ARCAPITA

US Real Estate Investment in a Post-Pandemic World

September 2021

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Summary:

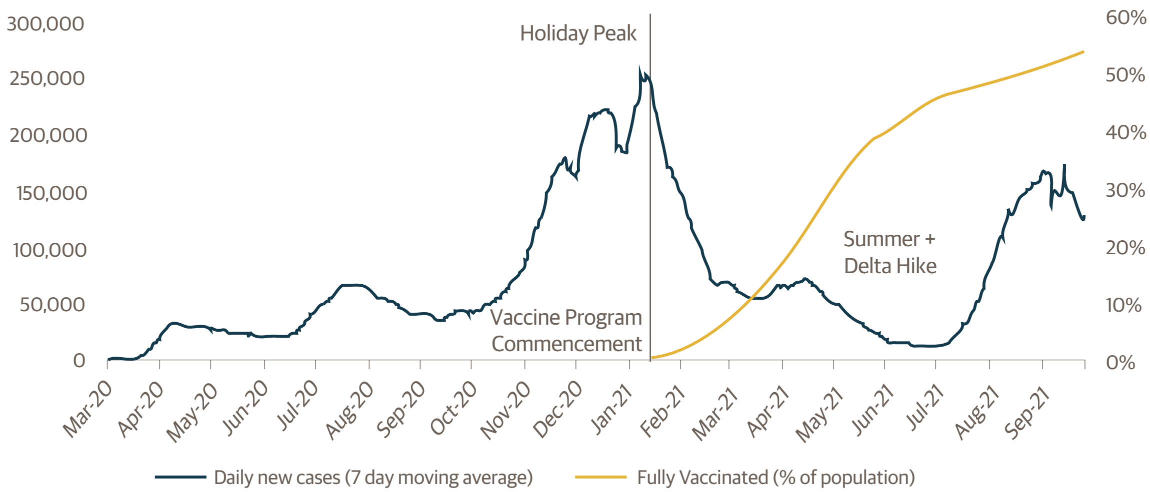
- Well-planned and gradual economic reopening in the US during the first half of 2021 has brought optimism among investors and market participants. The continued on-going vaccination drive and safety regulations are likely to keep cases at manageable levels as the economy stabilizes against a backdrop of continued spread and emerging variants.
- Commercial real estate sector performance has been marked by compressing cap rates in industrial and rental housing subsectors, increasing asset prices, and lower transaction volumes in the retail, hospitality, and office subsectors.
- Interestingly, distressed asset sales have remained at pre-Covid levels; significantly below what was witnessed during the last (2008-2010) recession.
- Investing in industrial and multifamily sectors has gained popularity since the early days of the pandemic, as the sectors continued to perform well with strong demand drivers. Conversely, investing in retail, office, and hospitality – sectors that were adversely impacted by trends resulting from or accelerated by Covid-19 – requires further assessment into the effects and longer term consequences of the shifts in demand within each subsector.

US Economic Outlook

Post-Pandemic optimism, recovery underway

The rollercoaster of uncertainty over the pandemic started to stabilize at the end of 2020, with the announcement of multiple, highly effective vaccines. The US has had a strong economic turnaround from 2020 with the first half of this year surpassing expectations on multiple fronts. Last year's stimulus packages succeeded in keeping the economy afloat through the most restrictive parts of the pandemic, and the 2021 stimulus plan promoted growth as the economy continues to reopen on the back of a strong vaccination rollout program. Around 65% of the eligible (12 and older) population is currently fully vaccinated and 75% of the eligible population has taken at least one shot[1]. Following the post-holiday season peak, daily cases had declined showing a sharp drop in the second quarter with the rise in vaccinations.

Daily New Cases vs. Vaccination



Source: Our World in Data

Q2 benefited from the gradual and consistent reopening of the economy. The CDC relaxed regulations around mask wearing and social distancing for vaccinated individuals, which signaled confidence in the vaccine efficacy. However, the loosening of restrictions coupled with the spread of the Delta variant, currently the most prevalent strain in the US, caused daily cases to rise. The summer hike is continuing in states like Alaska, Wisconsin and Maine. The surge has started to turnaround, though it is not clear when it will stabilize given the ease of spread through internal travel from highly affected states.

