EVERWEST REAL ESTATE MARKET UPDATE

First Half 2019

EverWest
REAL ESTATE INVESTORS

ECONOMIC OVERVIEW

After posting a strong performance in 2018, the United States (US) economy slowed during the first half of 2019.

In July 2019, the US marked a tenth year of economic expansion, its longest of the post-World War II era. However, global economic conditions have become increasingly unsettled, geopolitical developments uncertain, and capital markets highly volatile. "Safe haven" flows into US Treasuries have reduced the benchmark 10-year bond yield as low as 1.6% this summer. Economists disagree as to whether this short-lived inverted yield curve across bond maturities is signaling a near-future recession this time, however the phenomenon has historically typically foreshadowed a downturn.

Real GDP growth continues to be positive but is tapering, from a 3.1% (annualized) rate in Q1 2019 to an estimated 2.0% in Q2. Some key GDP driver trends:

- Business investment and profitability are trending down as the impact of 2018's front-loaded federal tax cuts fades
- Institute for Supply Management (ISM) purchasing managers' indices for both manufacturing and services remained in expansion territory through Q2 (i.e., above 50), but progressively weakened during the first half of the year.
- US exports are down as trade flows are increasingly impacted by the strong dollar, weakness among key trading partners, tariffs and intermittent China-US trade talks.
- Despite the return of sub-4% mortgage rates – in time for the peak spring/summer season – home sales have been moderate and monthly housing starts continue to lag year-ago levels.
- Consumer spending – which comprises 2/3 of the US economy – is a bright spot. Retail sales have posted several consecutive months of robust growth; as of July, retail sales excluding vehicles had risen 5.8% from year-end 2018.

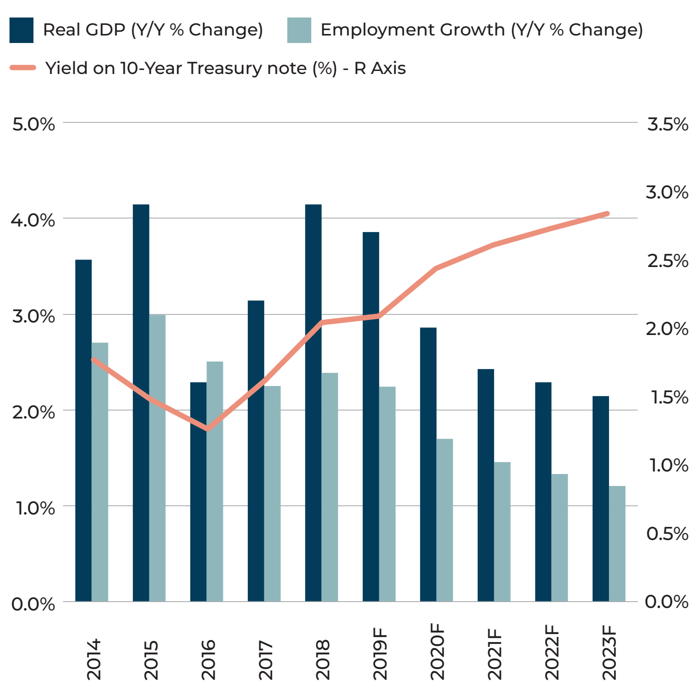
Monthly job gains have been uneven but the overall trend continues to be healthy. The economy added a total of 1.16 million new jobs through July 2019 – an average of 165,000 per month. The unemployment rate has been below 4.0% since mid-2018, and is currently a low 3.7%. Wage gains have begun to move up in response to competitive labor market conditions; as of July, they were 4.1% above their year-ago level (weighted for changes in labor force composition). Inflation has begun to pick up after several months of softness, due both to the tight job market and to the pass-through to prices of US import tariffs.

In July, the US Federal Reserve responded to the deterioration of the global economy with a 25-basis point cut in the fed funds rate (to 2.0% - 2.25%). It is prepared to do more, pending the tenor of incoming economic reports. The European Central Bank and other central banks have also adopted a more supportive monetary stance to counter weakening growth in their own economies.

Although risks are elevated, the outlook is for the US Fed to succeed in its efforts to support the economy. The Green Street Advisors July forecast calls for annual GDP gains of 1.8 - 2.0% through 2023 with accompanied slowed employment expansion averaging approximately 141,000 new jobs per month over the five-year forecast horizon. While the likelihood of a US recession within the next 1 – 2 years has risen, the latest consensus forecast of economists assigns only 33% odds to such an outcome. Any downturn that might occur the economists expect to be both shallow and short-lived.

Real GDP, Employment Growth and 10-Year Treasury Rate

Source: Deloitte, Green Street Advisors



REAL ESTATE INVESTMENT TRENDS AND RETURNS

Continued solid demand from investors; flattening outlook for cap rates

A broad-based slowing of economic growth and heightened geopolitical uncertainty (including Brexit and US-China trade talks) have led to intermittent financial market volatility since the fall of 2018. In this environment, the long-term leases and reliable income returns offered by commercial real estate are attractive to investors. The major asset sectors continue to enjoy healthy fundamentals. As a result, both debt and equity capital for real estate assets remains ample and pricing competitive. This report focuses on the equity side of the market.

Equity investment in US real estate during Q2 of 2019 totaled $127 billion, a 15.5% increase from the prior quarter and a 2.3% gain compared with the year-ago (Q2 2018) transaction volume. Second-quarter volume increased for apartment and office properties but fell for retail and industrial assets. Average all-sector property prices as measured by the Real Capital Analytics Commercial Property Price Index (CPPI) increased 2.4% between Q1 and Q2, and are 6.5% above their Q2 2018 level. The average cap rate paid for apartment and industrial properties declined slightly during Q2, while office and retail cap rates rose 10+ basis points (bps) from 1Q2019. The 10-year Treasury yield has fallen sharply year-to-date, which further the relative attractiveness of real estate income yields and maintain investor demand in this low cap rate environment, reducing the likelihood of widespread cap rate increases.

