

PwC Deals

US Real Estate Deals Insights Q2 2018

Executive summary

The second quarter of 2018 was quite active, particularly with respect to mergers and acquisitions involving REITs and private equity firms with strong brands and well-developed platforms. We also saw an acceleration in legislative and other public policy activity influencing the sector with developments in both Dodd-Frank and CFIUS, as well as continued focus by real estate firms across market participant types that are working to tech-enable their businesses to address related megatrends.

Importantly, however, we are also seeing an acceleration in focus on market participants' overall contributions to society and how they are managing their businesses to create value over the long term.

We expect that these trends will only intensify as investors and other stakeholders demand accountability from market participants to be purpose-led and values-driven, thereby creating an additional tailwind to transaction activity where some market participants today may not be doing so.

"We see an acceleration in focus on market participants' overall contributions to society and ability to create value over the long term – a trend that we think provides an incremental tailwind to deal activity."



Tim Bodner
US Real Estate Deals Leader

Trends and highlights

- Overall transaction activity for the quarter generally remained flat. We have, however, begun to see the transaction activity between REITs and private equity firms accelerate.
- We have not observed any significant adverse effects of the rising interest rate environment, which we attribute to stability in real estate operating fundamentals, as well as the ongoing competitive environment driven by capital inflows from private equity, pension funds and foreign investors.
- Public real estate companies have continued to trade at a median discount to net asset value ("NAV"), which evidences the persisting disparity between public- and private-market real estate values, and we believe will continue to spur M&A activity and activist shareholder focus on the sector.