GDP growth has been positive since the start of the year, with the economy surpassing pre-Covid real GDP levels in Q2. Updated Federal Reserve projections on economic growth are encouraging and put the economy on a steeper trajectory than pre-pandemic. Stimulus cheques had been a strong driver of consumer demand in the second quarter and consumer confidence saw a marked improvement during the same period. Price levels began to increase in Q2 as pent-up demand that was fueled by the easing of the lockdown, stimulus dollars, and increasing employment levels, exceeded available supply, which was affected by increasing supply chain challenges. Energy and commodity prices also played a part in rising inflation figures. However, we have already seen prices drop for several commodities and building supplies: lumber price gains for the year have been wiped out as supply increased and demand eased.

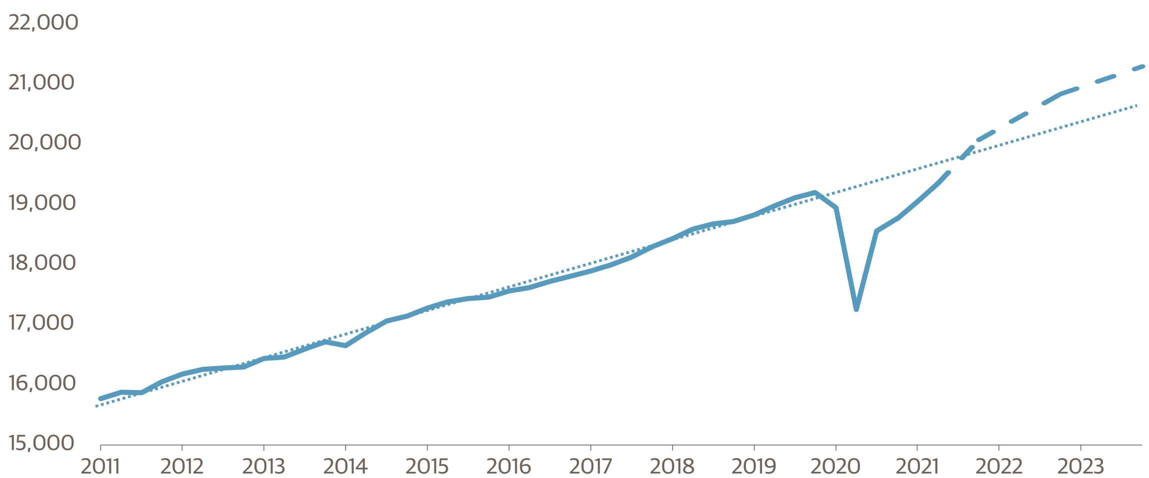
The Federal Reserve, with its view that inflation is transitory, is likely to continue with asset purchases over the near-term and maintain low interest rates over the medium-term, despite CPI surpassing 5% in the last few months. Though Fed policymakers seem to expect interest rates to increase by the end of 2023, Federal Reserve Chairman Jerome Powell reiterated that rates hikes are unlikely to take place before the economy returns to full employment, which may take significantly longer than the GDP recovery, given employment still trails the pre-pandemic peak by 5.7 million jobs[2]. However, after the recent improvement in employment rates, the Federal Reserve has indicated that it may soon start to taper off the quantitative easing, which would serve to counter inflationary pressures.

[1] CDC COVID Data Tracker as of September 24, 2021

[2] Reuters. *"US labor market powers ahead with strong job gains, lower unemployment rate."* August 6, 2021

The Federal Reserve Board projects unemployment to drop to 4.5% by year end. Job recovery in Q2 trailed expectations, however, employment continued to improve throughout the quarter. Q3 began with 943,000 jobs created in July, dropping the unemployment rate down to 5.4%[3]. The largest employment gain was in the leisure and hospitality sector, accounting for 40% of job creation for the month. August witnessed a lower job take-up because of added pandemic concerns, yet jobless claims continued to fall to their lowest post-pandemic levels. Job take-up, however, will need to continue improving in H2 to meet pre-Covid levels by the end of the year.

