The Pinkard Fund

Investor Update

October 2013

Market Update

Over the last few quarters we have discussed in this report some of the same market trends as they unfold in a rather predictable way – oversupplied apartment market, under demand in the office market and a recovering housing market. This time we will focus on how our views differ from conventional wisdom and how we are aligning our investment strategy with our views.

But first, let's discuss underwriting. When we underwrite the acquisition of a property, we collect a lot of data, we talk to experts and we run a lot of analysis to come up with our view of how a property will perform. We also run sensitivity analysis to gage both upside and downside potential and to fully understand the risks we are taking. All of this research and modeling goes into our pricing model and allows us to form a view on value. The problem is that despite the substantial time and effort that goes into the model, properties never perform as underwritten because many of our assumptions are based upon our view of the future, an imprecise science to be sure. So once the model is complete we ask ourselves what are the chances that we will beat our underwriting, and what are the chances that we will fall short?

Here are two examples. One is the conventional view of the apartment market by one of the well-respected market research firms in DC and the other is the actual underwriting of a suburban office building that we just completed. The apartment market view is this: There are approximately 15,000 apartment units which will deliver in the Washington region in 2014 and another 15,000 units in 2015. Given that the DC region absorbs about 6,000 units per year, it seems like the market will be oversupplied. However, according to the data, we have absorbed 9000 units in the first three quarters of 2013 and the shift in households from owners to renters, the large number of people in the Gen Y cohort that are living at home temporarily and the sheer number of Gen Y young adults that we have produced will drive higher demand over the next few years. Therefore, we will have modest rent declines in 2014 and 2015 (1-2% per year) and then rents will begin to go back up in 2016 and 2017. It is called a soft landing. Maybe that will all happen, but it seems to us that market underperformance is way more likely than out performance.

The other example is a suburban office building that we are considering buying. It is a 100,000 square foot, high quality office building that is 40% leased. We can buy the building for about 50% of the cost to reproduce it. The office market in the suburbs is still pretty grim, so we have projected that it will take us 2 ½ years to lease the remaining 60,000 square feet. In a normalized market we would predict lease up of the vacant space would take 6-12 months. We like the odds that we can do better than our underwriting.

From a risk perspective purchasing a distressed asset class at 50% of replacement cost seems to us a safer bet than wading into an apartment market that needs historically high levels of demand to perform moderately well. That is why we have been shifting our attention toward the office market and reducing our exposure to apartments.