Q2 2018 year-to-date* deal activity



Deal value

\$176.0 billion

1.7% decline vs. Q2 2017



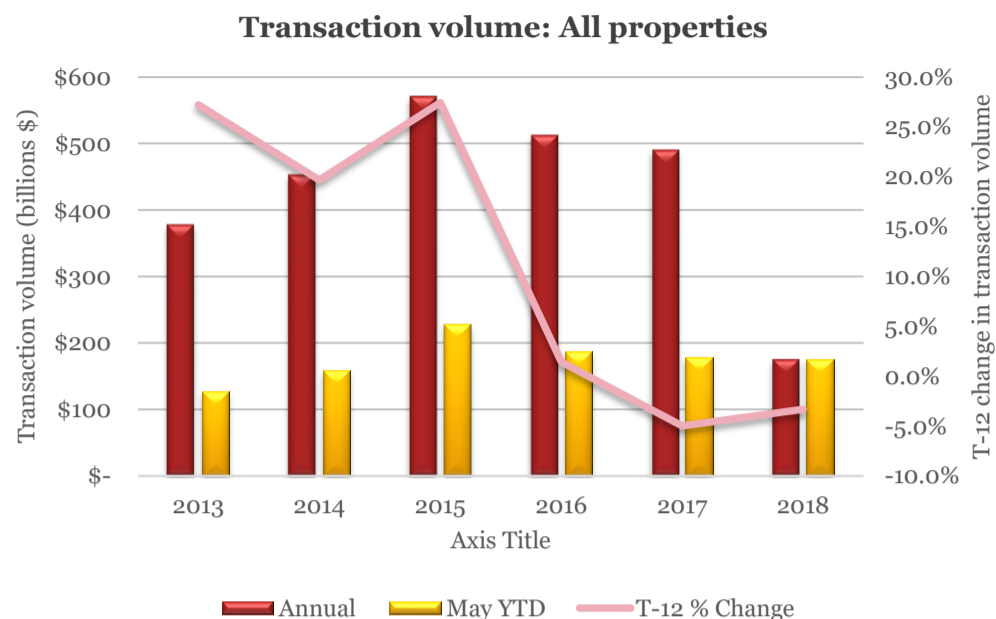
Deal volume

11,820 deals

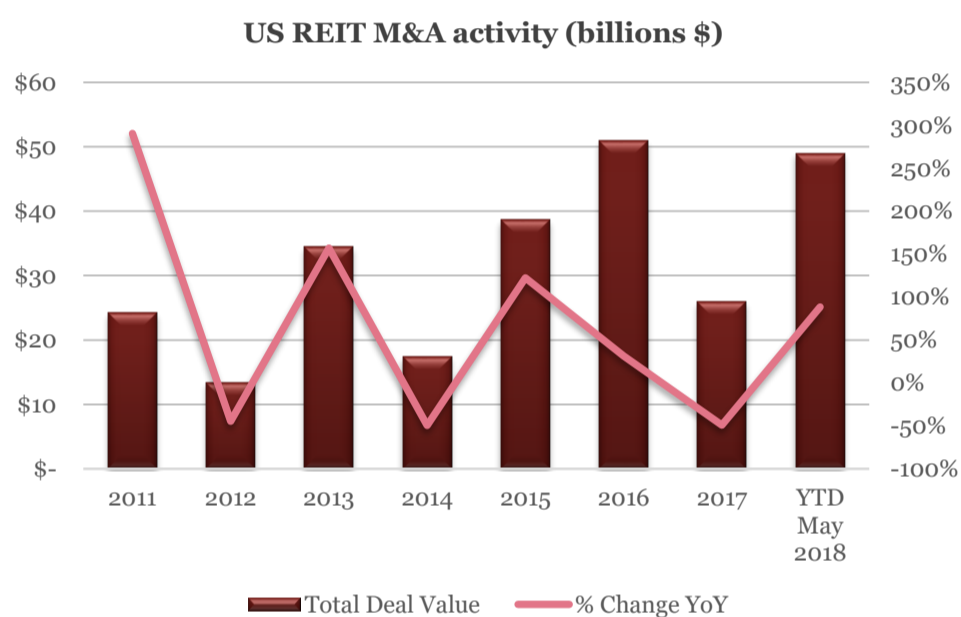
0.1% decline vs. Q2 2017

*Real Capital Analytics data through May of each year.

Transaction volume and regulatory environment



Source: Real Capital Analytics; data through May 2018



Source: NAREIT REITWatch; data through May 2018

Increasing portfolio and entity deals show desire to capitalize on NAV discounts

Transaction activity across all property types declined slightly from \$179 billion in the first five months of 2017 to \$176 billion year-to-date through May 2018, though the pace of decline (on a trailing 12-month basis) moderated as compared to the prior-year period.

Transactions in the industrial subsector continued an upward trend, rising by 23% year-over-year on a trailing 12-month basis, while retail and office transaction value declined by 23% and 14%, respectively, over the same period. Apartment and hotel deal value remained relatively flat.

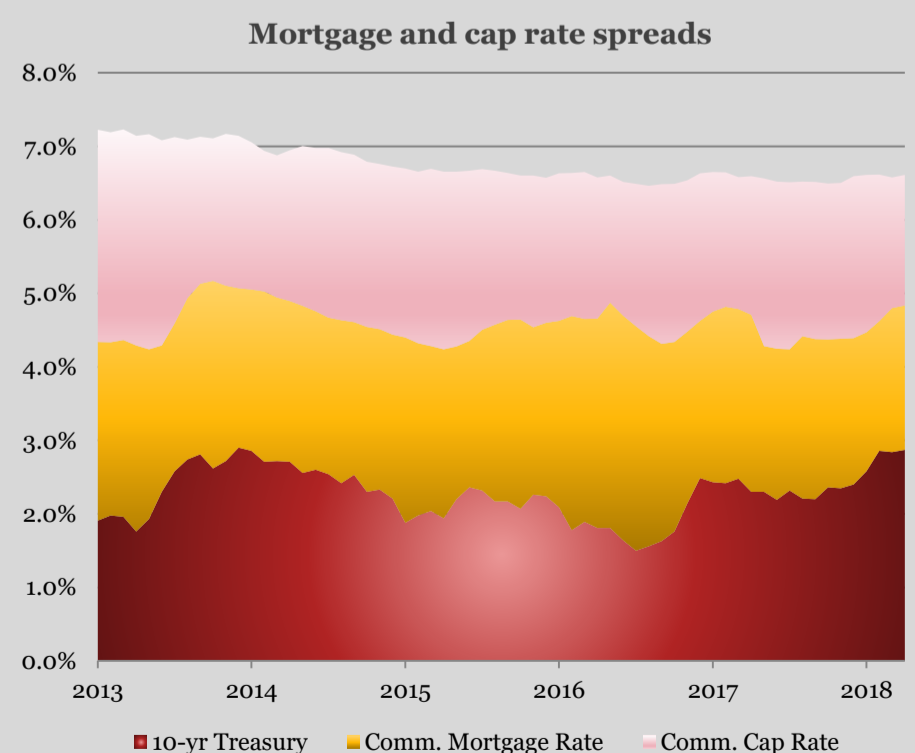
Though the volume of closed transactions has declined, the first five months of 2018 saw a spike in announced entity-level deals involving public real estate companies. According to NAREIT data (which is based on deal signing), M&A activity in the REIT space totaled \$49 billion in the first five months of 2018, nearly surpassing the previous peak since the financial crisis—\$50.9 billion during the entirety of 2016. One of the key reasons behind the current rise in M&A is a shift in investor focus as they push to capitalize on the discounts to NAV observed among public real estate companies. This shift is also evident in an analysis of deal volume as driven by entity-level transactions, which increased by 2.2% in Q1 2018 (the latest period for which data is available) as compared to Q1 2017.