US Real GDP Historic & Projected (USD bn)



Source: Federal Reserve Bank of St. Louis, Federal Reserve Board Projections

Note: Real Gross Domestic Product, Billions of Chained 2012 Dollars, Quarterly, Seasonally Adjusted Annual Rate. Forecast using The Federal Reserve Board Projections for US Real GDP annual growth: 2021 (7.0%), 2022 (3.3%), and 2023 (2.4%)

The first half of 2021 paved the path to recovery, but the ride is likely to remain bumpy. Economic reopening continues to be at the mercy of health regulations, emerging variants, daily cases, and vaccine rollout. Not all industries are expected to experience an equal recovery. We are likely to continue to see a supply/demand mismatch across industries as the economy stabilizes. Even though it is premature to declare victory from health and safety perspective, the outlook for the remainder of the year remains positive.

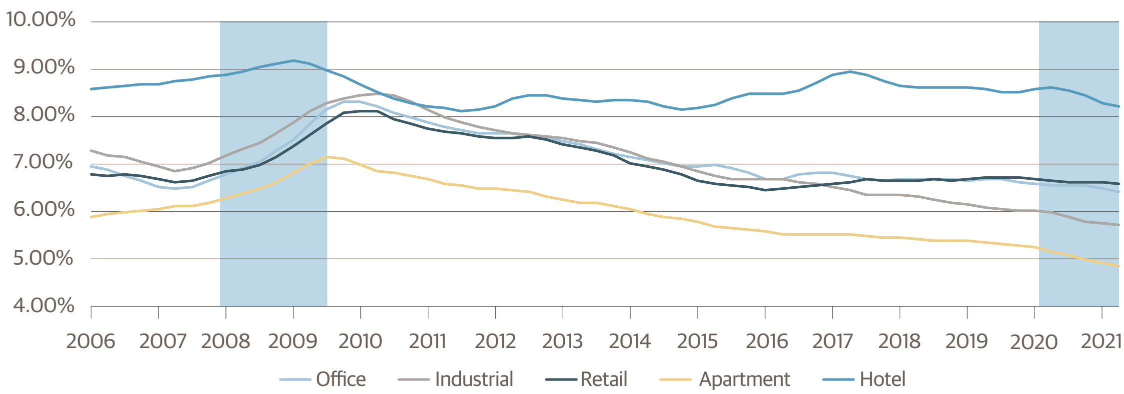
US Real Estate Market

Positive outlook with some sectors outshining

Commercial real estate cap rates have been mostly holding steady through the pandemic. Assets perceived to have less risk, such as industrial and multifamily, have witnessed a slight compression in cap rate. Cap rate spreads over treasury rates have expanded to much higher than historic levels and are at above 400 bps for all subsectors apart from multifamily. High spreads are not so much a reflection of risk premiums as they are a result of a marked drop in Treasury rates. Sustained high spreads may result in a period of cap rate compression. As monetary policy continues to support low interest rates in the short term, any rate increases in 2023 or soon after are not likely to lead to a "high-interest rates" environment for some time. With low yields on government bonds, commercial real estate is favorably positioned to be a source of higher-yield income and diversification for investment portfolios.

[3] Reuters. "*US labor market powers ahead with strong job gains, lower unemployment rate.*" August 6, 2021