The top ten metro markets for first half 2019 transaction activity include the nation's primary tech centers (San Francisco, Seattle, and Boston); major gateway cities (New York City, Chicago, and Los Angeles); and large, high-growth Southern metros (Dallas, Atlanta, and Houston). Together, these ten markets captured 36% of US commercial real estate sales during that period. San Francisco and Boston were more than 40% above their respective first half 2018 totals. Although it retained a high position in the rankings, Chicago's first half transaction activity dropped 42% from its year-ago level.

Private equity real estate returns have been decelerating for several years owing to the slowing of capital appreciation. The NCREIF Property Index (NPI) all-sector total return for Q2 2019 was 1.5%, down from 1.8% in Q1. The Q2 return combines a 0.38% appreciation and a 1.12% income component. The four-quarter NPI return was 6.5% for Q2. NCREIF's ODCE index (based on 24 core open-end funds) posted a modest 1.0% total return in Q2, gross of fees, and a four-quarter return of 6.4%. While the income component of ODCE's Q2 return was 1.01%, its appreciation component was -0.01% – the first time since 1Q2010 that appreciation has been negative. The ODCE funds employ modest leverage – at 21.5% on average as of Q2 – while the NPI is unleveraged.

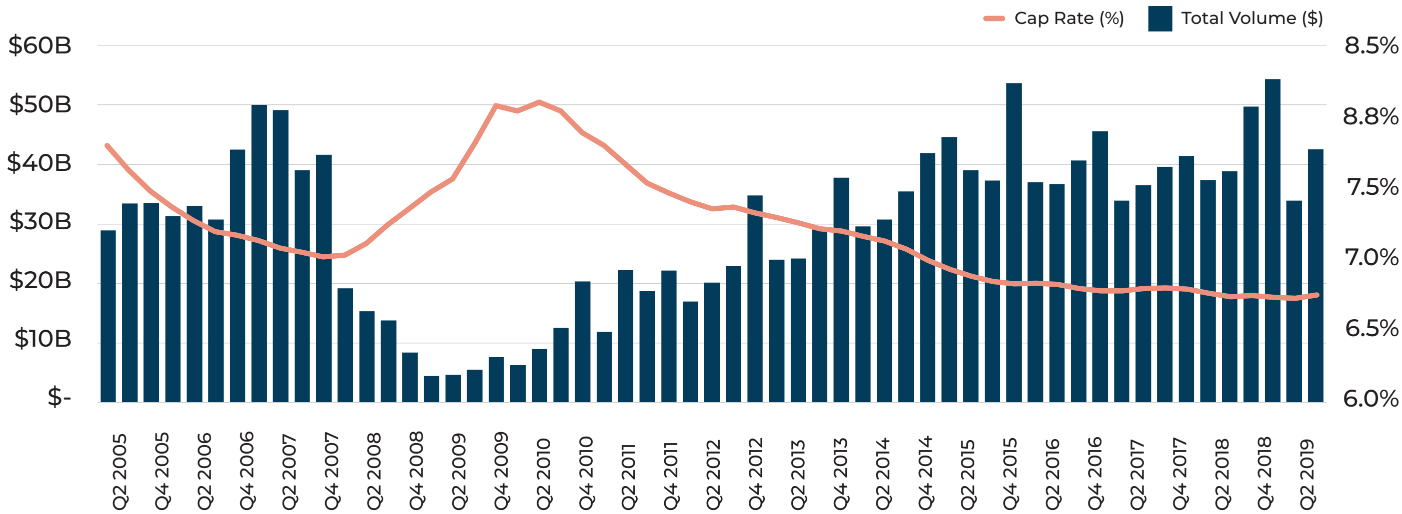
On the public equity side, NAREIT's All-Equity Index return for 2Q2019 was only 0.8%, down from a robust 16.1% in Q1. The return for publicly-traded equity REITs for the year through 2Q2019 was 12.7%.

	YTD	
Real Capital Analytics	**Vol ($b)**	**YOY**
Office	74.4	6%
Retail	32.4	-19%
Industrial	42.0	-9%
Hotel	16.0	-28%
Apartment	94.1	9%
Seniors Housing & Care	10.2	7%
Dev Site	10.7	-12%
Total	279.8	-2%
Major Metros	105.3	-6%
Secondary Mkts	129.9	2%
Tertiary Mkts	42.5	-9%
Portfolio	64.6	-13%
Single Asset	215.1	1%

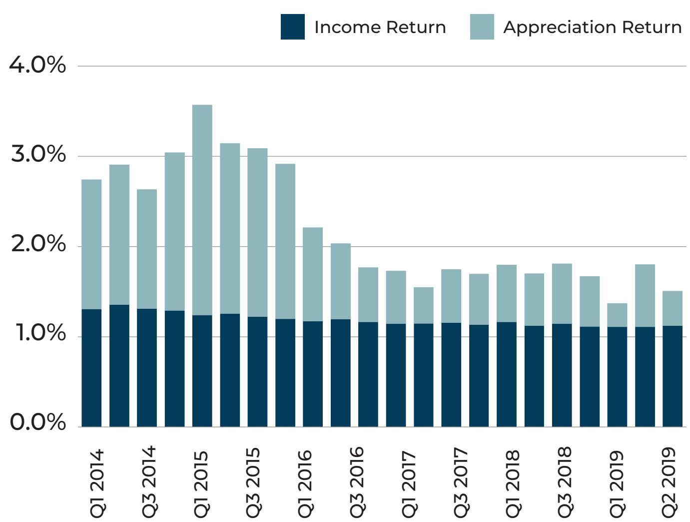
	YOY
CPPI - All Asset Average	6.3%
Average Cap Rate - All Assets	-1.4%

