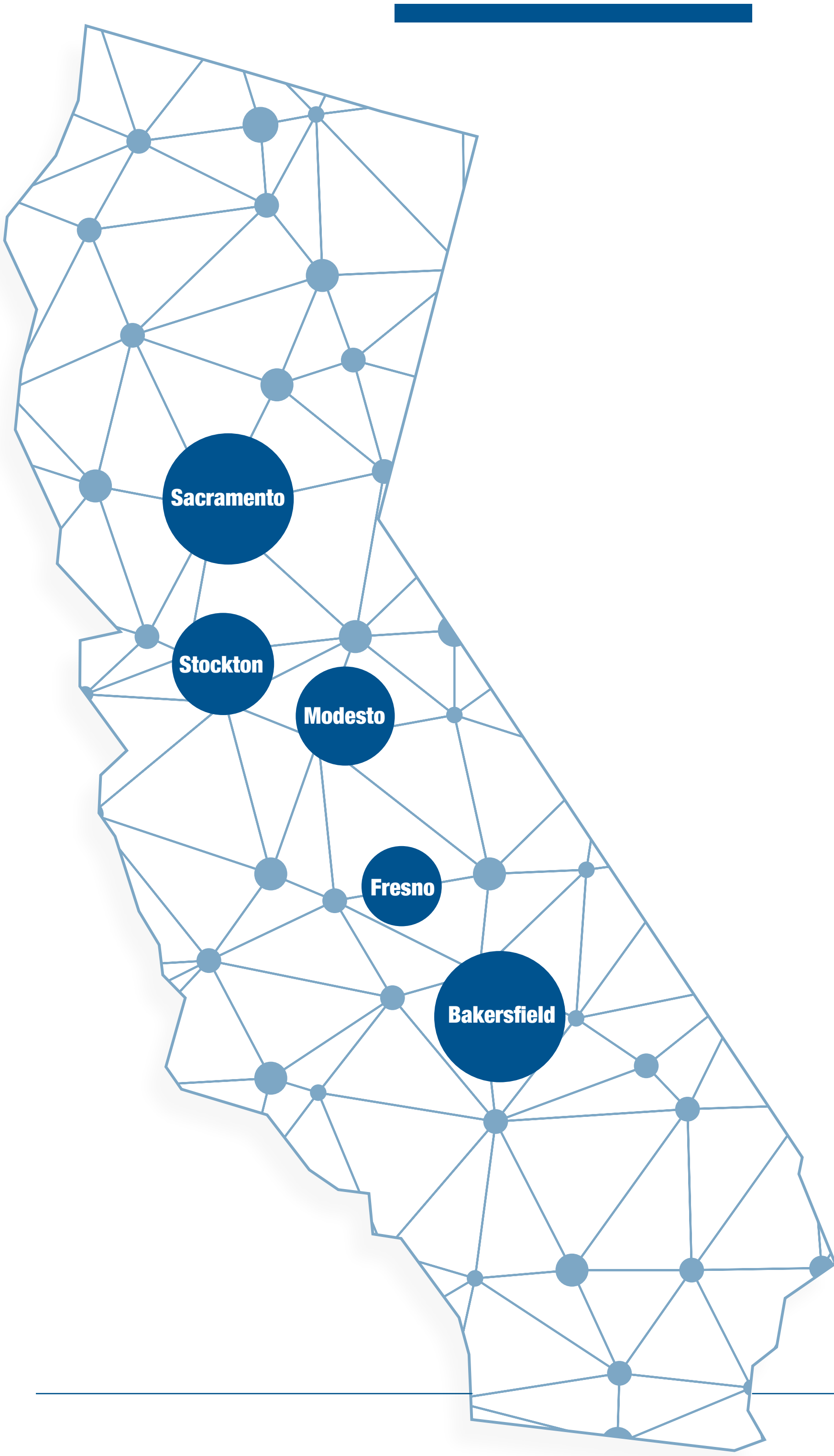
CALIFORNIA'S CENTRAL VALLEY



Land of affordability, growth and opportunity

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INSIGHTS

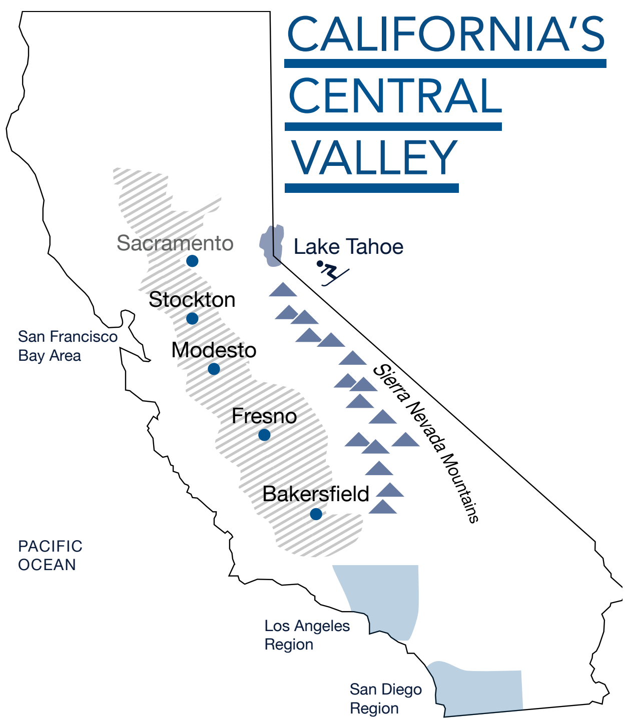
- As California's fastest-growing and most-affordable region, residents, businesses and investors are discovering the Central Valley.
- The average home price in San Francisco is nearly $1.5 million, versus approximately $320,000 in Stockton and Modesto, and $360,000 in Sacramento.
- California is the fifth-largest economy in the world, and businesses and residents are attracted to its diversity and quality of life.
- In second quarter 2020, the Central Valley's industrial market posted its 30th straight quarter of positive net absorption.
- Individuals and families currently hold most institutional-quality properties, but that is starting to change as more institutional investors explore secondary markets.
- Investment properties in the Central Valley offer investors attractive cap rates: Office buildings are typically at about 7.5 percent, grocery-anchored retail is at 6.75 percent to 7.0 percent and multifamily is at 5.5 percent to 6.0 percent.

EXECUTIVE SUMMARY

In today's low interest-rate environment, investors are working overtime in their search for yield. In the real estate arena, property investors are searching beyond gateway and primary markets — where stiff competition has compressed cap rates to record lows for some property types — and exploring opportunities off the beaten track in overlooked secondary and tertiary markets.

