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Black Creek Research Insights

What Rising Rates Could Mean For Commercial Real Estate Investors

APRIL 2018

Interest rates have begun trending up following a long period of declines from mid-2006 to late 2017, when the benchmark 10-year U.S. treasury rate averaged less than 2.9% and approached as little as 1.5%. Spurred by low unemployment and inflation, the Federal Reserve has stated its intention to continue increasing the federal funds rate. The financial markets have responded with a correction in stock and bond prices, and a steepening of the implied forward yield curve. Investors are betting rates will continue to rise, and while markets do not always get it right, 2018 has seen a quickening in wage gains and consumer price growth, setting the stage for future rate increases.

For commercial real estate (CRE), rising interest rates could mark the end of declining capitalization (cap) rates. However, several important cyclical real estate market factors are working to keep cap rates low.

These cyclical factors include low vacancy rates, strong embedded rent growth[1], strong CRE investment liquidity and rising foreign direct investment, and persistently wide risk premiums in the spreads between CRE capitalization rates and the 10-year U.S. treasury rate. The last point — that CRE cap rate spreads remain wide despite record price levels — is worth reemphasizing: headed into 2018, cap rate spreads were approximately twice as wide as they were at the peak of the last CRE market cycle that ended in 2007.

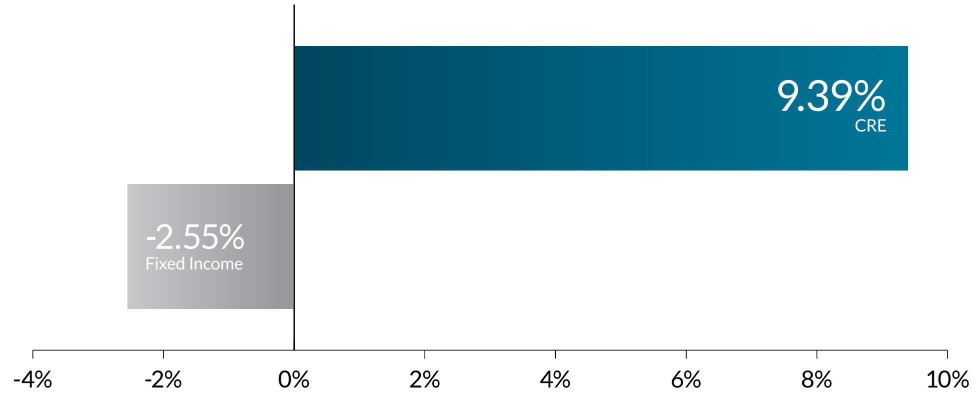
Usually, rising interest rates accompany rising inflation,[2] and in such a scenario, CRE is an effective hedge: historically, it has generated average annual returns of about 9.4% during periods of rising interest rates.[3] CRE's performance has been favorable relative to fixed income, which produced -2.6% returns during periods when interest rates rose.

CRE Performance Has Been Favorable Relative to Fixed Income

Average Annualized Returns During Periods of Rising Interest Rates[3]

CRE realized ***positive*** returns in **9 out of 10 periods**

Fixed income realized ***negative*** returns in **8 out of 10 periods**



Structural Factors Responsible for CRE's Strong Performance When Interest Rates Rise

Built-In Inflation Protection[2]

Real estate leases have built-in inflation protection: building owners pass through increases in operating expenses to tenants, and many leases contain provisions for fixed rent increases.

Insulation Against Downside Volatility[4]

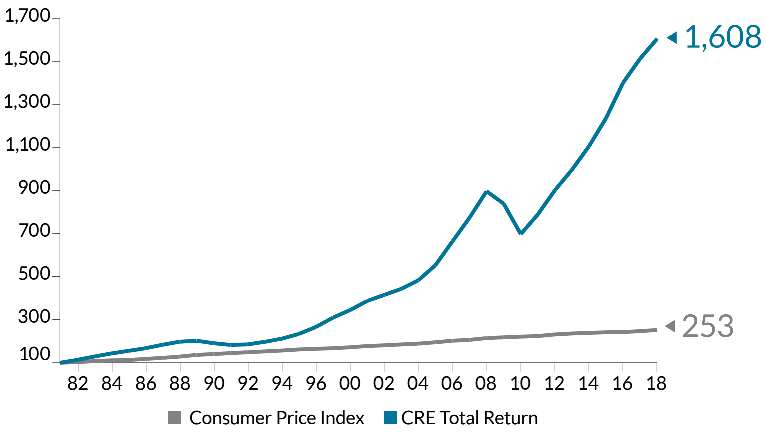
CRE returns have historically comprised about four-fifths income and one-fifth appreciation,[5] providing insulation against downside volatility since most leases last several years. Compared with fixed income, CRE has the added benefit of yield growth in a rising market, as rents on in-place leases reset to higher market rents.