Real Estate Cap Rates

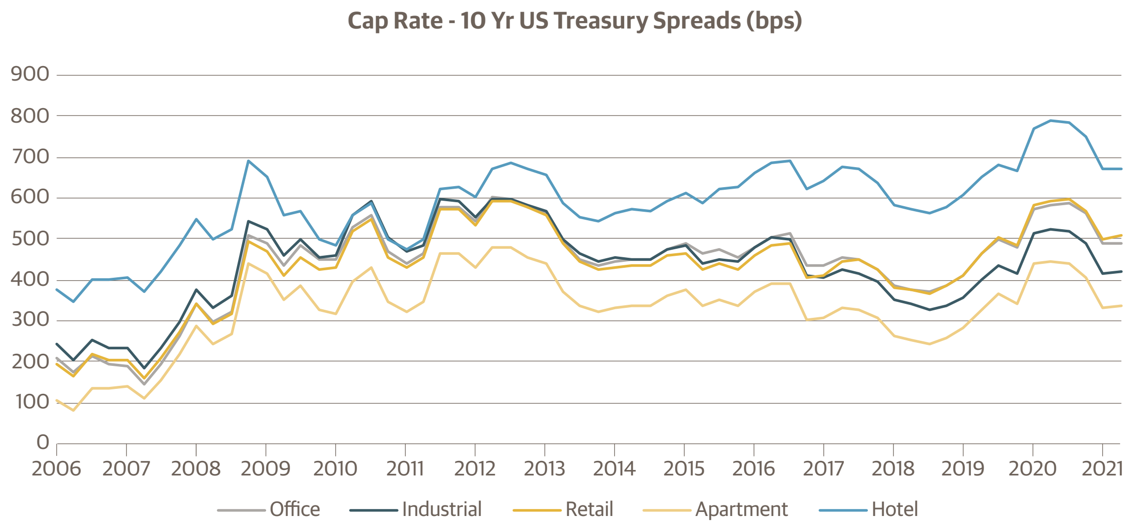


Source: RCA

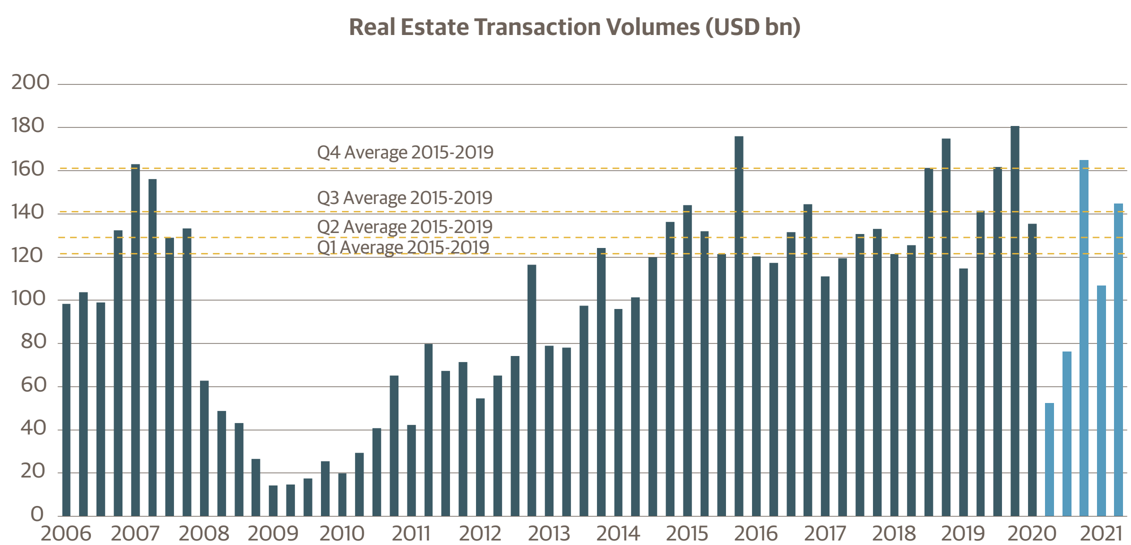
Prices of assets have been quite resilient through the pandemic and have increased in line with their pre-Covid trajectory. As has been the theme of the pandemic when it comes to commercial real estate, however, a disparity amongst subsectors and locations was evident. Prices increased by 11.4% y-o-y in July 2021[4]. Industrial and multifamily were the highest gainers. Non-major metros also experienced more pronounced price increases y-o-y than major metros [5]. There has been a gap between bid and ask prices on assets, with much fewer transactions taking place in the first four quarters of the pandemic, which has so far kept prices elevated even in the harder hit subsectors. In Q2 2021, retail and hotel prices increased by 3.2% and 1.4% y-o-y, much lower than the sector price increase and lower than inflation.

Transaction volumes had a significant drop of 28% year-on-year in 2020 with the onset of the pandemic. Volumes have been recovering this year, with transactions in Q2 2021 exceeding pre-pandemic levels for the same period. In terms of total volume, industrial and multifamily were in the lead in the first half of 2021, amassing USD 51.9 bn and USD 92.1 bn in value, respectively. Predictably, hospitality and retail have seen the lowest transaction volumes over the same period, with USD 20.4 bn and USD 22.8 bn in value, respectively. Transaction volumes have picked up markedly in 2021 and will likely improve towards normal levels within the second half of the year as buyers and sellers get more economic clarity and bid/ask spreads shrink.