One such opportunity is California's Central Valley, where investors can tap into the region's growth story and still find markets and properties that offer significantly higher risk-adjusted returns.

Although the Central Valley is well known as one of the world's most productive agricultural areas, continued population growth and economic diversity have made it California's up-and-coming region. The Central Valley's potent economy is also supported by Sacramento's large base of government jobs — the state capital ranks as the second-largest government center in the country behind Washington, D.C. — and a prominent healthcare sector fueled by employers such as Kaiser Permanente, Sutter Health and the UC Davis Medical Center.



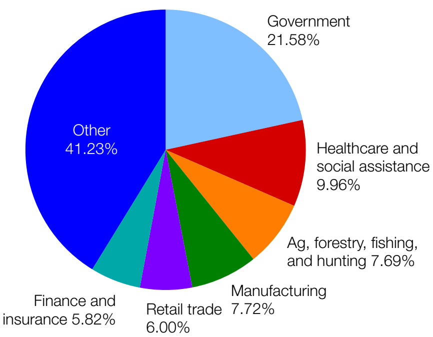
In addition, the real estate industry's mantra of *location, location, location* perfectly describes a key attribute of California's Central Valley and its desirable proximity to the state's two powerhouse employment and business hubs, San Francisco to the west and Los Angeles to the south. In fact, the area's affordable housing costs continue to attract residents from both of its larger, high-cost-of-living neighbors, making the Central Valley the state's fastest-growing region.

Institutional property investors looking for higher yields in less-competitive secondary markets are taking notice of these trends and recognizing the largely untapped potential for investment in the Central Valley's key cities of Sacramento, Bakersfield, Fresno, Stockton and Modesto.

