ELMTREE FUNDS
TRACKER
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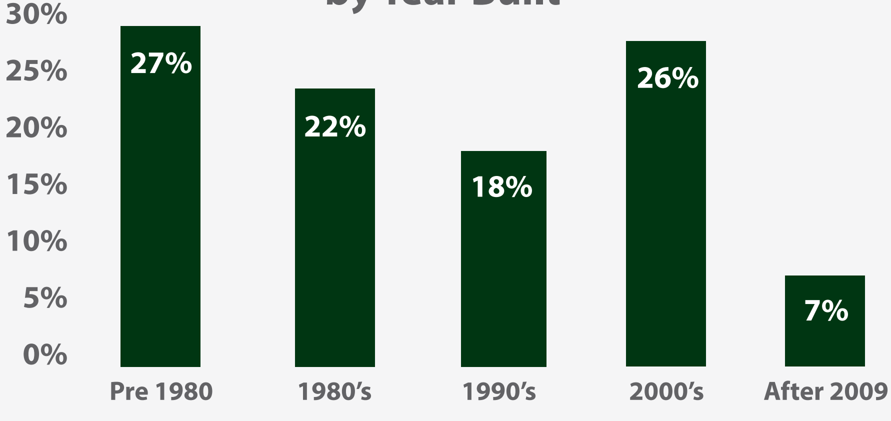
IN THIS ISSUE

2015 market**Outlook**

Over the past year healthcare real estate, which includes medical office buildings, hospitals, freestanding emergency centers, urgent care centers, ambulatory outpatient centers, skilled nursing facilities, and assisted living facilities among other property types, has emerged as one of the hottest property types for net lease investors. Increased investor appetite for such assets is a result of several factors including an increasingly aging asset inventory, an increasingly aging U.S. population, and a shift in consumer preference. These factors combine to create a landscape where healthcare providers need to seriously reconsider the ways in which they execute their real estate strategies in order to fully maximize their operations.

Healthcare providers have chosen to operate out of existing facilities rather than build new facilities that better meet patient needs. This trend is common for most healthcare asset types but has been most evident in the medical office property sector. According to Revista, a medical real estate data collector and provider, approximately 63% of the medical office assets it tracks were built before 2000. This creates two problems for healthcare providers. First, older assets are typically more expensive to maintain. If these assets are leased utilizing a NNN lease structure, the tenant often finds itself outlaying significant amounts of capital to repair and/or upgrade the facility which may otherwise be deployed into core business operations. Secondly, as the healthcare industry moves from a fee-for-service reimbursement model to a value based reimbursement model, tenants utilizing older facilities face increased financial risk if the older assets are unable to provide the same quality of care that patients receive in newer facilities.

Percentage of MOB Stock (total properties) by Year Built

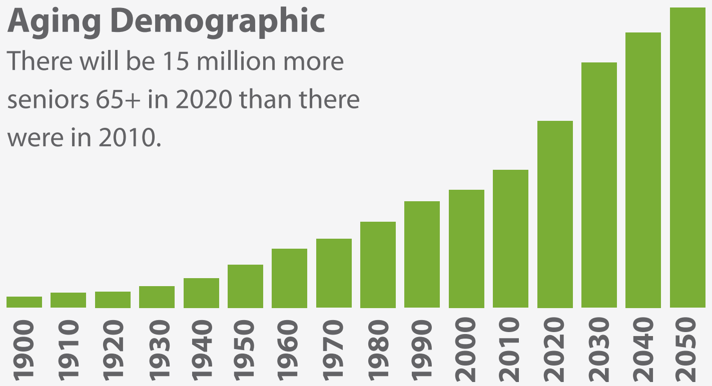


Similar to the healthcare asset inventory, the U.S. population is also increasingly aging. According to the U.S. Census Bureau, there will be 15 million more seniors aged 65 and older in 2020 than there were in 2010 with increasingly older populations extending past 2050. In order to put these statistics into context, it's important to understand the health service utilization rates of the older cohort of the U.S. population. According to Revista, more than 66% of seniors aged 65 or older visit a medical provider more than three times a year. And although Americans are living longer, they are not necessarily living healthier lives.

2015 market**Outlook** (continued)

Aging Demographic

There will be 15 million more seniors 65+ in 2020 than there were in 2010.