All-Sector Total Sales Volume and Cap Rate

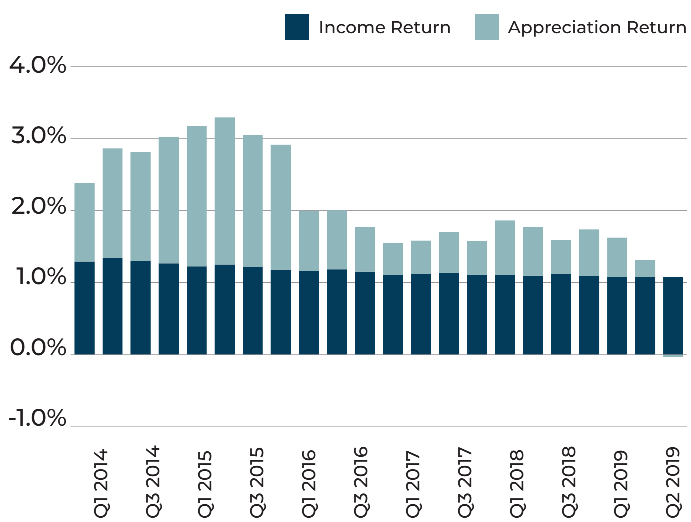
Source: Real Capital Analytics



Quarterly Returns (%) - NPI Index



Quarterly Returns (%) - ODCE Index



REAL ESTATE DEMAND-SUPPLY DYNAMICS

Varied responses to slowing economic growth across asset classes

US property markets clearly benefited from the late-cycle fiscal stimulus that fostered 2018's stronger economy. The economy has begun downshifting for reasons outlined above as tax cut impacts fade away. Each sector has responded differently to this slowing growth trend.

US Industrial

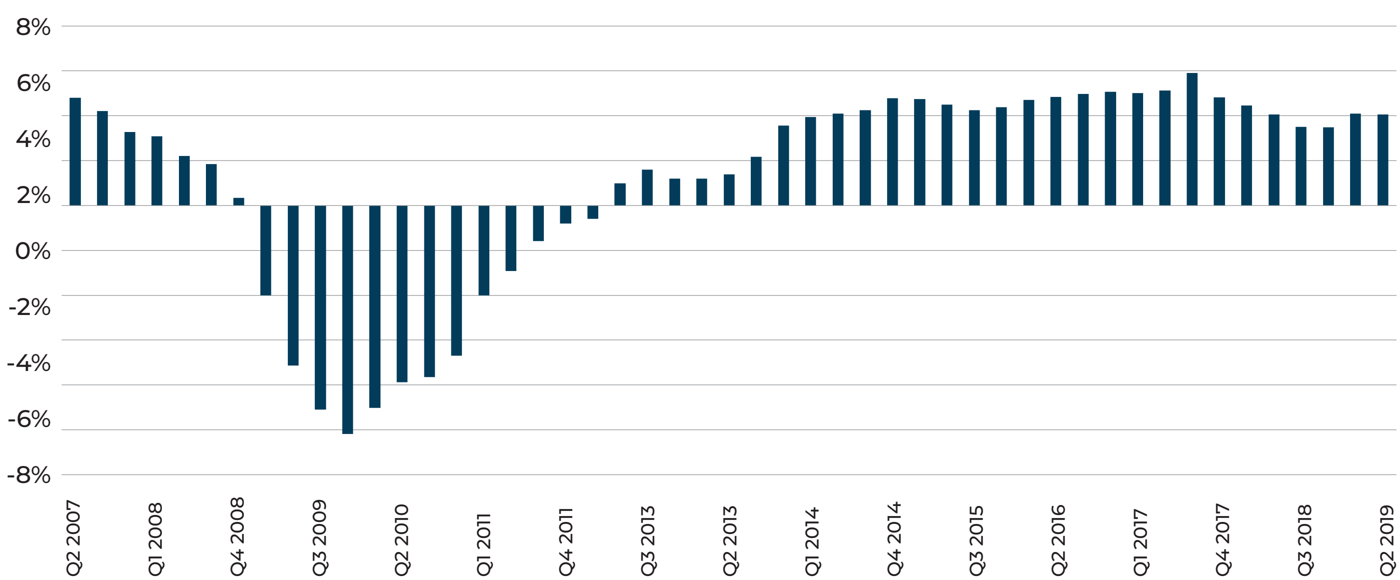
The industrial sector has experienced strong demand growth for the last four years. It is benefiting from a confluence of cyclical and structural factors: support from the prolonged US economic expansion is being augmented by demand from rapidly evolving eCommerce storage and delivery systems. Approximately one-third of post-GFC demand for industrial space has been attributed to e-commerce, which is expected to continue driving demand growth for several more years. Construction volumes are significant and rising, but until this year have been more than offset by robust demand.

In the first half of 2019, new completions exceeded net absorption. Availability barely moved, rising 10 bps to a still-low 7.1% (CBRE data). Rent growth has moderated over the past year but remains well above inflation at 4.1% annualized through June. The construction pipeline continues to offer new options for tenants in most metro markets, with an extra concentration in the dominant distribution hubs of Dallas-Fort Worth, Inland Empire, Chicago, Houston and Atlanta. Although construction is nearing the peak levels seen in earlier cycles, this was before the widespread penetration of eCommerce, which requires as much as three times the warehouse space as brick-and-mortar retail operations for the same volume of sales.

Coming off several years of under supply, construction volumes have been high and rising in recent quarters as developers chased fast-growing demand. Following over 20 quarters of demand growth exceeding new supply (save for Q3 2017), new industrial product deliveries will outpace net absorption in the near term as the market rebalances. Availability rates may rise modestly in some markets, and rental rate growth may ease. In the markets with major container ports or that serve as distribution hubs there could still be demand growth matching or exceeding supply growth bringing rental rate increases. Industrial development has a shorter time frame than other asset classes, which tends to prevent supply getting too far ahead of demand; we anticipate developers will stop adding supply in those markets that have balanced.