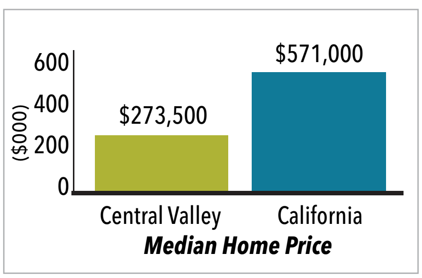
INTRODUCTION

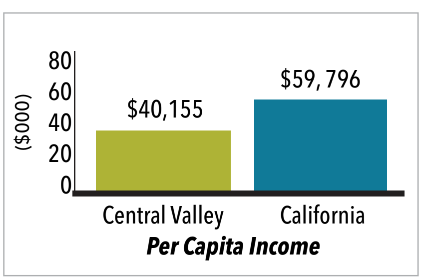
Central Valley Gross Regional Product

(GRP=$302.2 billion)



Sources: Greater Sacramento Economic Development Corp., Central California Economic Development Corp.





Source: California Central Valley Economic Development Corp.

California's Central Valley has long been a market overshadowed by its powerhouse neighbors, San Francisco to the west and Los Angeles to the south. As one of the fastest-growing areas of the state, the Central Valley has earned its own reputation as an economic engine, and it's now firmly on the radar of institutional real estate investors.

The Central Valley is gaining attention from both individuals and businesses for attributes such as its central location, stable regional economy, and affordability in a notoriously high-cost state. And, as the fifth-largest economy in the world, California is still a magnet for businesses and residents, alike. The state's Mediterranean climate is hard to beat, and its diverse natural attractions range from golden beaches to snow-capped mountains to beautiful desert landscapes and majestic giant redwoods.

The Central Valley's core economic sectors are government (including the nation's second-largest government center, Sacramento), healthcare and agriculture. These sectors account for almost 40 percent of the region's gross regional product. All three sectors are recession resistant and difficult to relocate out of the region.

The Central Valley also is posting strong population growth numbers, as it attracts residents looking for lower-cost alternatives outside of Los Angeles and the San Francisco Bay Area. The Central Valley is home to more than 7 million people, which on its own would rank as one of the top 15 states in the country. The latest data released by the California Department of Finance shows people are continuing to move from higher-cost coastal cities to more affordable inland cities. According to the report, eight of the 12 fastest-growing counties in the state are located in the Central Valley.

One of the drivers for population growth is the Central Valley offers a great quality of life at a significantly lower cost, relative to Los Angeles and San Francisco. "The challenge is that California, in general, has a high cost to do business and a high cost to live," says Richard Chapman, president and CEO of the Kern Economic Development Corp. (EDC). "We make the case that you can live in California and have that access, and yet [in the Central Valley] the cost of living is relatively comparable to the U.S. average, and the cost of doing business is also pretty similar." An individual who makes $60,000 in Kern County, for example, would need to make more than $110,000 in San Francisco to have the same quality of life, according to a Nerd Wallet Cost of Living Index.

The Central Valley is benefitting from its location, which is virtually in the backyard of San Francisco. The Bay Area has been experiencing soaring housing costs and constraints on new commercial development related to high construction costs and land scarcity. Residential real estate values continue to move higher in the San Francisco Bay Area, pushing individuals to look for lower-cost alternatives that still allow them to stay connected to that employment market. The Central Valley is directly in the path of that outflow. The average home price in San Francisco is nearly $1.5 million, versus approximately $320,000 in Stockton and Modesto, and $360,000 in Sacramento, according to Zillow.

SOLID GROWTH, HIGHER YIELDS

Investment in secondary property markets has been a hot topic in recent years. The unprecedented amount of foreign and domestic capital pursuing commercial real estate opportunities in the United States has resulted in significant cap-rate compression in primary markets. In the *CBRE North America Cap Rate Survey* for second-half 2019, national class A multifamily stabilized cap rates were 3.75 percent to 4.75 percent in the San Francisco Bay Area; class A office cap rates were 4.5 percent to 5.0 percent in San Francisco and 4.5 percent to 5.5 percent in Los Angeles; and class A industrial cap rates in both the San Francisco Bay Area and SoCal's Inland Empire were in the 3.75 percent to 4.25 percent range.

