ALLIANCE
REAL ESTATE
CUSTOMIZATION | TRANSPARENCY | CONTROL

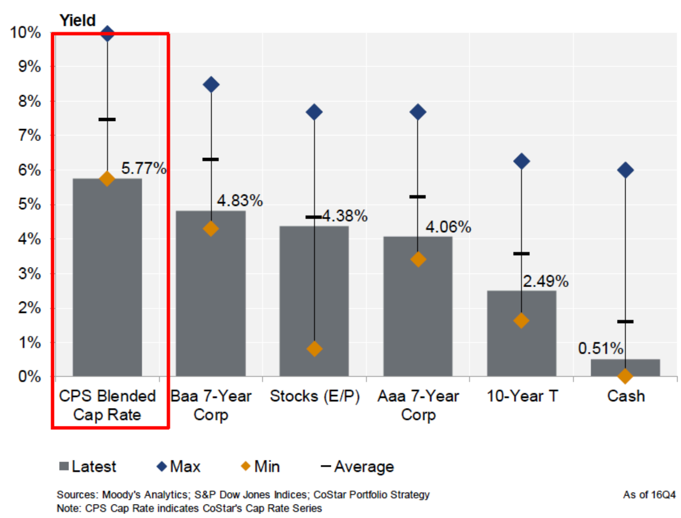
Hoping for the Best, Preparing for the Worst

2017 Outlook | February 2017

Overview

The US economy has enjoyed slow but steady growth over the last several years which, coupled with historically low interest rates, has led to a great environment for commercial real estate. In fact, from 2000 through 2016, commercial real estate, on average, outperformed the vast majority of other asset classes from a return perspective.

Asset Class Yields since 2000 (As of 31 Dec 2016)



However, the Alliance Real Estate ("ARE") team believes that blindly expecting such trends to continue is dangerous. A common question recently has been some variant of "How long until the music stops?" or "Where are we in the real estate cycle?". The pace of these questions has accelerated in recent months following the election of Donald Trump as our clients try to "look around the corner" and assess the impact that the policies pursued by his administration may have on the global economy in general, the American economy in particular, and the commercial real estate market specifically.

No one knows with assurance specific answers to these questions, but we do believe that some general themes can be identified which will influence our investing posture throughout 2017.

Theme #1: The Easy Money Has Been Made

In the wake of the Great Recession it was relatively easy to make money in commercial real estate as the rising tide of falling interest rates, capital inflows and steady economic growth lifted all boats. We believe these days are coming to an end. While we are not prepared to call a top in the commercial real estate markets we do believe that, more so than at any point in the last six years, it is crucial to pick the right deals in the right locations with the right operators.

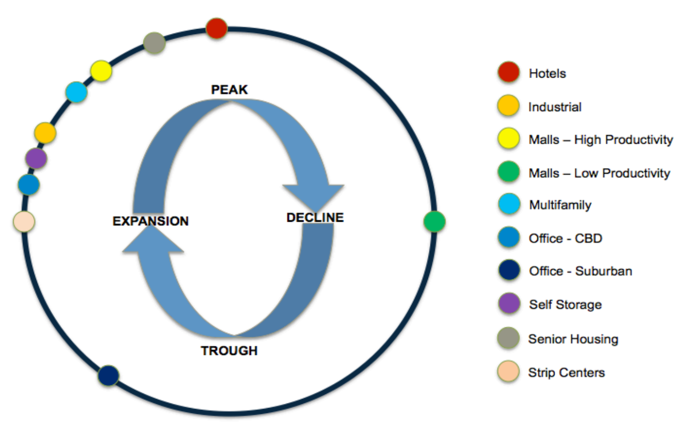
Theme #2: Macroeconomic Uncertainty is Rising Quickly

From Brexit to the election of Donald Trump and everything in between the last several months have seen the level of macroeconomic uncertainty rise exponentially. Real questions exist as to the size and timing of potential interest rate increases and the associated impact on cap rates and capital costs. Corporate tax reform could impact certain real estate-specific policies such as 1031 exchanges and the deductibility of interest payments in ways that materially influence real estate investment decisions. During this period of uncertainty, we believe that risks to the downside outweigh risks to the upside and that therefore prudence is warranted.

Theme #3: The Real Estate Cycle Continues to Mature

The bull market in commercial real estate has now run for close to six years and, in terms of a baseball analogy, generally feels to ARE as if it is in the 7th or 8th inning. Obviously within this broader context there are property types and investment approaches with more running room than others but again, to reiterate our first theme for 2017 – the easy money has been made. Going forward having a well-diversified allocation strategy and paying keen attention to the specifics of each potential investment is crucial.

Alliance Cycle Chart



Positioning for 2017

Within the broader themes identified above, ARE believes there are specific pockets in the commercial real estate market positioned to outperform in 2017. Generally speaking, the common thread between these ideas is recession-resistance, in keeping with ARE's belief that it is time to adopt a slightly more defensive posture. Moreover, ARE has identified a few offensive strategies that will benefit from longer-term secular shifts in the American economy and are unlikely to be materially affected by the current environment of near-term uncertainty.