[4] RCA."*RCA CPPI™ US: Commercial Property Price Indices.*" July 2021
[5] RCA."*US Big Picture.*" Q2 2021



Source: RCA



Source: RCA

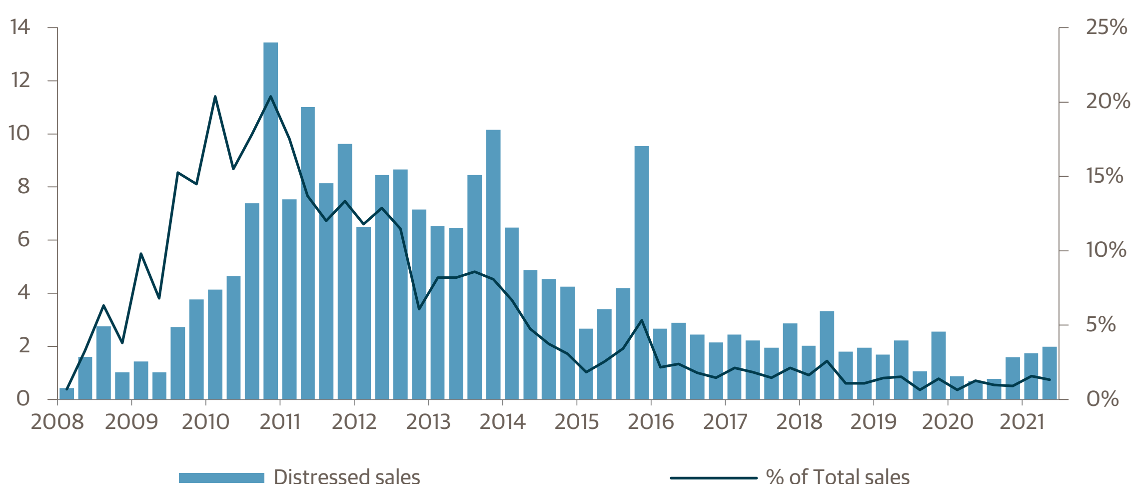
Note: Difference to 2015-1019 quarterly average Q2 2020 -59% / Q3 2020 -46% / Q4 2020 +2% / Q1 2021 -13% / Q2 2021 +14%

Private investors led most of the transactions that took place during the start of the pandemic at higher than historic levels, making up 56% and 57% of acquisitions in Q2 2020 and Q3 2020 respectively[6]. Cross-border investors maintained a steady portion of acquisitions, averaging 8% quarterly in 2020, and 9% in 2021[7]. In the 12 months preceding Q2 2021, the GCC countries accounted for more than 12% of cross-border acquisition volumes[8]. Cross-border acquisitions were mainly focused on the industrial sector, where 30% of investments were allocated in the 4 quarters trailing Q2 2021, a shift from pre-Covid focus on the office sector[9].

[6] RCA
[7] RCA
[8] RCA."*US Cross-Border Investment Compendium.*" August 2021
[9] RCA."*US Cross-Border Investment Compendium.*" August 2021

Though many investors have been preparing for distressed asset sales, the market has not offered many. More than USD 120 bn in dry powder is available to invest in opportunistic or distressed real estate[10]. The largest number of distressed asset sales were within the hotel industry, which was one of the most severely hit subsectors, especially at the start of the pandemic when travel came to an effective halt. The sectors that contributed the least to distressed sales were unsurprisingly industrial and multifamily. Regardless, the share of distressed asset sales within the commercial real estate sector was less than 1% of all transactions over the first 12 months of the pandemic, not different in proportion to distressed sales pre-pandemic[11]. Distressed sales as a percentage of all sales remained around the 1% mark by the close of Q2 2021[12]. During the Great Financial Crisis (GFC), distressed sales were at 1% of total transactions in Q1 2008 but continued to increase to reach 20% by Q4 2010.