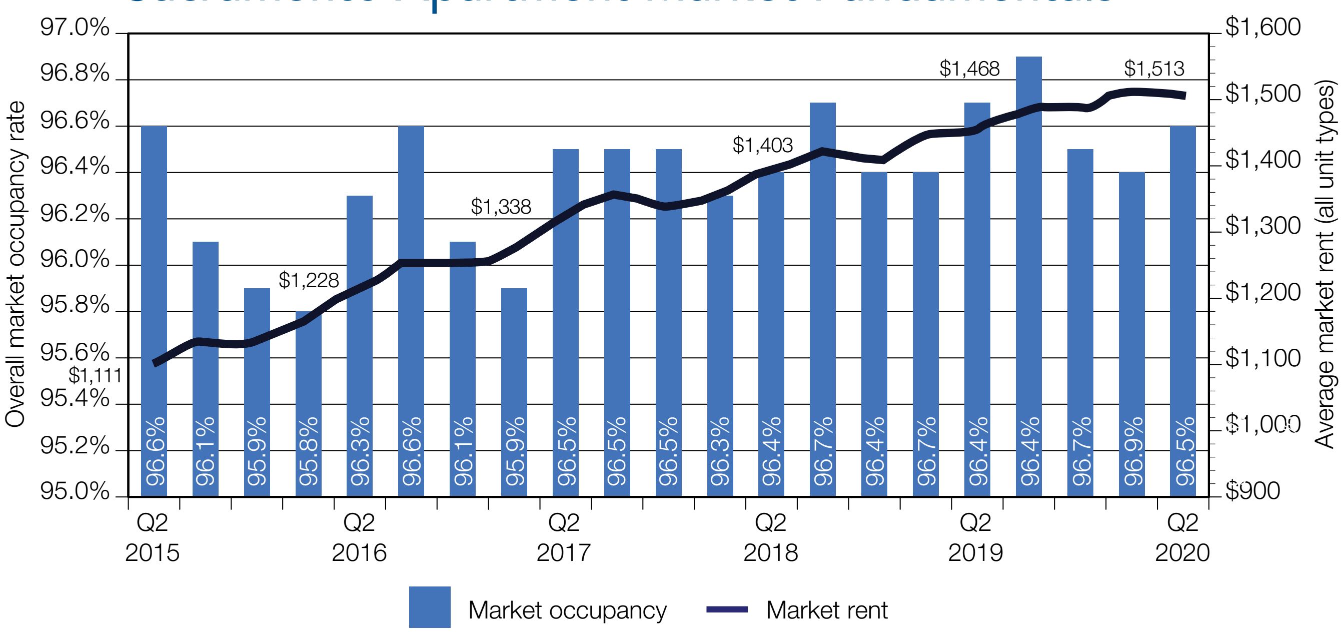
As such, investors have turned to secondary markets to find less-expensive real estate and more attractive yields.

Although California may have a reputation for pricey real estate and low cap rates, that is not the case in the Central Valley. Cap rates for stabilized office buildings are typically about 7.5 percent, while rates for grocery-anchored retail are between 6.75 percent to 7.0 percent and multifamily assets are in the 5.5 percent to 6.0 percent range, according to CoStar. Cap rates are even higher for assets with a value-add component. Investors find it is a lot easier to achieve IRRs in the mid-teens without the level of risk typically found in a primary market.

The Central Valley is a classic example of a secondary market that is being discovered by institutional capital. It is in the early stages of transitioning away from local and regional ownership to a larger base of institutional owners.

Currently, some of the largest owners are private investors, often second- or third-generation family members. According to CoStar, the Central Valley is home

Sacramento Apartment Market Fundamentals



Source: Colliers International, Q2 2020 to $80 billion of office buildings, most of which are owned by individuals and families. Ownership is just starting to transition, however, as some of the existing owners are aging, or as inherited properties are sold, and as a growing core group of institutional investors look to establish or expand their portfolios.

Institutional investors, such as Hines, Phillips Edison & Co. and Donahue Schriber, have been active in the Central Valley, as have several smaller investment managers, including Los Angeles–based Barker Pacific Group, Reno-based Basin Street Properties and Modesto-based Graceada Partners.

