to generate durable substantial yield, regardless of which way the cycle moves.

Two macro themes guide our investments at this point in the expansion:

1) "Durable Yield is King" in a low to negative global interest rate environment; and
2) "More We, Less Me" office space needs to be connected and amenitized inside and out as cities and employers engage in a "War for Talent."

Further, two investment themes inform our business strategy:

1) Knowledge-based growth markets have overtaken the gateway markets in attractiveness and stability; and
2) Well-constructed repositioning strategies offer significantly more upside than downside.

Disciplined office investing will follow these themes and find success, offering steady cash flows and potential for capital appreciation that compares favorably not just relative to other real estate but to broader global markets.

The Business Cycle

Before diving into our investment and macro themes, it is helpful to touch on the business cycle and its implications for the office sector. The current economic expansion, characterized by steady yet modest growth, continues to outperform expectations and fuel office demand. A growing U.S. economy, strong household formation rates, and steady job growth continue to bolster the investment landscape.

As of the most recent quarter and at 121+ months, the economic expansion has become the longest running in U.S. history. Real gross domestic product is estimated to have grown by an annualized rate of 2.0 percent in Q2 2019, supported by elevated consumer spending. The acceleration in household formation over the last several years suggests that newly formed US households have a positive impact on the economy and financial stability. Household formation rose by 31 basis points in Q2 2019 and has risen steadily for five consecutive quarters.

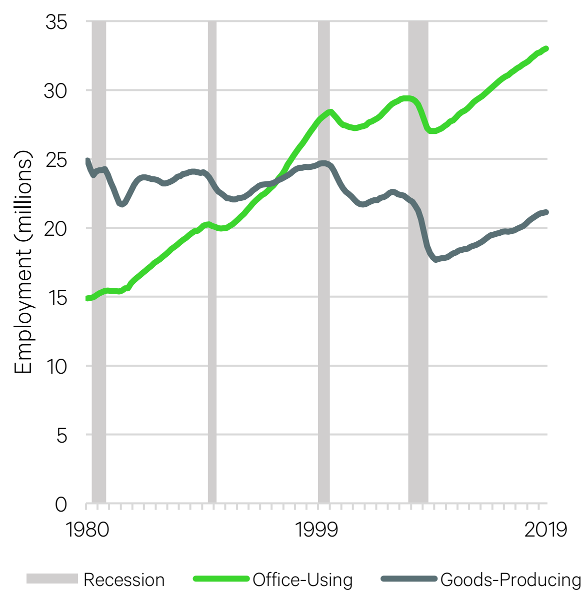
Transaction volumes for office rebounded to $37.6 billion in Q2 2019, a 30 percent increase from this time last year. Additionally, RCA's CPPI index shows a four percent annual increase in pricing year-over-year, which indicates that demand for office product remains healthy.[i]

The interest rate environment is also supportive for the relative value case for office. Contrary to popular belief, and despite eight interest rate increases between late 2016 and 2018, US cap rates have remained flat to down in commercial real estate markets. While this highlights the low correlation between Fed moves and asset pricing, the reprieve from interest rate hikes in the US combined with low Treasury yields provides further tailwinds and flexibility in financing activities. Accommodative monetary policy is likely to continue amid rising trade tensions.

The office sector's durable yield generation and office-using employment growth continue to create an attractive environment for investment (see Figures 1 and 2). Office commercial real estate is without a doubt linked to economic conditions, and it is understandable that—ten years into this expansion—the sector is viewed by some as contrarian. Yet, despite several years of economists' forecasts of declining growth and weakening real estate dynamics, the office sector continues to be a strong outperformer.

Cycles do not die of old age, particularly those in the post-WWII era. Rather, expansions die because of over expansion: too much debt, excess capacity, or negative capital flow dynamics. Despite concerns promulgated by worries over flat or inverted interest rates and the length of the recovery, we are not seeing any tangible signs of structural weaknesses now.