Distressed Asset Sales and Share of Tota (USD bn)



Source: RCA

[10] JLL. *"Real estate investors prepare for distress, but opportunities lag."* June 16, 2021
[11] RCA.*"US Distress Sales Little Seen Except for Hotels."* April 5, 2021
[12] RCA.*"US Big Picture."* Q2 2021

Many factors are supporting potentially distressed assets. Liquidity in the market is strong and likely to continue given the monetary policy outlook. Lenders have been accommodating and have shown a willingness to partner with owners to avoid foreclosures. This is different to what was experienced during the GFC, where liquidity was restricted. Compared to the GFC, where distressed assets were facing capital structure issues, distressed assets during Covid are struggling with operations. So far, it does not appear that the pandemic has caused an increase in the number of distressed sales, but rather more discounted sales, mainly in retail and hospitality. As asset performance is dependent on recovery from the pandemic, pressure may intensify on some assets in certain sectors, increasing the number of distressed assets in the hardest hit sectors. We expect a potential increase in distressed sales within the retail and hospitality sector. Successful outcomes for investors will depend on how accommodative lenders are, and more importantly, how much and how rapidly demand recovers.

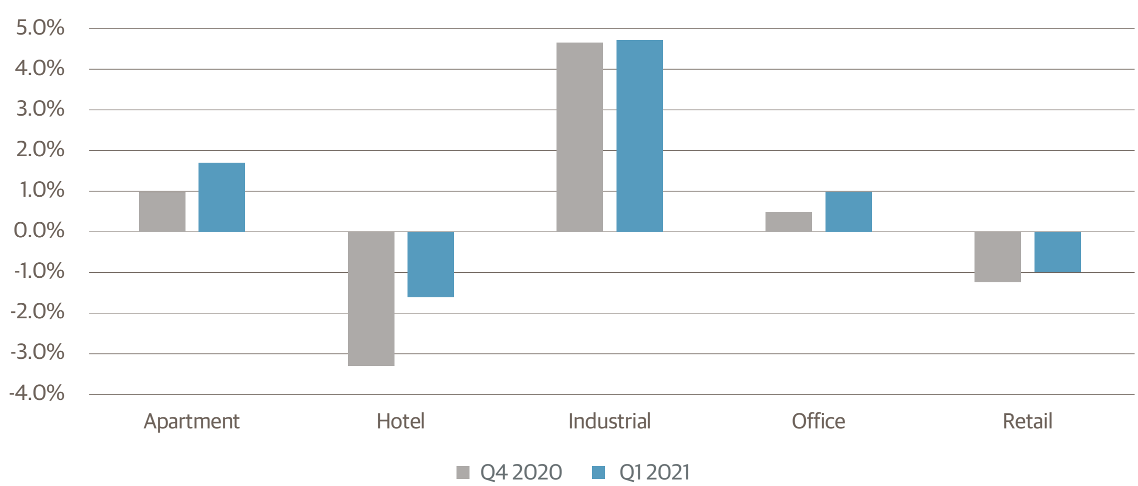
Shifting market dynamics favoring multifamily and industrial

The past year has tested market fundamentals for many real estate subsectors, characterized by demand shifts. The secular trends that are reshaping the real estate market have been a topic of discussion; many of these trends originated before the pandemic and were accelerated by its onset, while others were a result of the pandemic. The most significant trends have been:

- Retail transformation and shift in consumption from retail to e-commerce
- Building inventory and supply chain resilience
- Demographics
- Geographic migration
- Remote/flexible working

Remote work has been a prominent theme during the pandemic; however, we are beginning to get clarity on how likely it is to evolve further. As the number of vaccinated individuals increased, many employees have returned to their offices. Though remote work has come a long way in terms of convenience, it cannot make up for certain benefits that come with working in the office. Jamie Dimon, Chairman & CEO of JP Morgan Chase & Co., was quoted at a conference saying that remote working "doesn't work for those who want to hustle. It doesn't work for spontaneous idea generation. It doesn't work for culture." That said, many employers are likely to continue to be flexible in allowing some hours of remote work. Flexible or hybrid work is likely to continue, which would support office hoteling (having unassigned desks at the workplace), a trend that had started pre-Covid. As such, we see flexible working as more of a continuing trend as opposed to remote working.

NPI Quarterly Total Returns by Property Type



Source: NCREIF

Note: Annualized rates

In terms of performance and investment offering, the industrial and rental housing sectors offer value-driven investments with proven long-term fundamentals. Rental housing is expected to continue its positive momentum as long-term renting continues to become increasingly prevalent, substantiated by increasing cost of single family housing. Pre-pandemic trends underpinning student housing, such as stable, growing college enrollment, have demonstrated their resiliency, despite concerns of virtual learning. Meanwhile, industrial is supported by growing e-commerce and fulfillment demand, as well as last mile and cold storage as e-commerce becomes a viable option to displace retail grocers. While these sectors carry less risk, investors should expect lower associated returns. Conversely, retail, hospitality and office sectors offer investments that are more opportunistic, as they face demand shifts and supply either exceeds demand or is potentially obsolete. This is not to say that these sectors do not host solid assets with strong demand fundamentals and returns, however, when assessing opportunities within these sectors, more diligence is needed to assess potential increased risk.