"We like the long-term fundamentals of the Central Valley because of its consistent population growth; affordability; and stable, recession-resistant, core economic sectors," says Joe Muratore, co-founder of Graceada Partners. "And post-COVID changes in business and resident preferences are only further accelerating that growth."

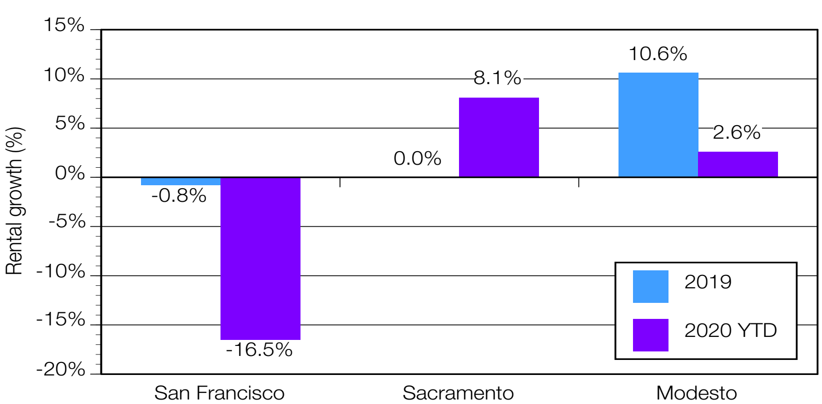
The Central Valley already has a reputation as an industrial/distribution mecca due to its central location and a solid transportation infrastructure that includes main interstates, major rail, freight and international air facilities that offer one-day turnarounds throughout the state, as well as parts of Nevada and Arizona.

In the second quarter 2020, the Central Valley's industrial market posted its 30th straight quarter of positive net absorption, according to a recent report by CBRE. The vacancy rate in Modesto is a modest 2.5 percent, while Sacramento registers 4.2 percent, and Stockton weighs in at 9.4 percent.

Perhaps the region's best story is the residential market — both multifamily and single-family housing — which has already made significant gains for investors but is primed for further increases in rents and values based on future population- and employment-growth projections.

Of note, one-bedroom apartment rents in Sacramento climbed 61 percent between July 2015 and July 2020, according to Zumper, while the city's median home price increased 44 percent during the same time period, according to Zillow. The Modesto market experienced similar increases during that time, with apartment rents up 51 percent and home values up 39 percent. For only the four months ended August 2020, Sacramento saw a 17.3 percent increase in one-bedroom apartment rent, while San Francisco has seen a 16.2 percent drop over the same period due to relocations, as post-COVID preferences continue shifting in favor of the Central Valley.

Average rents for one-bedroom apartments



Source: Zumper

The office market in the Central Valley continues to see record-low vacancy because rental rates have not kept pace with construction-cost increases, leading to virtually no new inventory in more than a decade. Fresno and Sacramento office vacancy stand at 7.5 percent and 10.1 percent, respectively, according to CoStar. The large government sector provides a base for office occupancy in the region.

With post-COVID changes in office use, the Central Valley is set to benefit, as most of the inventory is low-density, suburban style with ample open space, convenient access and lower occupancy costs.

MARKET PROFILES

SACRAMENTO

- Greater Sacramento is the largest metro in the Central Valley, with a population of 2.6 million residents.
- As California's capital, the government sector — the second-largest in the country behind Washington, D.C. — is a key component to the city's economy.
- Healthcare has been a big driver of growth during the past decade, and the region is also seeing notable growth in ag tech, life sciences and fintech.
- The multifamily sector ended 2019 with near-cyclical-low vacancies (3.4 percent) and strong rent growth (6.5 percent).
- With its high concentration of jobs in the government, healthcare and financial services sectors, Sacramento has a healthy office vacancy rate of 10.1 percent.

BAKERSFIELD

- The Bakersfield MSA ranks third among large U.S. metros for most diversified economies, with a mix of industry clusters that includes oil and gas, aerospace and defense, agriculture, and healthcare.
- With a 2019 population growth rate of 1.7 percent, Bakersfield was recognized as the state's second-fastest-growing large metro.
- Relatively affordable housing in Bakersfield continues to attract a steady flow of residents from expensive markets in SoCal.
- Strategically located next to the state's largest population center — Los Angeles — Kern County is home to more than 50 major distribution centers, including those for Amazon, Dollar General, IKEA, Ross, Target and Walmart.
- In July, Amazon announced plans to build a 2.5 million-square-foot distribution center near the Bakersfield airport.