Interest rate increases chip away at spreads, but investor appetite remains

In June 2018, the Federal Reserve raised the benchmark interest rate by 25 bps to 1.75%, which represents the sixth consecutive increase since the financial crisis. The Fed also signaled that it is likely to raise rates twice more during the current year.

The current environment has contributed to a shrinking spread between cap rates and interest rates, increasing the possibility of upward pressure on cap rates that has not yet occurred.

Still, as fundamentals continue to remain strong, investors are becoming more accustomed to a lower return environment for institutional real estate compared to cycles past, mitigating the likelihood of any sharp uptick. Moreover, it seems that with the abundance of capital chasing deals, there are other investors quick to take the place of any that feel squeezed out. Even for value-added deals that may be more difficult to price, some investors point to the interest of foreign investors in the US market as likely to reduce any negative impact of increasing interest rates.



Source: Real Capital Analytics; 10-year Treasury represents nominal 10-year treasury constant maturities

A Washington perspective on real estate deal strategy

By Alison Kutler; contributors Rachel Blumenthal and Lindsey Meyers

When planning your next US real estate investment, wherever it may be, developments in federal regulation may be an important part of your calculations. Just look at the recent changes to high-volatility commercial real estate (HVCRE) loans in the Dodd-Frank reforms. Because these changes culminated after active private sector input to lawmakers, they are a powerful reminder that regulatory developments brewing on the Hill may provide pathways to real estate sector growth, with benefits for both short-term and long-term real estate deal strategy. We have identified four policy developments impacting the real estate sector that should be on your radar as you plan ahead.

Dodd-Frank debate dead? In addition to changes to HVCRE loans, the recent Dodd-Frank reforms have weakened regulatory oversight. Loosening restrictions for mid-size banks means more lending opportunities in the real estate sector without fear of capital retribution. While the reforms are here, there is some speculation about whether—or to what extent—they will stay. All signs suggest that the debate around Dodd-Frank reform on the Hill is dead, but it may be resurrected by candidates on the 2020 presidential campaign trail, albeit more likely as a political gesture than a substantive platform position. Investors should nonetheless continue to work with lawmakers on financial reform policy as there is appetite for change. The current regulatory climate may provide opportunities to successfully advance additional reforms like guidance rollbacks, which could reduce a financial institution's compliance costs and send ripple effects across sectors, including real estate.

To sell, or not to sell REIT investments. Rising interest rates from the Fed might leave REIT investors in limbo about whether it's time to sell. To retain these investments, actively working with Washington to keep the economy strong and support real estate fundamentals is the smart play. Monitoring the trade talks, the new EU tariffs, and—above all—working with policymakers to mitigate economically risky legislation is one path forward.

If you tweet it, it will come. The United States Citizenship and Immigration Service (USCIS) tweeted earlier this year that reforms to the EB-5 Permanent Investor Visa program are coming. The EB-5 program was born in the 1990s to benefit struggling rural communities, offering foreigners permanent residency visas if they invested in certain US real estate projects. But thanks to gerrymandering, the program has diverged from its original purpose, and politicians on both sides of the aisle have indicted it as an easy pass to a green card for foreign investors. Keep an eye out for an overhaul to the program that may impact investment strategies across the sector.