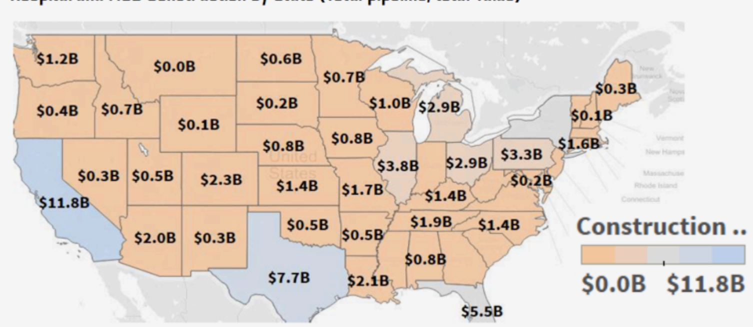
Population 65+ by Age
Source U.S. Census Bureau

Even with advances in modern medicine, the elderly population continues to suffer from chronic illness at an increasing rate. There are some estimates that by 2030, more than 170 million Americans will be afflicted by chronic illness. Consequently, these patients will need extensive long-term care that will force health care providers to significantly expand their capabilities in the future. Furthermore, not only are U.S. demographics changing, but also consumer preferences.

Now more than ever consumer preference is impacting the healthcare industry. The primary driver behind the shift in consumer preference is that individuals place a higher value on convenience and cost transparency rather than brand quality. Patients are increasingly opting to receive healthcare services at retail clinics, emergency hospitals, and urgent care centers that are conveniently located in the communities in which they live rather than the traditional larger hospitals and physician practices. According to PwC's Health Research Institute survey, 23% of respondents sought healthcare treatment in retail clinics and 73% of such respondents indicated they would use that service again in the future. These figures have nearly tripled since 2007, when only 9.3% of respondents sought healthcare treatment in retail clinics. These facts underscore the need for healthcare providers to reconsider how they execute their real estate strategies as it relates to their healthcare delivery model. In order for healthcare organizations to broaden their patient base and increase their market share, they need to place less emphasis on delivering care through the traditional hospital campus and employ a more retail based delivery strategy that reaches patients in the areas where they live and work.

The combination of an old asset inventory, an aging U.S. population, and a shift in consumer preference highlights the fact that the healthcare industry needs to drastically reconsider the ways it utilizes its real assets to provide healthcare services and meet patient needs. In order to combat this changing landscape, healthcare providers are partnering with real estate professionals to develop new assets that better serve their customers. As shown on the map below, provided by Revista, there is hospital and medical office building construction activity in almost all U.S. states. This phenomenon has tremendous consequences for the real estate industry. Real estate companies who understand the healthcare industry and have expertise in capital markets and real estate development will gain a competitive advantage and fulfill a key role as healthcare providers continue to address the changing healthcare environment.

Hospital and MOB Construction by State (Total pipeline, total value)



Older assets and an older U.S. population as well as a shift in consumer preference have placed tremendous pressure on healthcare providers to adapt to changing conditions. This has led healthcare providers to reconsider the ways in which they execute their real estate strategy to serve their patients. Such reconsideration has spurred medical real estate development which should continue to drive growth in the property sector.

Net Lease Market Update

Banks Implement Basel III

Under the Basel III legislation, lead banks on large construction loans are adopting a strict interpretation of the law that limits borrowers' ability to capture cashflow from projects as they near completion. The rules require that banks hold more capital against "high-volatility commercial real estate" loans than against most loans on their books. Construction loans generally fall into that category – but can be exempted if they meet certain standards.

For a loan to be exempt, leverage must be less than 80% and the borrower's equity contribution must be at least 15% of the project's "as completed value". In addition, the capital put up by the borrower – or generated by the project – cannot be withdrawn until the loan is repaid or converted to permanent financing.

For loans falling into the high volatility category, banks are required to hold capital against 12% of the balance as opposed to 8% for loans that are not deemed high volatility. This pushes loan pricing higher, as banks increase spreads to account for the higher capital charge. In order to achieve optimal pricing, borrowers have an incentive to qualify for exemptions, which often means losing their ability to reap revenue from a development that leases up while the construction loan is in place.