Figure 0-I: Employment by sector through cycles

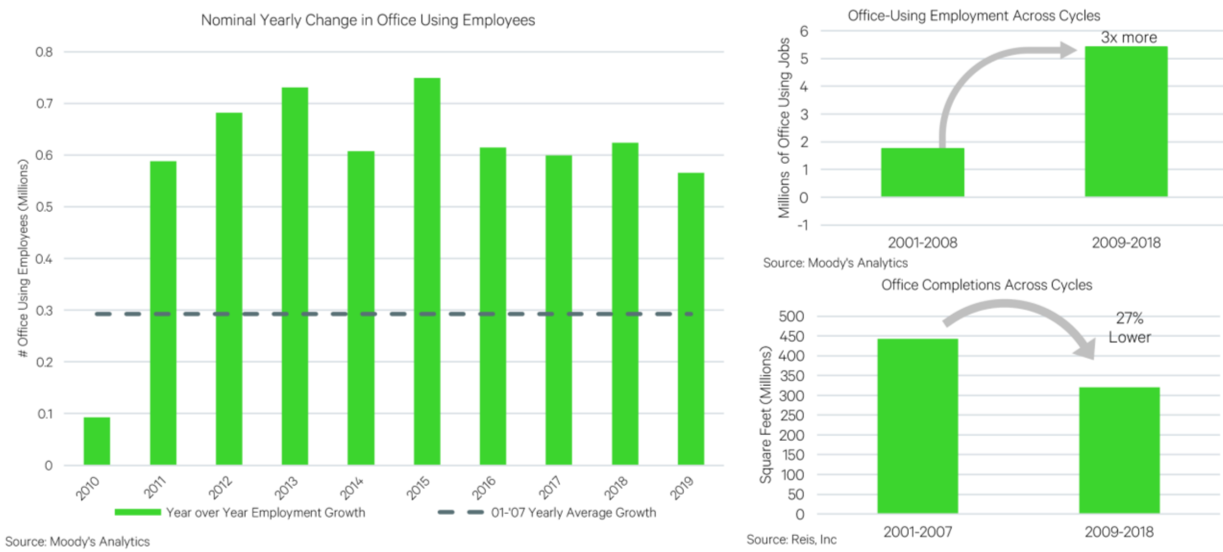


Source: Moody's Analytics as of Q2 2019

Supply-Demand Mismatch Offers Stable Cash Flows and Downside Protection

The current expansion has delivered more office-using jobs annually and three-times the amount of total office-using jobs than the previous expansion. **Yet unlike in previous cycles, supply has stymied, particularly outside of the gateway markets.** While office-using employment growth is well above the pre-GFC average, 27 percent less new product has been delivered (see Figure 2 below).

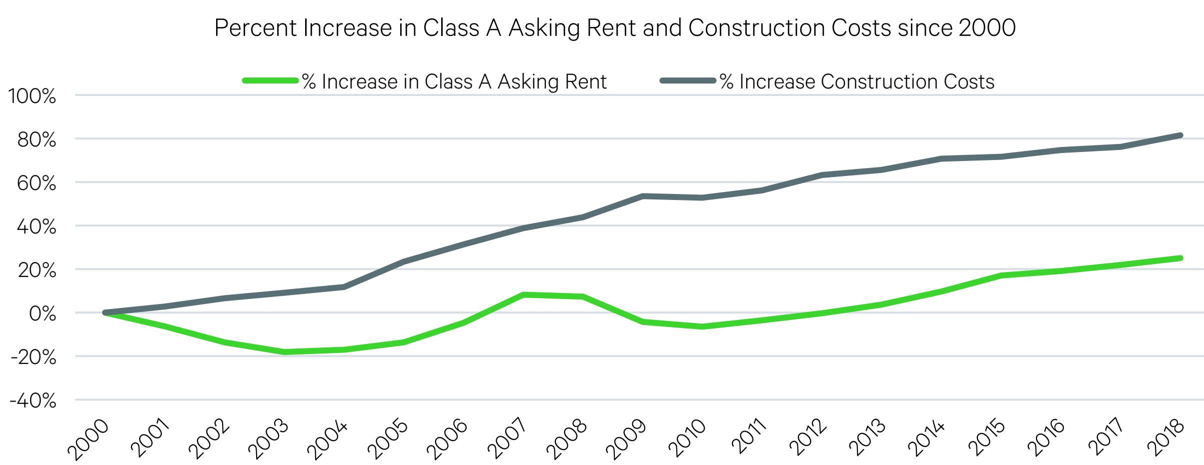
Figure 0-II: Office-using employment has been rising steadily since the recession, yet supply remains muted



This highlights an acute supply-demand mismatch, particularly in knowledge-based growth markets, which are experiencing the bulk of the nation's demand yet greatly diminished new supply. The lack of new supply is due to structural issues that are not easily solved; as an office investor, these structural limitations provide visibility into an ongoing diminished pipeline and importantly, cushion against the cycle.