Foreign investment reform is coming. There are reforms with bipartisan support on the table to update the review of transactions covered by the Committee of Foreign Investment in the United States (CFIUS), whose workload dramatically increased during Obama's second term and has become even heavier under the Trump administration. The Foreign Investment Risk Modernization Act of 2018 (FIRRMA) aims to better protect the US from national security threats by strengthening CFIUS's review authority. While Congress is still finalizing FIRRMA, the bill is expected to pass. The law will provide for a more exhaustive national security review of covered transactions and expand export controls, which may moderately limit executive branch authority over trade. The national security reforms will likely influence capital flows from overseas investors, and may especially impact Chinese buyers, several of whom have faced opposition by CFIUS in their acquisition attempts in recent years. Chinese investments in US real estate have historically provided a steady flow of capital. According to data from Real Capital Analytics, China has consistently been among the top three largest investors in US real estate for the past several years and accounted for 14% of total deal volume for the trailing 12 months at Q1 2018. However, the combination of Chinese regulations restricting the outflow of capital and political tensions between US and China on issues as far-ranging as cybersecurity and trade have caused a decline in Chinese real estate deal flow from an all-time high of \$17.6 billion in 2016 to \$5.3 billion for the trailing 12 months at Q2 2018 (with only \$92.6 million of transactions in the last quarter). While it's too soon to tell whether the increasingly mercurial relationship between the US and China will further thwart Chinese buyers from pursuing investment opportunities in the US, the CFIUS reforms could be sending a signal. In addition, companies with existing partnerships or investments from China may encounter new CFIUS roadblocks when making business-associated real estate transactions or possibly when buying vacant lots or leasing property near sensitive US government land and facilities, which one reform under consideration proposes. Investors should be mindful of these reforms and engage with lawmakers on the Hill, either directly or via trade associations, during the final drafting stages, particularly given that President Trump has expressed his support for these reforms, which are expected to land on his desk in August.

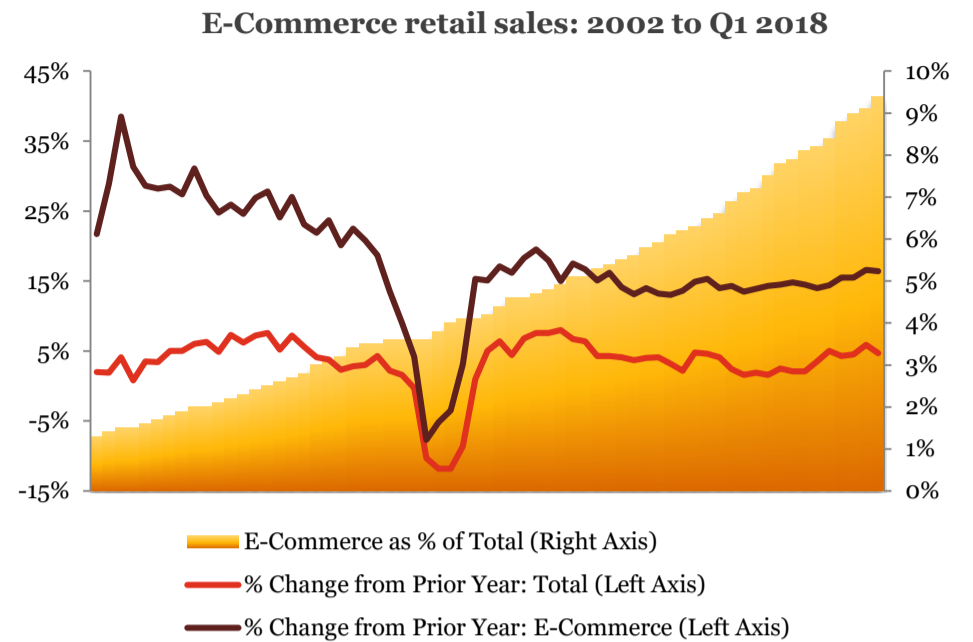
If post-facto, reactive outreach has been your go-to strategy, it's time for a change. Working proactively with lawmakers and closely monitoring developments can help mitigate risks affecting your deals strategy and growth. This is especially true in our current political climate where it's been more challenging to predict what policy and legislative changes are coming.

Continuing impact of e-commerce

E-commerce growth continues

E-commerce currently accounts for over 9% of total retail sales. Over the past 10 years, e-commerce sales have grown at a compounded annual rate of 12.9% as compared to just 2.6% for total retail sales. Applying the respective 10-year growth rates to current sales levels would result in e-commerce accounting for nearly 25% of total sales in the next decade.

The growth in e-commerce over recent history has fueled demand for warehouse space and is likely to continue to do so. While traditional retail remains challenged, investors recognize opportunities to repurpose space into new uses such as food halls, medical offices, entertainment, and education. As e-commerce grows, investors need to remain focused on properties that offer patrons an experience to increase overall foot traffic.