US Industrial Real Estate Rental Rate Growth Rates

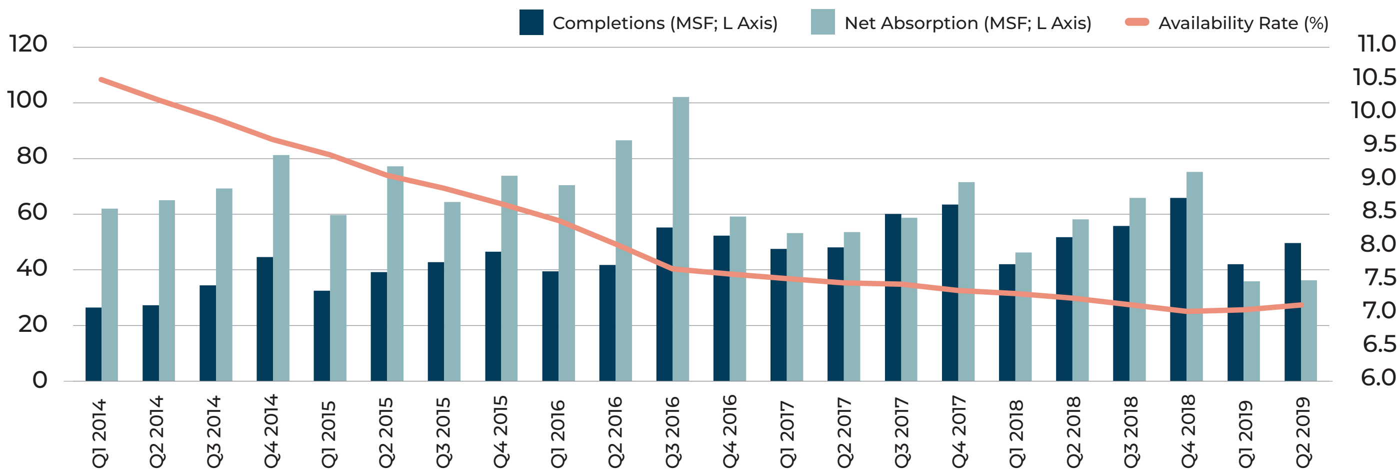
Data: CBRE



GFC = Great Financial Crisis, a commonly used reference to the severe 2008-09 recession

US Industrial Real Estate New Supply, Absorption, Availability Rate Trends

Data: CBRE



US RETAIL

Retail real estate has suffered in part for the same reason industrial has outperformed – structural shifts triggered by the growth of e-commerce. Traditional "brick and mortar" retailers are struggling to remain competitive in today's rapidly innovating and digitizing retail environment. Once past 2018's critical holiday sales season, an all-time peak in net store closures and retailer bankruptcy/reorganization activity were announced. According to CoreSight Research, by August 1 2019, there had been 7,567 closures and 3,055 openings for a net loss of 4,512 stores– almost twice the number reported for all of 2018. Although this shake-out will continue, an upturn in consumer spending may provide the industry with some breathing space over the short term.

The industry is migrating to a hybrid omni-channel operating model in which retailers are incorporating on-line sales channels with their physical store footprints, focusing less on new store openings and more on improving supply chain and fulfillment capabilities. Retail sales growth no longer translates directly into demand for physical retail space.

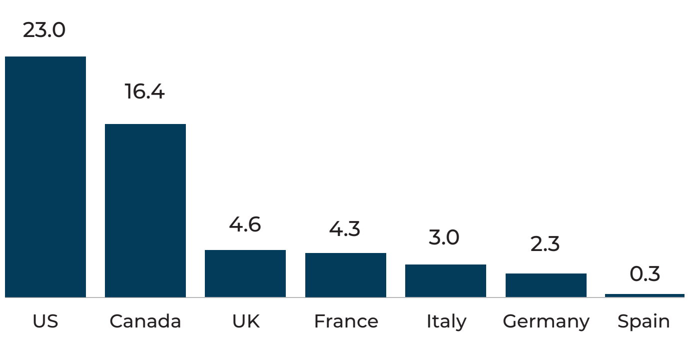
The retail real estate market is bifurcating: well-located, well-tenanted centers that have invested in an enhanced customer experience are performing well and increasingly dominant, while Class B/C shopping centers including power centers continue to lose tenants and become candidates for redevelopment. In the case of retail real estate investment strategy, analysis at a center-by-center level is essential given divergent trends across retail types and locations.

Construction of new retail space has been at historically low levels for a decade, allowing overall sector availability to gradually trend down.

The US retail market remains oversupplied. This gives retailers the balance of power in negotiating lease terms. There is simply too much retail inventory in the US, especially in the "commodity" general merchandise category (i.e., department stores). It will continue to be the most vulnerable of the four sectors - to a slowing economy, higher inflation, or spiking gas prices.

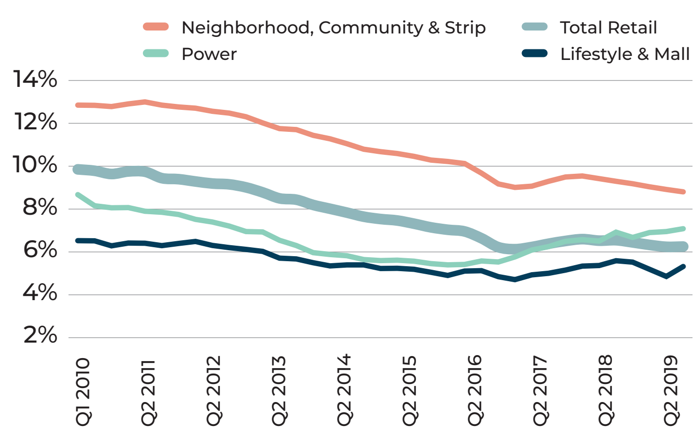
Shopping Centre SF Per Capita (2018): Select Geographies

Source: ICSC, Avison Young



Availability Rates by Retail Segment

Data: CBRE Econometric Advisors



US APARTMENT

While the industrial and retail sectors are a study in contrasts, recent apartment and office trends exhibit many parallels. Both sectors peaked in mid-decade in terms of demand growth, then spent several quarters in relative equilibrium.