Story from Commercial Mortgage Alert, October 16, 2015 Edition

The implementation of Basel III may create immediate issues for developers that have been relying on the favorable lending environment that has driven leverage levels to 90-95 percent LTC, specifically for build to suit properties leased to investment grade tenants. The high advance rates by banks coupled with a forward contract by a take-out purchaser was the optimal capital structure for most developers over the past 24 months. With the implementation of Basel III, the economics of a forward take-out and the need for more equity will drive developers to seek an alternative source of capital, mainly gap equity or a capital partner that can cater to their need for 100 percent financing. Capital sources that are nimble and can provide construction financing, such as ElmTree, will reap the benefits of Basel III.

Takeover Loans Have Few Takers on Wall Street

Wall Street banks are struggling to sell billions of dollars of loans they made to finance the corporate buyout boom, a sign that investor appetite for riskier debt remains muted despite a robust autumn rally in other financial markets. The slowdown threatens to cool the surge in mergers-and-acquisitions that has sent takeover volume in 2015 to record levels, thanks in part to easy credit.

For now, loan investors have lost their appetite only for the riskiest deals while relatively high junk credit ratings still attract buyers. Investment banks are growing reluctant to back new deals with heavier debt loads or in troubled industries like energy and pharmaceuticals. That in turn makes it harder for potential acquirers to capture takeover targets. The stresses contrast to a boom in sales of debt considered less risky, or investment grade. The banks must sell the loans by year's end to minimize holdings of risky assets that require capital charges under new regulations. But buyers have lost their taste for riskier loans because prices of such debt dropped sharply in September and October, saddling investors with losses.

Now bankers are being forced to heavily discount the new loans to clear their balance sheets, investors and bankers say. Banks must make up much of the difference when loans they make are sold at discounts by giving up their fees or taking losses, an unwelcome prospect at a time when M&A deal-making has emerged as one of their strongest businesses.

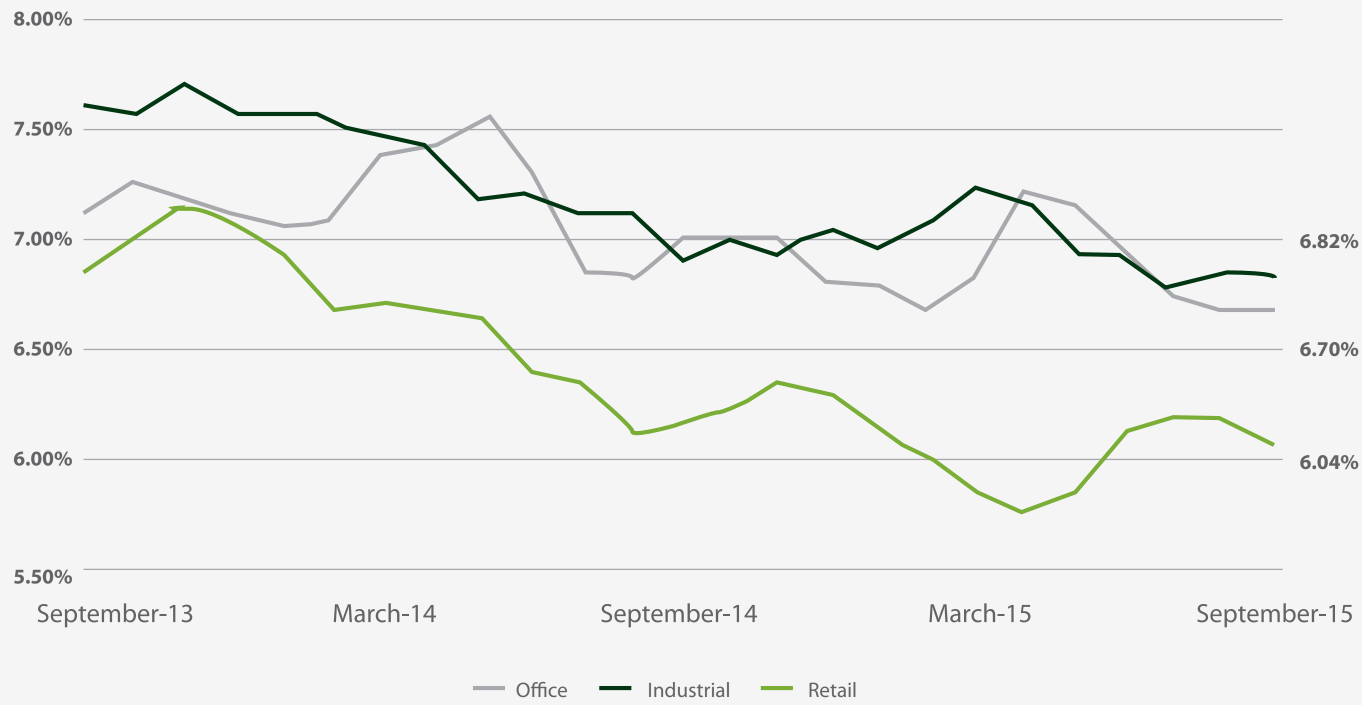
Story from Wall Street Journal Article, "Takeover Loans Have Few Takers on Wall Street". November 8, 2015