Source: U.S. Census Bureau

Warehouse rent growth reflects impact of e-commerce sales

Current quarter rent growth for retail fell 15 bps from the prior quarter and is now nearly 30 bps below the current cycle high in 2014. Compare that to rent growth for the warehouse market, which has increased 12 bps over the prior quarter but is over 50 bps below the current cycle high in 2015.

Although the PwC Real Estate Barometer® places a growing portion of the warehouse sector in contraction through 2019, investors are drawn to the sector as most sense that persistent investor demand and expanding tenant needs will keep warehouse products in favor over the next 24 months.

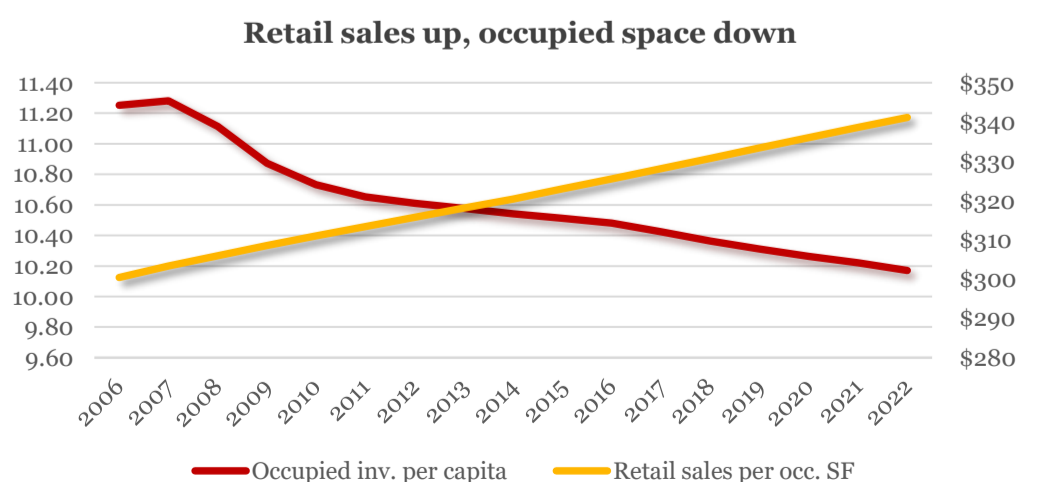
While the growing presence of e-commerce has challenged the retail sector, all is not lost for traditional retail assets. For example, although rent growth forecasts have slid in the recent past, landlords continue to lease to certain retail companies in expansion mode. As retail tenants remain selective on growth and their physical footprint, it behooves investors to do the same to evaluate a property's potential to capture the sector's potential.



Source: PwC Real Estate Investor Survey; retail represents strip shopping center

Brick and mortar retail's answer to e-commerce

The increased impact of e-commerce and changes in spending habits resulted in major retailers closing 5,000 stores in 2017 and an additional 3,000 stores so far in 2018, resulting a retail vacancy of 4.5% as of the end of Q2 2018 (according to CoStar data¹). While empty retail bays are the disdain of landlords, the retail sales data suggests that the removal of underperforming stores has benefitted the industry overall. Investors and landlords will benefit from the increased sales volume from customized experiences offered by retailers that make space-use and business decisions that outsmart the e-commerce trend.



Source: Reis Inc., CoStar, US Census Bureau, Moody's Analytics

¹ CoStar Group, Inc. CoStar Retail Statistics – Mid-Year 2018: National Retail Market