RSMeans, a leading construction cost estimator, shows that construction costs have increased 81 percent since 2000 (see Figure 3). With higher costs, fewer new construction deals pencil, particularly in non-gateway markets where replacement rents have not yet caught up to levels to offset higher construction costs (see Figure 3).

Figure 3: Rising construction costs have far outpaced rent growth



Source: RSMeans as of Q1 2019. Costar Group as of Q2 2019.

The escalation in costs is due to a combination of factors including:

1) Market demands for locations with transit, high-quality construction and robust, expensive amenities;
2) Larger buildings to compete with the elevated land costs in these preferred locations;
3) New regulations in construction methods;

4) Higher labor costs as many construction professionals permanently left the industry during the GFC;
5) Higher materials costs, in part due to global demand for building materials in other property types;
6) Significantly higher municipal fee structures; and, most recently
7) Lending regulations that make construction financing costlier and less desirable to banks who provide the majority of the leverage.

These hard and soft costs, combined with the elevated cost of land, have resulted in extremely limited amounts of speculative office construction in the highest-growth markets around the country. In this acutely construction challenged environment, knowledge-based growth markets experience absorption that consistently exceeds their pace of supply.

Most striking is the office sector's ability to generate consistently strong and durable yields, as this stands in stark contrast to the dearth or instability of yield among most global asset classes today. **Office may be a rare place in the entire market today to generate such strong and stable yields.**

MACRO THEME 1: In A Low Interest Rate Environment, Durable Yield is King

Opportunities exist to buy value-add office at cap rates that have been predominantly stable for the last several years. Our experience shows that assembling a portfolio of 10 million square feet with a typical value-add occupancy rate of 75 percent, investors can achieve a going-in yield of 7.5 percent and a three-year average cash-on cash return of over ten percent. The ability to drive such significant cash flow immediately is a strong differentiator for office. Further, these cash flows are durable, particularly with a well-diversified mix across tenants, industries and lease terms.

Assets with a relatively higher weighted average lease term ("WALT") are particularly privileged for yield. For example, stress testing a portfolio with a WALT of five years assuming another crisis, the in-place contractual cash flow buffers yield and protects from having to deal with tremendous upheaval in the midst of a correction, which lasted about two years during the GFC. Disciplined asset and market selection, diverse tenant rolls, and underwriting aligned with operations provide a secure footing to weather secular downturns and protect going-in yield.

Low interest rates are a boon to value-add office assets. Typical financing in value-add portfolios is 60 to 65 percent that floats over Libor, and the health of the debt markets has allowed spreads for high quality properties to fall to 150-160 basis points. Projected softening in rates drive financing costs to at or below three percent, providing excellent leverage and significant coverage for debt service even if these portfolios achieved no new leasing. This further protects the going-in yield, particularly if the floating rate exposure is hedged.

MACRO THEME 2: Changing Tenant Needs and the "War on Talent"

"Less Me, More We"

The nature of office space and leasing is rapidly evolving. Today's tenants desire move-in ready flex office space, coworking, virtual office space, and modern amenities. WeWork and other companies that provide shared workspaces have expanded the vision of future workspaces. The coworking phenomenon has changed the way people think about flexible-term executive suites, virtual offices, and creative/collaborative work environments.

Throughout most office markets in the U.S., a shift towards creative office space with less “me” space and more “we” space has become ubiquitous. As millions of new office-using employees have been added to the workforce, many companies have been able to limit their office space growth due to telecommuting, non-dedicated space models, conference room sharing, and productivity-based management. This shift in office-using behavior has not only been prevalent in the technology industry but has also crept into other industries seeking to attract young professionals who might prefer flexible hours, an open office environment, and to contain costs.

There is debate about the open office environment’s effect on productivity, but the trend is likely here to stay, with fewer square feet (150-200sf per employee) being the norm as opposed to the more than 250sf per employee historically. In this environment, the traditional, statically managed model of companies managing long-term leases and properties with low levels of amenities will not capture potential value to either the business or the real estate. In contrast, forward-integrated office firms that have the in-house capability to dynamically manage office space, combining high-touch modern spaces and high-quality services with different leasing options, can generate significant investor returns and durable, diversified cash flow streams.