The pushback from credit investors on buying junk paper should be a sign that easy money has temporarily left the market. This is potential foreshadowing that the market has hit a peak, and growth may stabilize and flatten since fundamentals seem to be in line in this historically low interest rate environment.

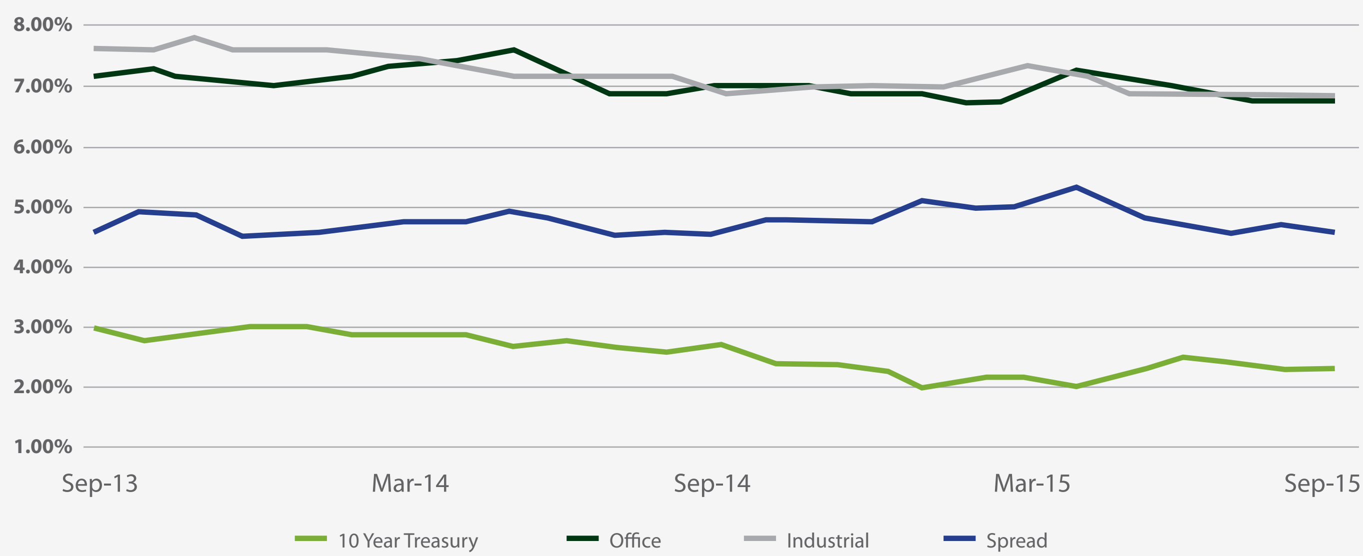
The tightening of credit from banks will force private equity sponsors to finance and leverage their acquisitions in another format. ElmTree believes that this will create several sale-leaseback opportunities with middle market or non-investment grade companies that cannot readily access the debt capital markets. Exit cap rates for sale-leasebacks result in an accretive multiple to monetize corporate owned real estate with multiples ranging from 10 to 14 times. With the capital markets closed for junk credit, the sale leaseback is a sophisticated solution that enables a private equity fund to capitalize their acquisition especially for an operating company with a heavy real estate footprint.

Net Lease Market Update (continued)

Net Lease Sector Cap Rates



NNN Cap Rates vs. 10-Year Treasury Yield



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