Public real estate valuations and REIT capital raising

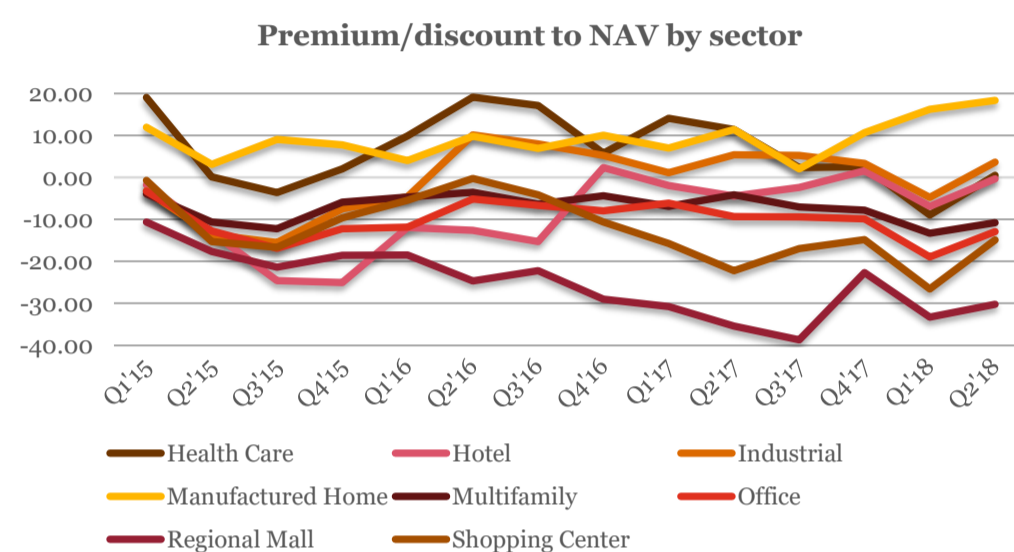
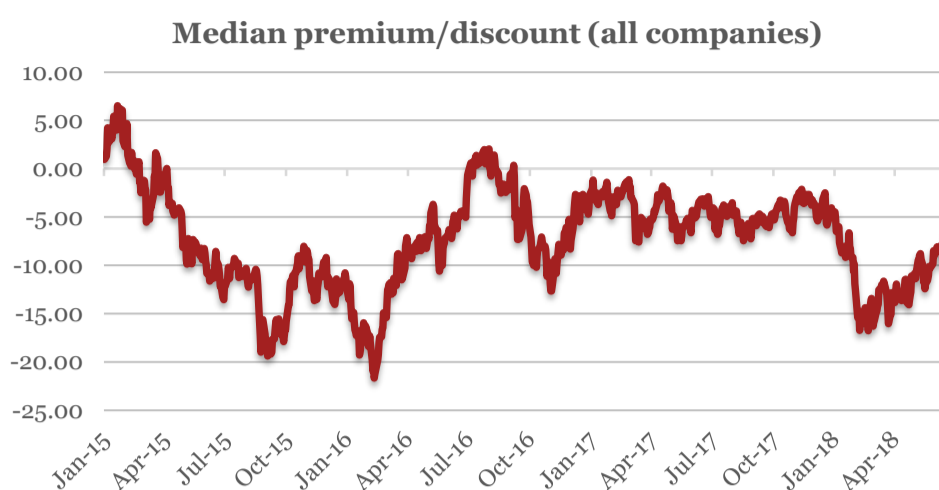
Discounts to NAV persist, driving M&A activity and shareholder activism

The second quarter of 2018 continued the trend seen over the past several years with respect to real estate companies trading at a discount to NAV. Based on a median of all US real estate companies tracked by S&P Global Market Intelligence, Q1 2015 was the last period in which real estate companies continuously exhibited a median premium to NAV.

While the median discount has continued to shrink since the beginning of 2018, certain real estate subsectors have shown a persisting disconnect between the public and private-market valuations of the underlying real estate assets. This disconnect is particularly pronounced among companies focusing on core real estate asset classes, with retail, office, and multifamily REITs posting the highest median discounts to NAV since the end of 2016. Conversely, companies in niche sectors, such as healthcare and manufactured housing, as well as industrial REITs, have generally traded at a premium to NAV during the same time period.

The observed trends with respect to real estate stock prices in relation to the private-market value of real estate assets, combined with record levels of dry powder among private equity real estate funds and the continuing capital inflow from foreign investors, have contributed to a rise in entity-level M&A in which buyers benefit from a company's existing platform in addition to its real estate portfolio (refer to "Key announced transactions" section).

Companies in sectors that have experienced the steepest discounts to NAV (for example, regional malls and shopping centers, which have been trading at a median discount in excess of 10% since Q4 2016) have also



Source: S&P Global Market Intelligence; data through June 29, 2018.