Amenitizing and tech-enabling a mix of tenant options, such as customized suites, move-in-ready workspaces and both short- and long-term leases diversifies the revenue stream and rent roll while providing tenants needed flexibility. Tenants who opt for longer term leases in customized suites provide stable long-term cash flow and predictable rent roll. Move-in-ready suites limit exposure to uncertain growth or contraction and accommodate special projects and short-term contracts. While offering these move-in-ready suites to tenants makes it harder to predict rent roll, the advantages of a higher rent and the ability to control the construction of the office suites help offset this uncertainty. Flexible enterprise leases, such as in the coworking model, are attractive to high-growth tenants looking to expand their footprint within a market or those who need “plug-and-play” space for temporary projects; in addition to maximizing occupancy and space absorption within a given asset, these can serve as a stepping-stone to long-term leases. Coworking spaces can be structured with the option of rolling the location into a fixed lease upon monetization, allowing the value to be captured by the property. The net effect is a more stable and diversified income stream that also benefits from market upside.

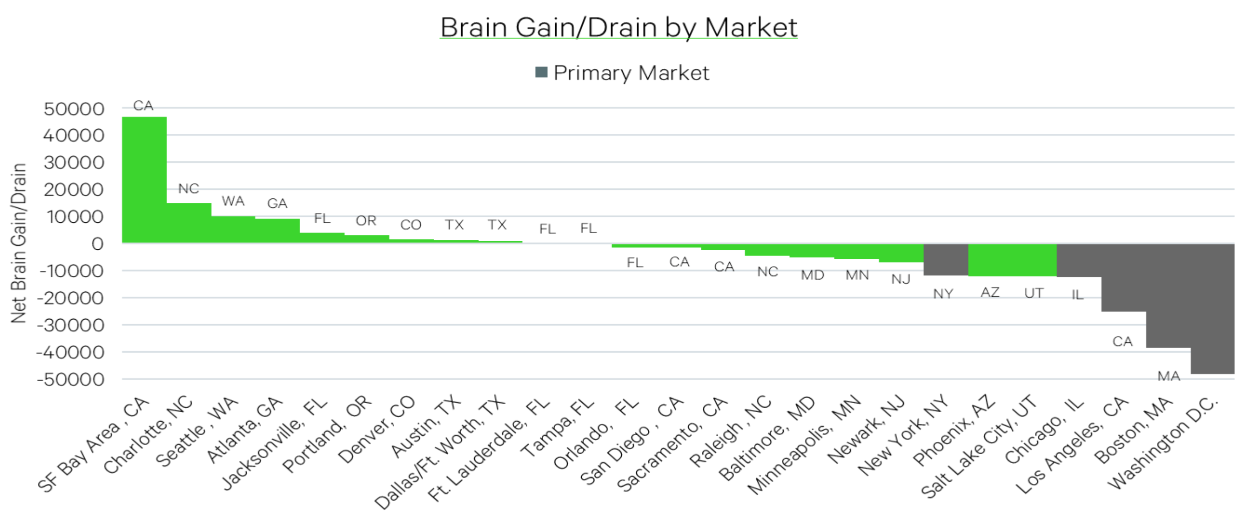
The “War for Talent”

Coined by McKinsey & Company, the “War for Talent” refers to the increasingly competitive landscape for recruiting and retaining employees. In today’s economic climate of low unemployment, the ability of an area to educate, attract and retain highly skilled and talented employees should be a paramount factor informing the investment decision.

Firms must be able to provide their employees with an environment where they can easily balance the pressures of work with the demands of everyday life, the so-called “live-work-play” dynamic. This means that companies need to have physical locations that are easy to access, by both public and private transport, and have sufficient amenities surrounding the workplace. Targeted investments that follow the existing and planned infrastructural, cultural, and recreational amenities provided by cities and the private sector will deliver above-market returns.