This pattern changed in 2018 as renewed economic growth translated into stronger demand and improving fundamentals. This year's softening economic growth has yet to impede their underlying strengths.

Although the US apartment sector has seen significant construction activity for three consecutive years, it defied expectations by posting sufficiently robust demand to maintain balanced conditions. Vacancy moved upward in 2016-17 as new completions outpaced still-strong demand and while effective rents growth rates softened they remained maintained above inflation levels. The acceleration in economic growth in 2018 translated into stronger rental demand and in 2019 vacancy slid below 4% nationally, supporting a resurgence in rental rate increases.

The construction pipeline remains significant but year-to-date 2019 deliveries were slightly below their relative 2018 levels.

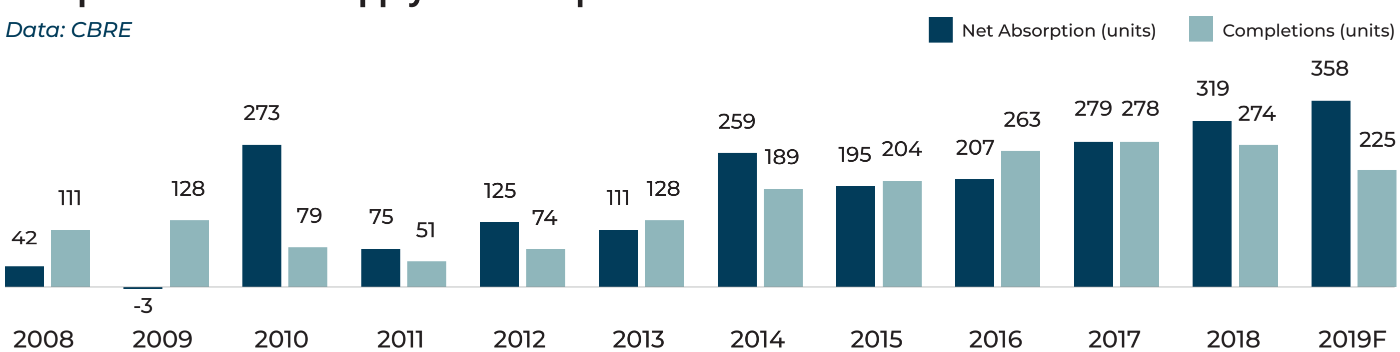
CBRE recorded 179,000 absorptions in the first half of 2019 (for an annual projection of 358,000 units), and 112,500 completions.

Demand ahead may slow in response to moderating job growth and demographic shifts, although greater economic uncertainty may keep some households renting for a longer time.

Immigration levels are declining and millennials continue to age out of their 20s – the two groups most likely to rent. As the sector's still-sizable pipeline of new product delivers, we expect achievable rent growth to cool in many markets. Multifamily starts have declined since mid-2018, which should reduce completions after 2020 and may help keep the market in balance. Additional support for the sector may come from the for-sale side of the market. A slower economy and heightened uncertainty generally cause some potential home buyers to defer purchases until conditions improve, helping maintain or raise demand for apartments. Home sales have shown little response to this year's steadily declining mortgage rates, a sign that economic uncertainty is weighing on some potential buyers.

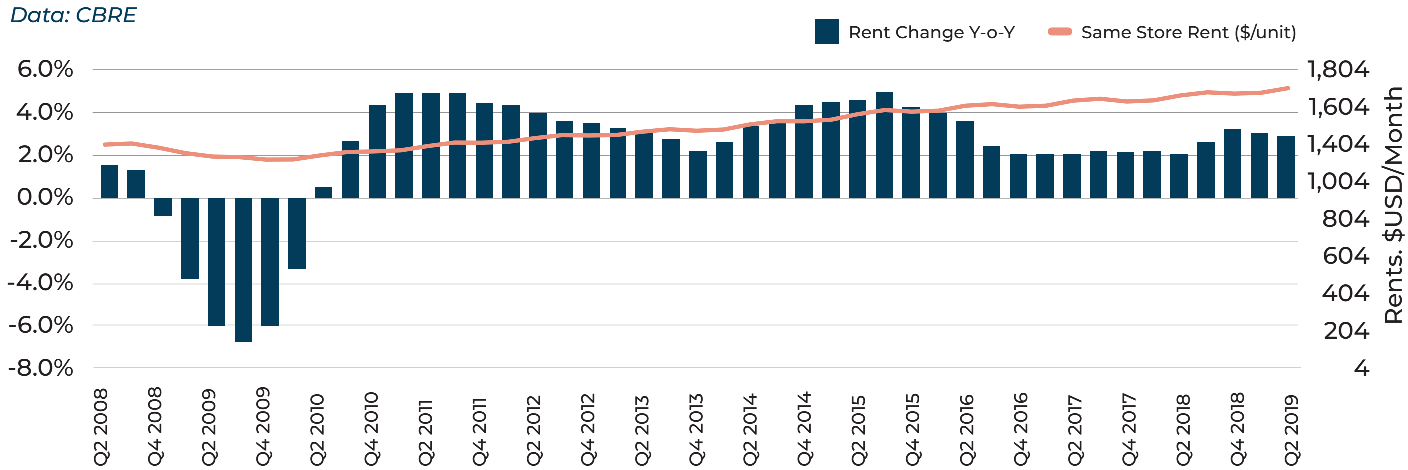
US Apartment New Supply and Completions

Data: CBRE



Average Apartment Rents; Rent Increase Rates

Data: CBRE



US OFFICE

The US office market gathered pace during 2018 after a flat 2017 performance. A lower level of completions combined with robust net absorption reduced office vacancy to 12.4% by year-end, a new low for this cycle. Rent growth strengthened in response to renewed demand pressures. The sector's performance was markedly stronger in the second half of the year.