We summarize the performance of the subsectors, and assets we believe deserve focus below.

Value-driven Subsectors

Subsector	Vacancy[13]	Cap Rates[14]	Tailwind Trends	Headwind Trends	Asset Focus
Industrial	5.1%[15] → 2020 ↑ 2019	5.7% →	• Inventory & supply chain redundancy • E-commerce	• Construction cost	• Infill multi-tenant • Select single-tenant
Rental Housing	5.3%[16] ↑ 2020 ↑ 2019	4.9%[17] ↓	• Demographics	• Construction cost	• Single-family • Infill affordable medium income • Student housing

Opportunistic Subsectors

Subsector	Vacancy[18]	Cap Rates[19]	Tailwind Trends	Headwind Trends	Asset Focus
Hospitality	38.2%[20] ↓ 2020 ↑ 2019	8.2% ↓	• Pent-up demand for leisure travel	• Oversupply • Travel Restrictions	• Full-service gateway cities
Retail	10.5% ↑ 2020 ↑ 2019	6.6% ↓	• Geographic Shifts	• Retail Transformation	• Need-based retail • Experience-based retail
Office	18.5% ↑ 2020 ↑ 2019	6.4% ↓	• Geographic Shift	• Flexible Work	• Tier-2 Grade A

[13] REIS Inc, growth y-o-y, Q2 2021
[14] RCA Hedonic Cap Rates, growth y-o-y, Q2 2021
[15] Co-Star."*Unites States Industrial National Report.*" July 2021
[16] Apartment
[17] Apartment
[18] REIS Inc, growth y-o-y, Q2 2021
[19] RCA Hedonic Cap Rates, growth y-o-y, Q2 2020
[20] Co-Star, August 2021

Determining value-driven and opportunistic investments

Industrial and multifamily have had the highest transaction volumes since the start of the pandemic. Strong fundamentals and demand drivers helped them gain further popularity. Assessing investments within these sectors during the pre- and post-pandemic periods has been largely the same. Positive trends for industrial and multifamily will likely bolster returns across assets in those subsectors over the medium term. Assets that are well-positioned (e.g., location, specifications, and amenities) will outperform, assuming a right-sized basis. Investing in the opportunistic subsectors, however, requires enhanced due diligence, study, judgement, and risk tolerance. Risk associated with investing in these subsectors has increased since the start of the pandemic, given the demand shifts. Extra focus is needed when considering tenant mix, tenant credit-worthiness, and rent renewal and escalations as rent or tenant loss may become long-lasting. These factors are to be considered in addition to typical, asset-specific considerations.

Office

- Covid has accelerated office space conversions from the rigid cubicle format to an enhanced work experience that entails having an open, versatile, flexible work-space.
- Landlords have lost the leverage they had in the market and tenants will define how the sector evolves over time.

Preferred locations for office buildings have shifted after the pandemic. There has been a geographic shift in terms of office leasing, as many tenants moved their offices to second-tier cities to seek rent reductions. Office leasing in non-major cities has been performing better than central banking districts. In each location, the criteria for a winning building would differ depending on the type of tenant and their need for space and other building specifications.

Office buildings have evolved over the years, with the most recently-built buildings (built within the last 10 years) benefiting from versatility in terms of layout. These modern buildings have flexible floorplates, allowing tenants more flexibility in choosing the size and layout of their office space. They also work well for shared office space and are usually built close to amenities. We see good opportunity potential amongst modern buildings as they suit the direction that office lease demand is taking. Older buildings, built more than 20 years ago, tend to be column intensive and have bad air circulation and outdated systems. These buildings will have difficulties renewing their leases as lower rents make it feasible for tenants, who now require less office space, to lease in more modern buildings. There is also a high risk of functional obsolescence in these buildings.