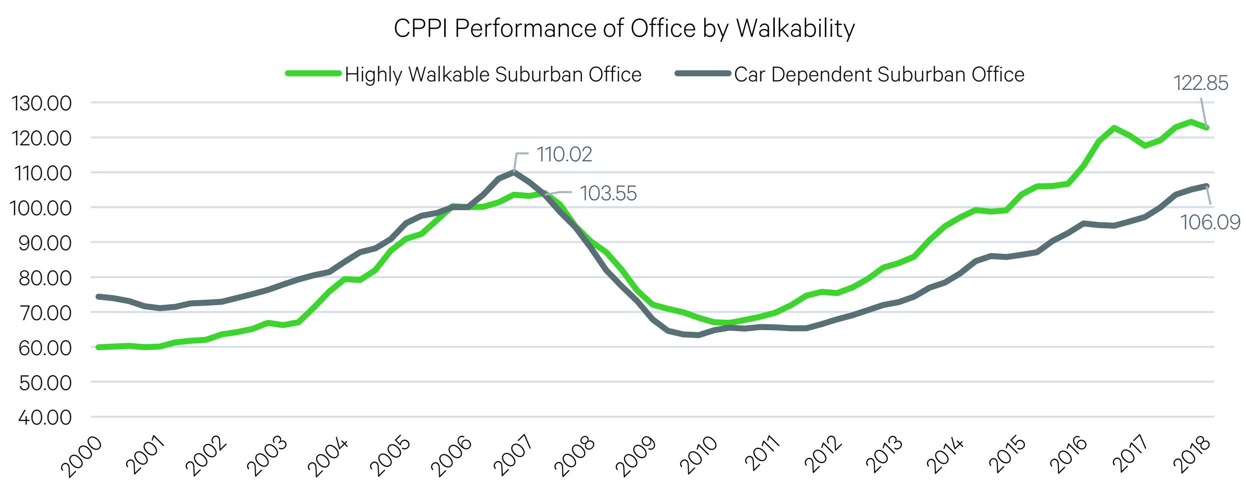
One way to tell how well an area is doing in the “War for Talent” is to measure the net “Brain Gain” of the area. Simply put, “Brain Gain” is calculated as the inflow of educated human capital in an area minus the outflow in that same area. The data shows highly skilled employees departing many markets where they were educated. “Brain Gain,” with corresponding office-using employment growth, is strongest in knowledge-based growth markets, while the gateway markets continue to experience a significant “Brain Drain.”

Figure 4: Markets with an ability to attract well educated talent pools have performed well through the current expansion



There is also clear performance delta between amenity-rich and car dependent business centers as shown below in Figure 5. In targeting Prime Business Centers, a strong premium exists for submarkets that provide tenants with a diverse mix of day and nighttime amenities. Since the recession, highly walkable indices are up almost 19 percent. The premium of investing in walkable areas outside of the downtown core delivers returns without accounting for market selection, asset strategy, or vintage.

Figure 5: Highly amenitized and well-located office assets lost value slower and recovered quicker than their car dependent counterparts



Source: Real Capital Analytics Commercial Property Price Index (CPPI) using WalkScore amenity scores

This exodus of highly talented new employees to cities that offer a better quality of life, affordable housing options, and higher paying jobs has developed unique opportunities in the office market. Many of the non-gateway markets are seeing annual office-using employment growth in the tens of thousands of employees. This dramatic growth, coupled with the structural issues limiting supply, has resulted in a significant opportunity for value-add investing, repositioning suboptimized buildings in prime locations to fill the void of tenant needs without having to compete with new construction. Strong execution in value-add assets will drive NOI growth and attractive yield as their tech savvy curb appeal enables employers to win the "War for Talent," while the lack of new supply provides significant downside protection.

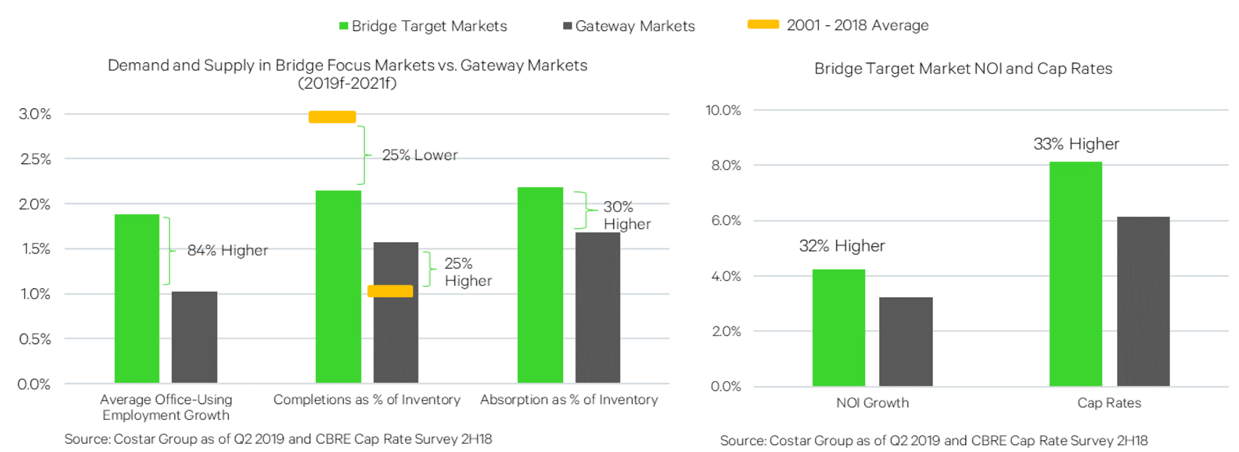
INVESTMENT THEME 1: Knowledge-Based Growth Markets Have Overtaken the Gateway Markets in Attractiveness and Stability