This strength continued in the first two quarters of 2019. Absorption of 30.4 million square feet in the first half of 2019 exceeded the new supply of 26.1 Million square feet, pushing the vacancy rate to 12.2% – its lowest rate in over a decade. Asking rents meanwhile increased by 5% according to CBRE. Improvement has focused in the nation's suburban office markets, while its CBDs – where vacancy is lower but construction more significant – held steady.

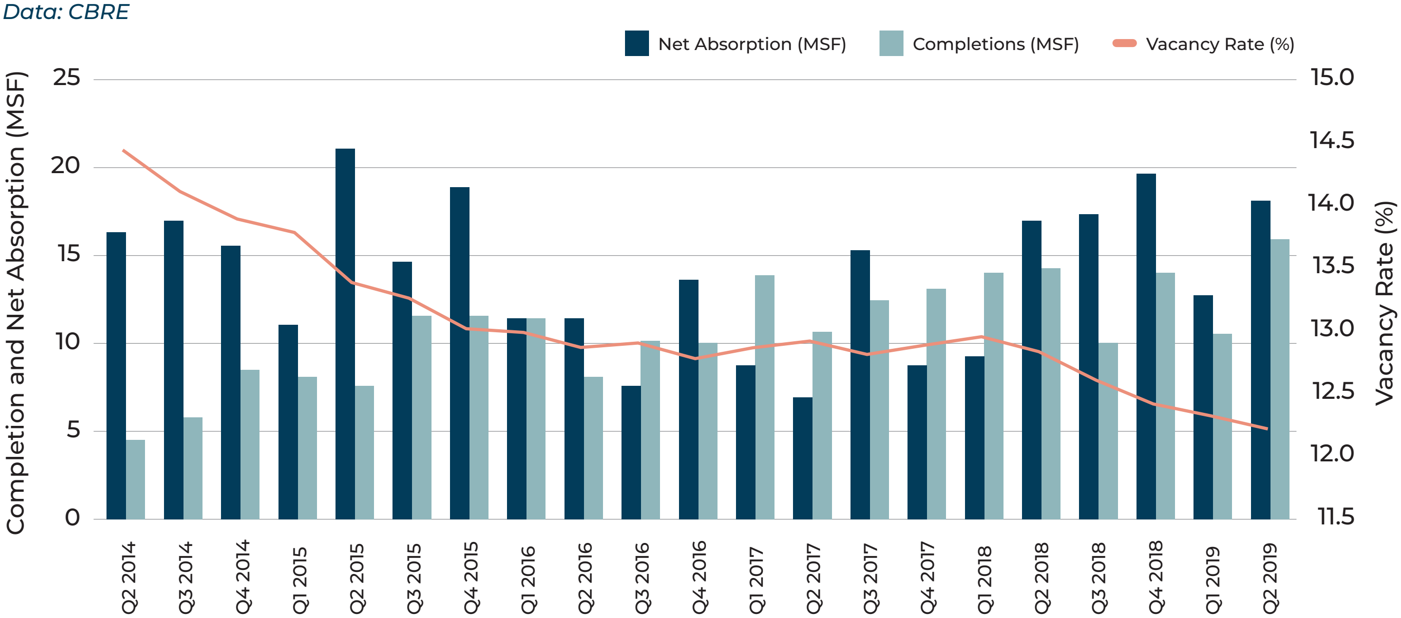
The vacancy rate in many metro areas is well below the US average. These metros tend to be tech-driven markets like San Francisco, Boston, and Seattle, as well as rapidly growing second-tier cities like Orlando, Raleigh, and Charlotte. Notably, WeWork and other providers of coworking space have followed the technology companies by signing sizable leases in a growing number of cities, especially those favored by the technology and knowledge sector. Although the office sector's new supply pipeline is large and continues to expand, it remains well below the levels reached in previous up-cycles. This can be attributed to the confluence of more conservative lending practices, widespread construction labor shortages, and escalating input costs.

New office development is highly concentrated; almost 2/3 of all square footage now underway is located in only 10 metro markets. Because of this, office demand: supply conditions must be evaluated on a market-by-market basis. The San Francisco metro, for example, has 7.0 million sf of new office product underway – fifth highest in the country and an outsized 7.0% of its base. A center for the rapidly-expanding tech industry, San Francisco's office market is extremely tight; vacancy is 4.8% metro wide and only 3.7% in its CBD, causing rents to spike (CBRE). It needs a significant amount of new office space to accommodate its tenant base and therefore new construction levels are helpful rather than alarming. Several other metros on the top 10 list for new office supply are also tech centers with very low vacancy rates, such as Boston, Austin, and Seattle. The near-term prospects of markets with elevated vacancy and outsized supply pipelines – such as Atlanta and Dallas-Ft Worth – are more worrisome.

Several mid-sized metros in the South and West have attracted an outsized share of population and employment growth during this economic upturn. Denver is one of these. Although metro Denver's 2Q 2019 office vacancy is modestly above the US average, its construction pipeline is moderate and demand for office space robust. Metro office vacancy has declined 150 basis points (bps) over the past year (CBRE), supporting average asking rent growth of 2.8% in CBRE's books and giving it a 2nd place ranking out of 50 US metros on Green Street's combined occupancy and rental rate growth metric after San Francisco.