The office market is currently a tenant driven market. Their preferences decide which buildings will remain relevant. Buildings that are aligned with tenant preferences will attract more demand and their landlords will regain negotiating power. It is important to understand tenant preferences and whether the building is suitable to get a sense of whether it will succeed as an office building in the future.

Retail

- The retail space was undergoing a structural shift before the pandemic as many retailers, like department stores, struggled with sales. This shift was accelerated by the pandemic as many retailers closed their shutters, leading vacancies within the retail sectors to increase rapidly.
- The pandemic accelerated the move to e-commerce compounding the loss experienced by retail vendors.

Retail malls had been struggling from before the pandemic with location being relevant to success. This continues to be the case post-Covid. However, what we believe to be winning locations for retail are those close to urban and suburban living spaces. These will serve as focal meeting points for the living communities and will continue to attract footfall. Shoppers have also grown accustomed to online shopping and are less inclined to drive to far out locations for their purchases.

In our opinion, gone are the days of super-regional malls and department stores. Going forward, smaller scale retail will be more successful. These offerings are easier to manage in terms of leasing and are more focused and cater to the localities they serve.

In terms of structure, what is likely to be successful is a retail offering that provides a bespoke experience: curated shopping and experience/lifestyle centers for community gathering. As weekly shopping has predominantly shifted online, there is no longer a periodic attraction to retail centers. The draw to retail is more likely to be experience-based in the future. Outside of these assets, we expect there to be assets that become functionally obsolete, and for investors with redevelopment capabilities to find opportunity in them.

As with office, tenants will play a major role in the success of an asset. Since there is abundant supply to choose from, tenants will be attracted to well-located units that are more likely to be successful in attracting customers. Many new retail outlets are coming into the market and there is likely to be a segmentation between strong retailers and weaker ones, and competition for higher quality units.

Hospitality

- The hospitality market was becoming too diverse in terms of offerings and its fundamentals were signaling oversupply pre-pandemic. A halt in travel for business and recreation caused by the pandemic crippled the industry.
- Leisure demand is leading the recovery in the US, which is benefitting from a cyclical bounce of a successful inoculation program and seasonal vacations.
- This segment requires business travel to fully recover to pre-pandemic levels. However, in our opinion, it is likely to return at a lower-pace to a reduced level as face-to-face client management is unlikely to return to its former levels.
- Despite the anticipated accelerated recovery for leisure-focused hospitality, it remains difficult to identify Shari'ah compliant investment opportunities in this sub-sector due to the prevalence and importance of alcohol sales for revenues.

Hotel location not only affects revenue, but it also factors into the operating costs. In the northern states, unionized labor requires labor to be employed full-time. This creates a high fixed operating cost burden. To consider northern states, one should look at gateway and major cities, such as New York and Chicago, where that exposure to cost is justifiable. For other, lesser visited states, cities such as Pittsburg, it is a high risk to take on at this point when the market direction is still unclear.

It is important to consider how well the hotel specifications meet the requirements of the demand specific to the location. In locations where you are likely to have business customers, it is necessary for the hotel to be well-suited for those demand requirements. In non-major cities, for example, where business travel is likely to take a significant hit going forward, business hotels will have to compete for customers. The ones that best meet the requirements of business travelers are likely to come out on top.

Concluding Remarks

While we are confident that office and hospitality subsectors will recover from the pandemic-lows, we expect the recovery will be uneven across assets. For office, we anticipate premiere assets recovering more quickly, while for hotels, we expect premiere assets in vacation locations to return to normal levels of occupancy as we expect vacation travel to resume in earnest before business travel.

Conversely, we continue to see value in industrial and multifamily property types, both of which will continue to benefit from pandemic-induced trends and long-term fundamentals. Within industrial, we remain focused on well-located buildings with relevant specifications across both single and multi-tenant property types. For multifamily, we are focused on well-located, highly-amenitized assets in geographies with positive demographic trends, including job and population growth.

ARCAPITA

Arcapita Overview

With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia.

Arcapita is a global alternative investment manager offering diverse investment opportunities, focusing on private equity and real estate. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region over the past two decades. With offices in Bahrain, Atlanta, London and Singapore, Arcapita's management team has completed over 90 transactions with a total value of approximately $31 billion and possesses a footprint to invest on a global scale. Arcapita focuses on defensive and counter-cyclical sectors supported by long-term macroeconomic and demographic trends.

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