In previous cycles, the central business districts of Boston, Chicago, Los Angeles, New York City, San Francisco, and Washington, D.C were stalwarts of the commercial office real estate industry; lower cap rates and stronger pricing reflecting the relative safety of investing in these markets. **Fundamentals and market dynamics no longer support that case.** Since the GFC, over-supply of office in these cities, combined with out-migration in favor of lower-cost-of-living, “Brain Gaining” metros, have caused knowledge-based growth markets to assume the transaction volume, favorable operating characteristics and resilience traditionally afforded to the gateway markets.

Based on the macro themes described above, Bridge identified 25 Target Markets[ii] with these characteristics, marked by robust office-using employment growth and extremely limited supply. These markets continue to offer appealing fundamentals, liquidity and downside protection ten years into the expansion. Perennial favorites such as Denver and Dallas are joined by coastal Florida and the periphery of large metros such as Boston and Washington, D.C.

Target Markets are expected to have 84 percent more office-using employment than gateway markets over the next three years.[iii] Over this same time period, these markets are expected to see 25 percent less supply as a percentage of existing stock compared to their annualized average between 2001 and 2018; gateway markets, on the other hand, are expected to see 25 percent *more* supply, despite the flow of human capital going the other way (see Figure 4 below).[iv] The net result is 30 percent higher absorption in Target Markets, translating to one-third stronger Net Operating Income growth.

Figure 6: Target Markets are projected to materially outperform gateway Markets, with substantial office-using employment growth and absorption



Knowledge-based growth market asset pricing remains significantly below replacement cost at a comparative bargain to gateway markets and at significantly higher acquisition cap rates. As a result, existing assets in these markets can be acquired at a 50 percent or more discount to replacement cost while creating more than enough headroom to mark-to-market rents. The double benefit of stronger operating characteristics with higher cap rates on acquisition[v] significantly compounds the total return, while also providing a higher current yield and downside buffer.

Meanwhile, supply-constrained knowledge markets also benefit from strong liquidity, over the last four years gaining nine percent in transaction volume while gateway markets have seen volume fall by 12 percent.[vi]

INVESTMENT THEME 2: Well-constructed repositioning strategies offer significant upside with limited downside

The Upside

Shifting tenant requirements and the acute supply-demand imbalance in high-growth, knowledge-based markets create the significant investment opportunity to acquire high-quality, yet suboptimized assets at a deep discount to replacement cost and to reposition for the modern tenant with the built-in downside protection of a lower basis than new construction. Such a strategy fills the void for modernized, tech-enabled office space in these markets, which suffer from both limited new supply and often (due to limited capex dollars available from REITS, regional owners or end-of-fund-life managers) underinvestment of existing, well-located assets.

Supply in these markets will remain low for three main reasons: 1) Rents needed to justify new construction are difficult to underwrite as they remain significantly above rents on existing assets; 2) Physical construction costs, entitlement outlays and the time and effort required to get through approval structurally limit supply; and 3) Many equity and debt capital providers fear a repeat of prior cycles where the supply hits just as a recession begins, so equity capital is cautious.

Consider the acquisition of an under-improved, 75 to 85 percent leased building in a market with strong net in-migration and demographic growth, next to work-live-play dynamics and transport links, (what we have in totality coined as prime business centers inside of these markets). Today, such a class A/A- high-quality building can be acquired at an approximately 50 percent discount to replacement cost. The value-add investor could then reposition with 10 to 15 percent in capital improvements, amenitizing common and tenant spaces over 6 to 12 months, with plenty of room to grow rents and still remain at a significant discount to rents necessary to support new supply. Approximately 80 percent of a modern building's square footage will be used for long-term office space leases, with 5 percent shared amenity space, 5 percent coworking and 10 percent flex space; multiple leasing options drive occupancy and stable cash yield. This product has a low J-curve due to a robust going-in-yield even throughout the improvement process. 60 to 65 percent of the return (a 2:1 ratio) will be driven by ongoing cash flow, a rarity in this yield-starved market, with the remainder in capital gains from the captured rent and absorption growth and differentiated value of the asset.