Office New Supply, Absorption and Vacancy Trends

Data: CBRE



From Freelancers to Fortune 500 clients: The Evolution and Future of Coworking

*By Wendy Waters, Vice President, Research Services & Strategy, GWL Realty Advisors**

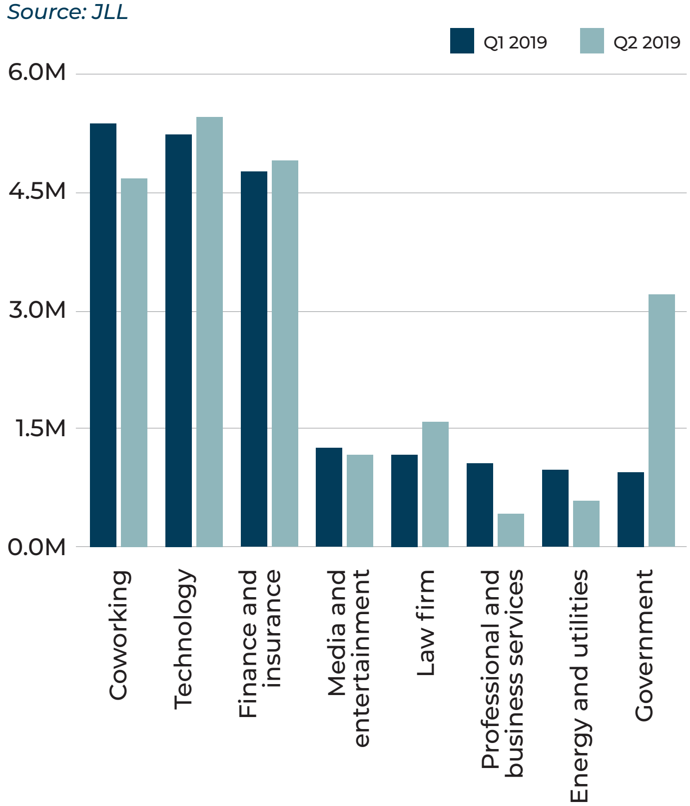
INTRODUCTION

Coworking companies have become the fastest growing tenant type across office buildings in North America and globally, especially in the technology-focused gateway centres. Their offering, focused on esthetically pleasing, functional workspaces combined with hospitality, flexible terms, and trouble-free technology has attracted users from freelancers to start-up companies to giant financial services and technology companies into these spaces. Whether a company or freelancers want private offices, open plan within a private space, or a mix of both, coworking companies offer this. Or, clients can choose to use a hot-desking open area workstation. Flexibility is a key attractant.

In Q1 2019 Coworking generated the largest share of leasing activity, according to JLL. While activity declined modestly in Q2, it remains a top three sector for office leasing YTD.[1]

US Office Leasing Activity by Industry, Q1 + Q2 2019

Source: JLL



Coworking providers—including brands such as WeWork, Spaces (IWG), Industrious, Knotel and Convene as well as myriad niche and local players have given office tenants new options. Moreover, they demonstrated to traditional landlords that a market exists of tenants ready to pay a premium for a higher level of service and workplace quality– as well as for lease terms by the month instead of the decade. Traditional office tenants now will choose to pay the coworking premium whether at other locations, or upon lease expiry and relocation. And now some landlords are offering their own coworking brands such as Hines Squared, Tyshman Studio and Oxworks.

A FEW THOUGHTS ON THE BUSINESS MODEL

WeWork's Initial Public Offering (IPO) discussion provides a context for distinguishing the coworking business model and its place in the evolution of office space, from issues specific to WeWork which are well documented elsewhere.[2] WeWork has a similar core business model to other coworking companies. However it has a faster pace of growth, greater appetite for debt, and more unusual relationship with its founders and investors than similar companies. The remainder of this white paper focuses on the broader coworking trend and its implications for office investors.

Coworking as a throw back real estate venture

Some observers have expressed concerns about the business model itself, which are probably overstated. Coworking companies must enter longer term leases with office landlords, build the space to a standard to attract workers and companies, and then lease it on short terms.

This is actually similar to what office landlords and investors do themselves: buy buildings (a long-term position) and lease them at shorter terms of 5 to 20 years. Although building owners have benefited from capital appreciation more recently, this was not always the case. Office building investors of the past often owned assets for net rental revenues, making this aspect of coworking a throw-back, rather than an innovation. (Indeed, with cap rates low, some office buildings may have similar limited potential for long-term capital appreciation.)

* The parent company of EverWest.

1 JLL Research, United States Office Outlook – Q2 2019. Accessed 11 September 2019 at https://www.us.jll.com/en/trends-and-insights/research/office-market-statistics-trends

2 For example: Maureen Farrell, "WeWork Parent Weights Further valuation Cut." Wall Street Journal, 8 September 2019 and Lisa Eadicicco, "WeWork IPO reveals company loand millions to CEO Adam Neumann and other company execs" Business Insider 14 August 2019.

Profitability and stable growth

WeWork reports that a location typically becomes profitable after 18 months of operation. Although the other providers do not offer this information, their experiences are likely similar. Some coworking providers choose to expand at a measured pace, avoiding debt. Others such as WeWork have been more aggressive in order to capture market share.

Risks from a downturn

Certainly, in downturns office landlords sometimes struggle to maintain occupancy and revenue levels. The best locations and buildings typically see a flight to quality and sometimes rents can be maintained while lesser buildings see rents move downward. When the next recession hits, coworking companies may similarly encounter a lower demand from occupiers and will need to reduce rents to maintain occupancy.

Coworking companies may face challenges in locations where reduced fees now cause the operation's expenses—including headlease rent, salaries, and operational costs–to exceed its revenues. Those operators with less debt, good locations and that are expanding at a measured pace may survive the downturn with minimal pain. For landlords, if coworking fees from members start to fall, there may be pressure to reduce rents or face having the space returned to them in a sluggish market.

