EverestHoldings

January 2015

Phoenix Housing Market Update

OVERVIEW

As we begin 2015, most home builders are trying to put 2014 behind them as one of the more disappointing years in recent history. Despite some optimism at the end of 2013 that the continued economic recovery would create demand for new housing, that demand never materialized. In some areas the demand actually softened. However the demographic data suggests that the next few years could see a strong recovery from pent up demand. For multifamily developers, the market is showing signs of strength as many prospective buyers find that they have been priced out of the housing market. This is especially true of the desirable infill areas where rents remain attractive compared to for sale housing costs. Demand fundamentals look attractive but developers will need to manage the pace of growth to avoid overbuilding.

DEMOGRAPHICS

Under a normal recovery scenario the market demand for new homes would be much stronger than what we have experienced. Looking back at census data to 1959, we can see that on average there were 1,370,000 new housing units built each year (multifamily and single family). When we look at the data for just single family homes, the 50+ year average is just under 1,000,000 units. In 2013 there were a mere 620,000 single family units built and 370,000 multifamily units constructed.

In short, the multifamily market appears to have made significant strides toward a recovery, however single family construction is still 40% below the 50 year average. This is especially confounding given the demographic shifts already underway. Millennials, generally characterized as those born between 1982 and 2000, are entering the prime home buying years as the leading edge of Millennials is now in their early thirties.

Most industry observers expected this to create strong demand for new homes; however the last few years have been disappointing. The causes are twofold; 1) Millennials have been some of the hardest hit since the recession and continue to show unemployment and underemployment well above Gen X's and Baby Boomers, and 2) Millennials have thus far delayed major life decisions like marriage and kids which are key catalysts in household formation. Many have referred to Millennials as the boomerang generation given their propensity to return to their parent's home after college or some period of independence. Once this group starts to form households at a more normalized rate, expect a significant pop in housing starts.

OUTLOOK

The economic outlook for 2015 is generally positive. Among the housing experts we follow there seems to be a consensus for job growth, corporate earnings and wage growth are all positive. These in turn should lead to better household formation and buying power for potential homebuyers. This bodes well for both multifamily and new home sales. The jury is still out on how the drop in oil prices may affect housing. For Phoenix it should not have a significant impact as we are not reliant upon oil and gas as an industry. Texas, however, may get hit later in the year depending on how low oil prices stay depressed.

We are also watching the mortgage industry closely. It was recently announcements that mortgage insurance rates will be reduced by almost half ($900 per year), however we do not expect a significant impact will be seen in our market. Raising FHA mortgage limits would be a huge deal, but that is not on the horizon as far as we know.

On a national level the average forecasts for new home permits is for a 15-20% increase. This would be a strong result and have a significant impact on construction jobs. In Phoenix, we are expecting similar growth. While this would still put us well below historical norms, it would be a significant improvement on 2014. Multifamily should have another strong year as there is a solid pipeline of projects under construction and vacancies have remained near historical lows.

INSIDER KNOWLEDGE:

- The leading edge of Millennials had the highest homeownership rate in history from age 25-29. They now have the lowest homeownership rate in history from age 30-34. What happened? The short answer is they bought at the peak of the market and lost a home to a foreclosure or short sale. This is a long term issue that will play out over the next 3-5 years.

- Private label mortgage lenders (i.e. non government backed) accounted for 20% of the total market before the recession. Now they represent just 3% of the market.

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INSIDER KNOWLEDGE (CONT'D)

- Short term recovery in housing is dependent on jobs and more jobs. Although job growth has been good over the last few months, too many of the jobs are low-mid wage positions that have not done much to boost home sales.

- Homeownership rate in the Phoenix metro peaked at more than 73% in mid-2006 at the peak of the housing boom. It has bounced around in the 60-63% range since mid-2011. Good for multifamily developers, not so much for homebuilders.

- Student debt is a significant issue that is not mentioned much in the housing discussion. The percentage of homes sold to first-time homebuyers, the most likely buyers to owe student debt, fell to 29% this year compared with the long-term average of 40%. Another study has suggested that student loan debt has caused an 8% drop in home sales among Americans ages 20-39.

- The perception that Millennials don't want to own is false --- a Trulia survey found 78% say home ownership is part of their personal American Dream, up from 65% in 2011.

OPPORTUNITIES:

Taking into account these factors, we evaluate on an ongoing basis the types of investments we are pursuing and how the general market opportunities fit with our investment platforms. Here are some of the key takeaways from that analysis.

SINGLE FAMIY RESIDENTIAL

Given the current lull in housing activity we are finding investment opportunities in submarkets where builders have not yet saturated the market. Examples include areas like Maricopa, Surprise, Hunt Highway corridor and Queen Creek, just to name a few. These are municipalities that have the existing infrastructure to support large scale housing development, have needed services to support population growth and are within reasonable commute times to major employment centers. With the lack of builder demand we believe there is a window of time where land can be purchased and entitled for residential development in anticipation of a more healthy housing market.

There have also been significant investments from both institutional and high net worth individuals in single family for-rent housing. In our view this opportunity has been 'played out' as there are few remaining foreclosures and short sales.

Another investment platform is land banking for builders. While there was decent transaction volume that took place in 2012-2013, the slowdown in housing last year meant there was very little deal volume. Until we see a dramatic rise in permits (and better pricing), we do not anticipate actively pursuing land bank deals.

For longer term investments, we believe that acquiring large tracts of land in the path of growth can provide attractive returns in high growth markets. Some of the key factors for path of growth investment include finding parcels with distressed sellers in locations where infrastructure (i.e. roads, utilities, etc..) are existing or near completion.

MULTIFAMILY

Of all the sectors we track, Multifamily is the closest to full recovery since the recession. As of 3Q14 there were more than 7,500 units under construction in the Phoenix MSA. Tempe and Scottsdale account for nearly 60% of the projects under construction so the new units are coming to a somewhat concentrated area. Given the stage of recovery, the multifamily market is operating efficiently and not lacking capital for investment or the kinds of dislocations that we normally see with other investment opportunities.

However there are potential investment opportunities that could play out in the coming years; 1) similar to our single family strategy finding apartment sites in the next areas to develop (2-3 years out) that can be purchased at compelling values, 2) infill projects that can be rezoned to multifamily given sufficient time and 3) land banking or land joint ventures with seasoned apartment developers.

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