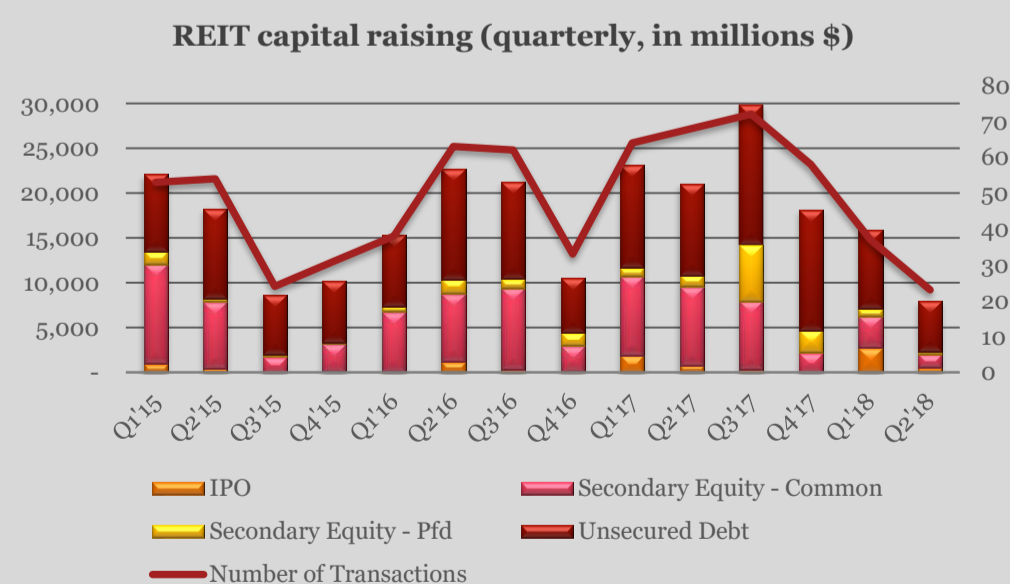
been the subject of increased shareholder activism as investors seek out strategies to maximize value. In certain instances, such activism has spurred a push toward take-private activity and sector consolidation in order to take advantage of private-market real estate values and reduce costs through scale.

REIT capital raising continues to decline

REIT capital raising declined in Q2 2018 compared to both Q1 2018 and Q2 2017 across all types of capital. Total capital raised during the second quarter of 2018 amounted to \$7.9 billion (consisting of 23 transactions), as compared to \$21.1 billion (68 transactions) during Q2 2017. On a year-to-date basis, the number of transactions decreased by 55% from 132 in 2017 to 60 in 2018, while total capital raised declined from \$44.2 billion to \$23.8 billion (46%). On a last-12-months basis, capital raising volume showed a moderate decrease of 6% (from \$75.9 billion to \$71.8 billion).

Secondary common equity transactions experienced the sharpest drop, with volume declining 83%, 71%, and 50% on a quarter-to-date, year-to-date, and last-12-months basis, respectively, as compared to the same period in 2017.

Consistent with the trends described above with respect to real estate companies' share prices exhibiting a discount to NAV, unsecured debt



Source: NAREIT, PwC's Capital Markets Watch and Dealogic

has been the subject of increased shareholder activism as investors seek out strategies to maximize value. In certain instances, such activism has spurred take-private activity and sector consolidation in order to take advantage of private-market real estate values and reduce costs through scale.

Key announced transactions and sector outlook

Key announced transactions

The second quarter of 2018 continued the previous 2017 and Q1 2018 trend of large portfolio transactions from private equity, institutional real estate investors, and established publicly traded REITs. The most significant drivers of M&A activity continued into the most recent quarter, with public REITs trading below their NAV (as discussed previously), the growth of e-commerce favoring the industrial sector, continued focus on acquisitions of homogenous portfolios, and private equity and institutional investor dry powder. The quarter also saw continued deal activity by traditional real estate services providers into new technology offerings, new investment offerings, and an expanded geographic presence.

- In April 2018, Prologis announced a merger with DCT Industrial Trust in which Prologis will acquire DCT for \$8.4 billion in a stock-for-stock swap, further expanding its investment in industrial and distribution real estate.
- In May 2018, Blackstone announced an all-cash deal to buy Gramercy Property Trust for \$7.6 billion, further expanding its presence in industrial real estate.
- In May 2018, Colliers International Group announced a deal to acquire a 75% stake in Harrison Street Real Estate Capital, one of the largest real estate investment firms dedicated to the education, healthcare, and storage sectors, for \$450 million, with an additional \$100 million payable in 2022 subject to certain performance targets.
- In May 2018, Blackstone also announced the acquisition of luxury hotel owner LaSalle Hotel Properties in a deal valued at \$4.8 billion (including debt). However, Pebblebrook Hotel Trust has continued to pursue LaSalle despite Blackstone's offer.
- In June 2018, W.P. Carey Inc. announced a merger with Corporate Property Associates 17-Global in a stock-for-stock transaction valued at \$6 billion. The deal could make W.P. Carey the #2 US net lease REIT by market value.
- In June 2018, Greystar Partners announced a \$4.6 billion deal to acquire Education Realty, a developer of student housing. This transaction will be the first for Greystar's newly formed Greystar Student Housing Growth and Income Fund.