Geographic diversification will also help many coworking firms endure the next down cycle. Those operating across markets and in regions with different economic drivers may find it easier to ride out any downturns felt unevenly across regions and industries (which is often the case save for the Global Financial Crisis, the last recession). This said, some locations in distressed markets may still close.

Moreover, because many businesses start during downturns (when their founders are suddenly jobless), they need flexible space options; coworking in some ways has "built-in recession insurance" within the business model. The shorter term, flexible leases also make the decision to occupy a coworking office almost risk free in a downturn, rather than risky as a 10-year lease would be.

COWORKING'S DIFFERENTIATING FEATURES

Flexible lease terms starting from a one-month or even daily commitment distinguishes coworking from traditional landlord-tenant relationships that require long-term commitments. However, packaged office providers such as Regus (IWG) have been offering simple monthly desk rental for decades. **What distinguishes coworking from packaged office is the overall experience** that meshes with 21st century business and individual needs.

How coworking is meeting 21st century business and worker needs:

1. Coworking companies have **rebranded and elevated the packaged office business** into one with **a superior customer experience alongside a superior technology backbone.** Initial coworking space users were often freelance computer programmers and web designers who needed uninterrupted high speed internet. They also wanted that technology company vibe of more creative interiors and places to socialize as well as attractive spaces in which to host clients. Coworking companies provided this and most members today see value in this combination as well as the all-inclusive offering. Video conference facilities, wireless printers, and both ethernet and wifi options come included in the monthly price. This allows freelancers and larger companies using coworking spaces for branch offices or project space to focus on their core business rather than trouble shooting IT.
2. **Coworking meshes perfectly with the rise in importance of the experience economy**. A structural change has occurred in which people have become less focused on consuming goods and more interested in prioritizing experiences. In the battle for talent, offering a superior workplace experience is now a way to attract and retain employees and coworking offers employers an office space solution should they decide not to create this environment in house.
3. The creative **turn-key space with private office as well as open plan options** offered by Coworking companies works for individuals needing space, small businesses unsure of their growth and larger firms wanting project space or simply attractive, hassle-free office options especially for branch locations with fewer employees. This flexibility seems to work for everyone.

   WeWork reports in its 2019 IPO filing that 40% of its members now work for companies with 500 or more full-time employees, up from 30% in 2018. Combined with companies with fewer than 500 employees and coworking spaces are increasingly an alternative office space option for employers rather than an aggregation of freelancers.

4. **Flexible lease terms** are a key innovation from coworking companies, and the aspect of the arrangement most attractive to many firms. In the 21st-century business environment, companies and divisions are often growing and changing quickly but also at the whim of the economy or contracts. Predicting how much office space will be required in 5 to 10 years is challenging. Coworking companies do the long-term leases with the landlord and sublet at a premium. However, when combined with the services noted above, it becomes an attractive value proposition for some firms.
    a. **4b. New IFRS accounting rules further the attractiveness of month-to-month leases**. A long-term lease must now be listed as a liability on a balance sheet. A 10-year deal could therefore be a significant obligation relative to revenues, whereas month-to-month leases can be treated as an operating expense.
5. **Coworking also fits with a desire for human connections, whether one lives in suburban or high density locations**, two key American living styles today. Technology enables many workers, whether freelancers or employees of large and small firms, to work from anywhere. Yet, people often prefer to work near others–to collaborate, receive inspiration, or simply to be "alone together" in a way that seems less isolating. Coffee shops have long served as third places, but lack the secure wifi and cannot offer privacy when needed. Now there is coworking, even outside the dense downtowns where locals may be escaping cramped apartments. Suburban coworking spaces, sometimes in struggling shopping centers, have proven popular with suburban freelance workers as well as employees of larger firms with the permissions to work from anywhere (Boston-based WorkBar, for example).

THE FUTURE OF COWORKING

Coworking is here to stay. Flexible lease terms work for the fast-pace of business evolution in the 21st century. Moreover, outsourcing the effort to provide a superior workplace experience allows everyone from freelancers to larger firms the opportunity to focus on the core business.

This said, more change is ahead. Some brands, and some locations regardless of brand, may not survive an economic disruption. For landlords reviewing potential leases with coworking companies, it is important to consider whether your location is a likely survivor. In addition, most landlords take steps to mitigate risks to cash flow should a coworking operation go dark. As documented in our PREA Quarterly article, these include bank letters of credit or surety bonds to ensure—as with any start up—some compensation should a coworking location in the building fail.[3]

The relationships between coworking providers and landlords are also changing. Profit sharing alongside risk sharing has begun to emerge. Although fully-operational examples are scarce, the model appears to have the landlord paying the up-front build-out costs while the coworking provider offers the platform and service–and they share the revenues. CBRE's Hana is one such profit sharing offering.

Office landlords are also taking inspiration from coworking, evolving their own offerings and finding ways to learn key lessons from these new players. Some landlords are creating their own coworking brands. Several have become investors in the leading proponents, perhaps as a way to become insiders on this trend. And in more distressed markets, such as Calgary Alberta (with the energy downturn resulting in a 25% office vacancy rate) landlords are offering turn key spaces at flexible lease terms, and with upgraded building amenities, in order to fill vacant space; for tenants, this is at a substantial discount to coworking, although without the high-touch coworking service offering.

Coworking is part of an evolving workplace experience, changing to match business needs. The next phase will likely include greater involvement from office landlords. This is already visible in new building designs in which a greater amount of space is dedicated to high-quality, shared amenities. EverWest, along with its parent company GWL Realty Advisors, continually monitors these trends, applying key lessons to assets under management across North America.

3 Wendy Waters, "Coworking's Impact on Global Office Markets." *PREA Quarterly. Spring 2019.*

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