First and foremost, in 2017 ARE is focused on opportunities within secondary and tertiary markets. We believe that investors, on average, are underestimating risk in primary markets and overestimating risk in secondary and tertiary markets which, in the aggregate, creates opportunity. This is a response to the massive inflows of capital, both foreign and domestic, to primary markets over the last several years. This influx of capital, which is expected to continue, was initially driven by a domestic "flight to safety" and then transitioned on the foreign side with the liberalization of certain tax laws allowing non-US investors to access US commercial real estate more easily. As a result, pricing in these gateway markets is rich and current construction trends are worrisome. Conversely, secondary and tertiary markets are more cheaply priced and development activity remains fairly muted. As such, ARE believes the risk / return equation favors secondary and tertiary markets.

Within secondary and tertiary markets, ARE is specifically focused on workforce housing, necessity retail, self-storage and manufactured housing. These property sectors all have qualities that make them recession-resistant and therefore somewhat defensive in nature. Similarly, these property types also benefit from relatively low rent bases vis-à-vis other commercial real estate alternatives. This allows for relatively modest rent increases from an absolute dollar basis that are still meaningful on a percentage basis – a recipe for continued rent growth even during a period of economic uncertainty and/or an economic downturn.

Despite a bias towards defensive real estate in 2017, ARE also believes that opportunities exist by taking advantage of several longer-term secular shifts in the American economy that are unlikely to be derailed by near-term uncertainty.

Secular Shift #1: Continued Rise of Technology and E-Commerce in America

As was evident during the holiday season, Americans are becoming more and more comfortable shopping online – a trend that we believe will continue. An interesting component of this shift that has developed with the adoption of services like Amazon Prime is an expansion of the types of items purchased online – shoppers are no longer limiting online purchases to large-ticket discretionary items, but are instead buying smaller carts of everyday items more often. ARE does not believe by any stretch that the Internet will displace all need for physical stores and retail real estate (hence our focus on necessity retail), but we do believe that the rise of e-commerce and consumer demand for faster and more frequent deliveries presents an opportunity in industrial real estate. Specifically, ARE is pursuing Class B in-fill industrial properties that have the capacity to cater to third-party logistics providers focused on solving the "last mile" between online sellers and consumers.

ARE also believes that a related opportunity exists to take advantage of America's growing consumption of digital content, cloud storage and on-demand services which continues to put pressure on the country's digital infrastructure. The need for ever more storage located closer and closer to the end user makes ARE bullish over the long-term on data centers.

Secular Shift #2: Aging of America

America is just beginning to confront the reality of aging Baby Boomers and the variety of impacts this demographic shift will have on the country as a whole. Like many areas of the US economy the continued aging of America will directly impact the commercial real estate industry. ARE believes that an opportunity exists to take advantage of this reality through smart investments in both medical office buildings and senior housing facilities.

Conclusion

ARE believes that an appropriate outlook for 2017 can be best summed up by Maya Angelou's words from "I Know Why the Caged Bird Sings" - "Hoping for the best, prepared for the worst, and unsurprised by anything in between." While we, like everyone else, will likely run into surprises throughout the year, we believe that an approach to commercial real estate investing that hopes for the best but prepares for the worst is a prudent position to take given the high degree of macroeconomic uncertainty and current realities of the real estate cycle.

ARE recommends a somewhat defensive posture focused on recession-resistant opportunities in secondary and tertiary markets with offensive exposure to certain property types positioned to benefit from broader secular shifts in the American economy. We believe such an approach will help to protect clients on the downside while preserving the ability to participate in the longer-term growth of the American economy.

*Please feel free to reach out to **Christopher Hanley** (410.963.1376 | chanley@alliancerealestatellc.com) or **Alan Fuller** (205.613.3619 | afuller@alliancerealestatellc.com) with any questions about our thoughts or to discuss becoming a client of ARE. Additional information can be found on ARE's website – www.alliancerealestatellc.com.*

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ARE Overview

Founded in 2016, Alliance Real Estate, LLC is a privately held investment management firm specializing in providing real estate investment management and advisory services to family offices. Alliance's unique approach is focused on providing its family office clients with customized and targeted real estate portfolios via separate accounts delivered with total flexibility, absolute control and institutional quality oversight at reduced costs compared to competing alternatives. With offices in Birmingham, AL and Washington, DC, Alliance is led by a team of seasoned, committed real estate professionals whose extensive track records, ownership mentality, client focus, and differentiated approach to real estate investing adds significant value across portfolio design, construction and implementation.

Alliance's senior management team of Alan Fuller and Christopher Hanley bring a wealth of experience in commercial real estate investing, fund management, investment banking, operational activities, capital raising and investor relations to bear in executing for Alliance's clients.

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