The Downside

How does such a building perform during a recession? Taking a representative portfolio in knowledge-based growth markets and stressing it for cap rate expansion, we find robust returns and stable cash-on-cash even with higher than expected cap rate expansion. A prudent underwriting approach will incorporate cap rate expansion. Figure 7 below shows the changing asset-level gross IRRs for this sample portfolio, in which 20 basis points of expansion is the base case built into the underwrite. Stressing the cap rate expansion to 160 basis points, the worst three-year period of the GFC, takes the return to a 13.4% gross IRR. However, an owner-operator who is not a forced seller can continue to clip the current cash-on-cash return in this environment. Even during the GFC, liquidity returned to the market quickly, with a similar five-year analysis showing only 75 basis points of cap rate expansion (producing around a 19% gross IRR). Any cap rate compression or stability – as has been the case this cycle - would have a meaningful positive impact on returns, though this scenario should not be underwritten.

Figure 7: Conservative Underwriting and Cap Rates

Cap Rate Expansion	IRR	3-Year CoC
-10 bps	25.0%	10.1%
0 bps	24.2%	10.1%
10 bps	23.5%	10.1%
20 bps	22.8%	10.1%
40 bps	21.4%	10.1%
80 bps	18.6%	10.1%
160 bps	13.4%	10.1%

A further stress test will measure the portfolio's durability of cash yield during periods of market distress and declining rents. Such a stress test can include the following assumptions as per Figure 8:

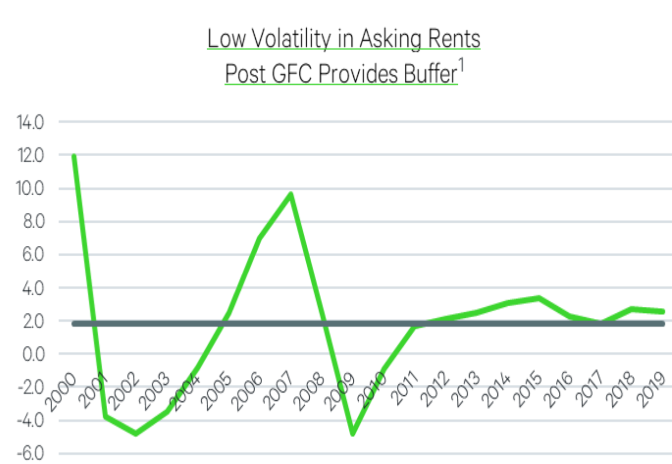
Figure 8: Stress Test Representative Portfolio Vs. GFC Scenario

Metric	Downside Scenario	GFC
Rental Rate Decline	-5% rent growth for 3 consecutive years (over 15% compounded)	Worst year was -4.8%; next worse year was -0.9%[1] (6% compounded)
Leasing	All leasing activity pushed out 3 years	Only 1 year of negative absorption excluding deliveries [1]
Renewals	Renewal probability decreased by 25%	Occupied square footage declined 0.6%[2] peak to trough
Cap Rates	160 bps of expansion	160 bps of expansion; worst over 5 years only 75 bps[3]
Sales	Pushed out to 5 years[4]	3 years of reduced sales (below pre-2006 levels)[2]

What we find is that yield remains robust and durable even in a market environment more draconian than the GFC. The downside scenario shows a 7.7% cash-on-cash return. Downside IRR and multiple are reduced to 8.9% and 1.5x, respectively; recapturing cap rates to the 5-year post GFC level of 75 basis points increases returns to 13.0% IRR and 1.8x multiple.

Furthermore, a fundamental difference between this cycle and previous ones is the concentration of supply in gateway markets despite the overwhelming human capital migration to supply-constrained, knowledge-based growth markets. Thus, another GFC-like scenario, even at similar or worse rental rate declines, would be significantly buffered by the lack of supply coming onstream in Target Markets, highly distinct from previous cycles. This dynamic is represented in Figure 9 below; the low volatility in asking rents post the GFC is a result of the muted construction this cycle that has run well below the pace of demand. Suggesting a low risk of an asset bubble, this stability provides a significant buffer to returns and cash flows in a downside scenario.

Figure 9: Change in Asking Rents Over Time



Finally, in-place tenants and middle market companies rarely default on space, and therefore, long-term in-place leases for over 75 to 85 percent of a building create stable cash flows to support both moderate debt service and a strong current yield.