Real estate deals outlook

The second quarter of 2018 saw elevated levels of real estate M&A activity, including several announced take-private transactions. Given the current economic and commercial environment, as well as the impact of shifting demographics and generational lifestyle preferences, we expect M&A deal volume to remain above average, particularly in non-core or niche subsectors that are expected to benefit from these megatrends and, as a result, attract more mainstream investor attention. In addition, moving forward:

- On average, we expect share prices of real estate companies to remain below NAV in the near term, resulting in limited REIT capital activity, particularly with respect to IPOs and secondary equity offerings, which some may view as dilutive. In the same vein, we believe unsecured debt will remain the most prominent source of capital raising among REITs, particularly in sectors that face the steepest discounts to NAV. This trend is likely to persist as REITs seek to de-lever their portfolios, in part to make assets more attractive to potential private-market buyers and streamline the asset monetization process.
- Given these discounts to NAV, coupled with the current level of shareholder activism in the real estate sector, we anticipate acquisition activity to continue to decline among REITs, with some companies becoming net sellers in an effort to free up capital for redevelopment or return it to investors in the form of share buybacks. Nevertheless, we believe that the continuing stability of operating fundamentals will lead some entities to monetize less than their entire ownership interest in their assets (e.g., through joint venture arrangements), allowing them to participate in operating cash flows and benefit from expected future value appreciation.
- We anticipate that US commercial real estate will continue to attract attention from overseas investors, including countries with growing economies that have recently relaxed regulations around outbound investment or begun to pivot away from a domestically-focused investment strategy (such as Japan and Mexico).
- As technological innovation continues to disrupt established processes and relationships within the real estate sector, we anticipate that an increasing number of companies will need to continue to evaluate a vertically integrated technology solution as part of their business strategy and competitive advantage.

About PwC's Deals Practice

For a deeper discussion on deal considerations, please contact one of our practice leaders or your local deals partner:

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Smart dealmakers are perceptive enough to see value others have missed, flexible enough to adjust for the unexpected, aggressive enough to win favorable terms in a competitive environment, and circumspect enough to envision the challenges they will face from the moment the contract is signed. But in a business environment where information can quickly overwhelm, the smart dealmakers look to experienced advisors to help them fashion a deal that works.

PwC's Deals Practice advises real estate companies and real estate-focused private equity firms on key M&A decisions, from identifying acquisition or divestiture candidates and performing detailed buy-side diligence, to developing strategies for capturing post-deal profits and exiting a deal through a sale, carve-out, or IPO. With more than 9,800 deals professionals in 75 countries, we can deploy seasoned teams that combine deep industry skills with local market knowledge virtually anywhere and everywhere your company operates or executes transactions.

Although every deal is unique, most will benefit from the broad experience we bring to delivering strategic M&A advice, due diligence, transaction structuring, M&A tax, merger integration, valuation, and post-deal services.

In short, we offer integrated solutions, tailored to your particular deal situation and designed to help you extract value within your risk profile. Whether your focus is deploying capital through an acquisition or joint venture, raising capital through an IPO or private placement, or harvesting an investment through the divestiture process, we can help.

For more information about M&A and related services to the real estate industry, please visit <https://www.pwc.com/us/en/industries/asset-wealth-management/real-estate.html>

About the data

The information presented in this report is an analysis of transactions in the real estate industry where the target company (or asset), the target ultimate parent company, the acquiring company, or the acquiring ultimate parent company was located in the United States of America. Transaction, capital-raising, yield and property fundamental data was sourced from Real Capital Analytics, NAREIT, Reis Inc., PwC Real Estate Investor Survey®, PwC US Capital Markets Watch, Dealogic, and Emerging Trends in Real Estate® - US and Canada: 2018. Data with respect to premiums/discounts of public real estate company share prices to net asset values was obtained from S&P Global Market Intelligence and include certain companies which are no longer publicly listed. Macroeconomic data was sourced from the US Census Bureau, CoStar and Moody's Analytics.

Transactions are based on the closing date, unless otherwise specified herein. Transaction volume is based on independent reports of properties and portfolios \$2.5 million and greater. Data classified as retail relates to strip shopping centers (neighborhood and community), with the exception of transaction volume which includes all retail sub-sectors. Certain data is based on preliminary activity reported for Q2 2018. Percentages and values are rounded to the nearest whole number which may result in minor differences when summing totals.