Income Growth Outpacing Cap Rate Changes[4]

Income growth usually exceeds cap rate changes during inflationary periods, with average annual income growth outpacing cap rate changes by a margin of 2.4% when inflation was at least 3%.[6]

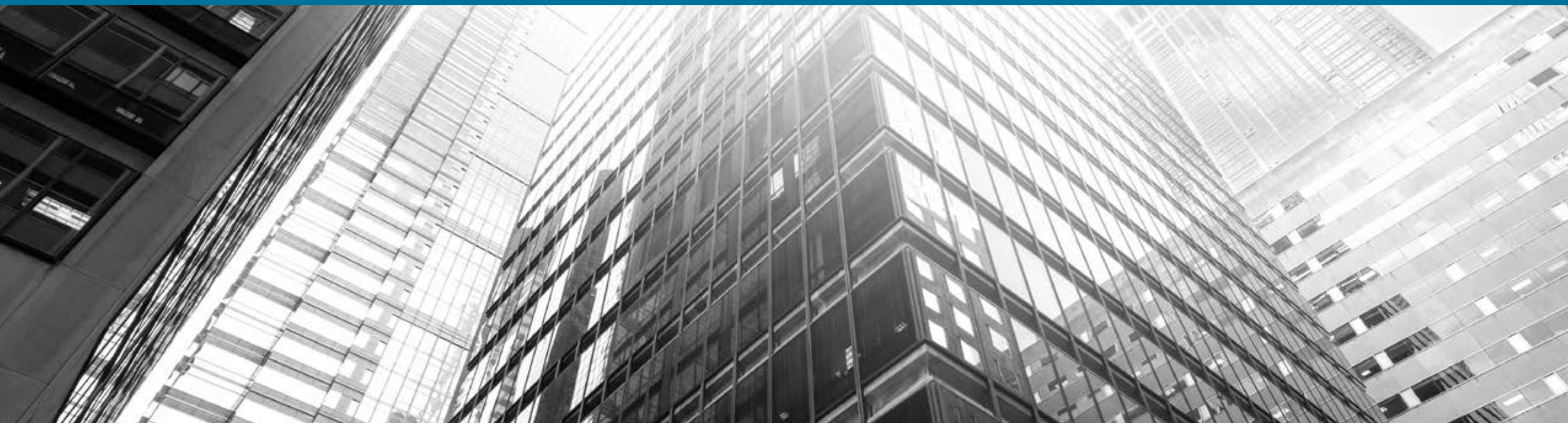
CRE Has Significantly Outperformed Inflation[2]

CRE Total Return and Inflation[7] Indexed, 1982=100



Beyond performing well when interest rates rise, CRE has provided a good inflation hedge: $100 invested in CRE in 1982 would have returned $1,608 including the initial investment, compared with $253 invested at the rate of inflation.[2]

Investors who are concerned about rising interest rates and inflation should consider owning commercial real estate for its strong historical performance during rising interest rate periods and as an effective hedge against inflation.[2]



[1] Embedded rent growth refers to the revenue gains building owners receive when in-place leases reset to higher market rents.
[2] Although commercial real estate has historically provided returns that have exceeded inflation, there is no guarantee that the REITs sponsored by Black Creek Group LLC can generate the returns necessary to exceed inflation. Investing in commercial real estate does not eliminate the risk of loss.
[3] Per National Association of Real Estate Investment Fiduciaries (NCREIF) data. Average of total returns in all quarters since 1982 when 10-year treasury rates ended higher than the last quarter. An investment in a non-traded REIT sponsored by Black Creek Group LLC is not a direct investment in commercial real estate, but rather an investment in a REIT that owns commercial real estate, and has material differences from investing directly in commercial real estate. An investment in a non-traded REIT sponsored by Black Creek Group LLC is subject to upfront selling commissions and dealer manager fees, distribution fees and advisory fees and expenses, as well as certain risks specifically applicable to an investment in the securities of a non-listed REIT, which may adversely impact the value of an investment in the REIT's common stock. For more information, please refer to the applicable prospectus. Capitalization rates are based on a property's projected net operating income from the in-place leases for the 12 months after the date of purchase, including any contractual rent increases contained in such leases for those 12 months, divided by the purchase price for the property, exclusive of acquisition costs and fees.
[4] Many REITs do not produce income but still pay distributions. These distributions may represent a return of capital. There is no guarantee that shareholders will receive distributions or that an investment in the REITs sponsored by Black Creek Group LLC will be profitable or that the REITs will realize growth in the value of their assets. A REIT's distributions may be paid from sources other than cash flows from operating activities, such as cash flows from financing activities, which may include net proceeds from primary shares sold and borrowings (including borrowings secured by a REIT's assets). A REIT's future distributions may be paid from these sources as well as proceeds from the sales of assets, proceeds from the issuance of shares pursuant to the REIT's distribution reinvestment plan cash resulting from a waiver or deferral of fees, and interest income from its cash balances. There is no limit on distributions that may be made from these sources. To the extent a REIT pays distributions from sources other than cash flows from operating activities, it may have less funds available for the acquisition of properties, and stockholders' overall return may be reduced.
[5] Per NCREIF data.
[6] Per NCREIF data. Average of appreciation return in all quarters since 1982 when the consumer price index (CPI) was at least 3% higher than a year before.
[7] Sources: NCREIF, Bureau of Labor Statistics.

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BCG-RET-MI-RR-OCT18