We thus find that on a risk-adjusted basis, thoughtfully repositioning office in Target Markets represents one of the most compelling relative value opportunities in today's global markets.

Optimized and Risk-Adjusted Portfolio Construction

Capitalizing on our macro and investment themes, we construct the following portfolio to optimize both returns and risk-management:

1) *Vertical Integration of Operations and Leasing* – A platform with forward integration has the ability to drive cost efficiencies, secure cash flows and "create alpha" at the asset level through hands-on execution and building strong tenant relationships. Alignment between asset management and operations allows for a more realistic business plan, accountability and optimal monetization at exit. Crucially, owner-operators have the ability to make changes in real time as they see challenges.
2) *High-Quality Assets in High-Quality Locations* – Assets should have strong bones, in the best locations, yet be suboptimized. These will be class A/A- and 75 to 85 percent leased, in supply-constrained, knowledge-based markets, close to transit links and work-live-play dynamics.
3) *Focus on Light and Moderate Value-Add* – This approach secures cash flow. Repositioning strategies are particularly advantageous when a modest, but not extreme, amount of tenant roll is expected in markets where there is headroom in marking to market rents. Focusing on quality assets with limited rent roll in the first several years provides immediate cash flow and durability.
4) *Diversification of Tenants* – Diversifying tenant credit and industry exposure, with limited concentration of either, combined with multi-tenant rent rolls that consist of national and regional credit tenants represents an optimal tenant mix. This can be achieved with technologically-driven leasing management, integrated into due diligence and operations.
5) *Capitalizing on Shifting Tenant Needs* – Modernizing and amenitizing office space where there is limited new supply fills a significant void in these markets while creating the headroom to capture higher rents and absorption. Changing tenant needs should be viewed as an opportunity, not a threat, to provide up-sell potential and a diversified revenue stream.
6) *Longer Duration Strategy* – A longer harvest period increases optionality of exit to allow for optimal monetization. This optionality is positive because if market conditions remain benign, the extra years will be unnecessary, and if there is a period of liquidity crunch then one does not have to be a forced seller and can continue to clip attractive cash yield. This is particularly attractive in the vertically integrated model, which can attain additional cost efficiencies in a downside scenario.

Strategic portfolio construction and operational expertise mitigate downside risks while achieving sustainable returns—the combination is a highly attractive, defensive strategy in today's market.

Summary

Long into the expansion, commercial real estate performance continues to be positive, bolstered by robust fundamentals, a stable economy, and strong capital markets. The length of the expansion may have many investors asking the same question that was asked in 2017: *Why Office Now?* Bridge asserts that that the case for value-add office remains stronger than ever, particularly in supply-constrained, knowledge-based markets. The office sector continues to see significant office-using employment growth and a steady transition to the knowledge economy that is demanding of modern work environments. Meanwhile, the dramatic oversupply of new office space typical of long cycles has not occurred, which strongly favors value-add strategies in an increasingly cost-prohibitive new construction environment.

The combination of a disciplined asset selection process with well-conceived improvements that increase tenant satisfaction and solve vacancy issues presents a highly attractive investment thesis. Contributing to the defensive characteristics of this approach, high-touch operations can accelerate the delivery of expense savings and tenant management. Finally, a leasing focus is key to success in office investing, and an in-house leasing network supported by vertically integrated operations provides the ability to address local tenant needs on a comprehensive basis and to transform ordinary office properties into state-of-the-art, modern, appealing workspaces that command premium market rents and improved occupancies.

Bridge expects these macro and investments themes will perform well whether the economy continues at a slow and steady pace or if we find ourselves in a recession. We expect this to be a capital allocation strategy that will help our investors weather the ebbs and flows of the macroeconomy, while driving durable yield and returns that compare highly favorably to other global asset classes.

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The Moody's/RCA Commercial Property Price Index ("CPPI") is published by Moody's Investor Service, Inc. The CPPI is based on the repeat sales of the same assets at different points in time. See www.moodys.com for additional information regarding the calculation methodology of the CPPI.

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[i] Real Capital Analytics as of Q2 2019.
[ii] CoStar Group as of Q2 2019.
[iii] CoStar Group as of Q2 2019.
[iv] CoStar Group as of Q2 2019.
[v] Past performance is not a reliable indicator of future results and should not be the sole factor of consideration of this forward-looking statement.
[vi] CoStar Group as of Q2 2019.