FRESNO

- Fresno is the state's fifth-largest city and is located approximately three hours from both the Los Angeles and San Francisco population centers.
- Although Fresno County is the nation's No. 1 agriculture-producing county, the region's employment base is expanding through growth in agtech, healthcare, manufacturing, and transportation and warehousing.
- Located in one of the state's fastest-growing counties, apartment rents in Fresno climbed 7 percent in 2019; however, they still rank among the most affordable in the state.
- Fresno industrial market inventory totals approximately 71 million square feet, with a vacancy rate below 4 percent in early 2020.

STOCKTON & MODESTO

- The two neighboring counties of San Joaquin (Stockton) and Stanislaus (Modesto), combined are home to nearly 1 million people, and a growing base of residents commuting to higher-paying jobs in the Bay Area.
- As an affordable alternative to the Bay Area, especially with increased telecommuting, the Stockton and Modesto markets saw increases of 50 percent and 38 percent, respectively, in two-bedroom apartment rents between August 2016 and 2020.
- Both cities enjoy strategic locations and infrastructure access — transit modes include the Port of Stockton, Union Pacific Railroad; BNSF Railway; Stockton Metropolitan Airport; Interstates 5, 205 and 580 and Highway 99 — that make them ideal warehouse and distribution centers.
- The Stockton industrial market has more than 36 million square feet of net rentable space, while Modesto has nearly 19 million net rentable square feet.
- Amazon operates five large fulfillment centers in the area and has plans for a major expansion at the Stockton airport for bringing in air cargo.

Sources: California Department of Finance, CBRE Research, Colliers International, Kern County Economic Development Corp., Marcus & Millichap, RENTcafé, WalletHub

OUTLOOK

The Central Valley has certainly not been immune to the negative effects of COVID-19. Although the course of the virus and full economic impacts related to it are still playing out, there is widespread speculation the pandemic may create some longer-lasting shifts that will benefit the Central Valley economy. It could also fuel more residential and business growth in the Central Valley as people look to move out of the state's more expensive major urban centers. A more permanent shift to remote working, at least part-time, could make the Central Valley even more attractive as a cost-effective housing alternative for residents in the Bay Area, especially if workers only have to commute into an office a few times a week. As many manufacturers look toward reshoring to strengthen their supply and production lines, this could also bode well for less-expensive labor markets such as the Central Valley.

Investors are also taking note of a potential game changer ahead: The long-awaited arrival of high-speed rail could deliver greater connectivity to both Los Angeles and the Bay Area, and further accelerate economic growth across the region. The Fresno to Bakersfield section is part of the first phase of California's high-speed rail system that will eventually provide essential connections between the Central Valley, San Francisco and the Los Angeles Basin, with stations in downtown Fresno and downtown Bakersfield. The first operational segment of the rail line between the San Joaquin Valley and Silicon Valley is tentatively scheduled for 2025, with a 500-mile system connecting San Francisco to Los Angeles projected by 2029.

The prospects of continuing population and job growth — as well as higher risk-adjusted returns — position the Central Valley as an interesting and attractive opportunity for real estate investors. Many sectors currently boast solid real estate fundamentals — from office and multifamily in Sacramento to industrial/logistics in Stockton, Modesto and Fresno — and positive demographic trends should provide investors with both income and growth potential.

Investing in these growing Central Valley property markets will require local expertise and a keen understanding of local market dynamics. There is less transparency with smaller markets and submarkets, fewer institutional-quality assets, and greater price sensitivity on the buying opportunities for both stabilized and value-add properties. An insider's view of local property markets, players and tenants is critically important to sourcing deals and understanding asset value. So, while opportunities exist for commercial real estate investment — and more runway ahead — navigating the nuances of the distinct markets and avoiding potential missteps will require partnerships with local players who have boots-on-the-ground knowledge, experience and insights.

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