

The Pinkard Fund

Investor Update

April 2015

Market Update

For Q1 2015

In 1981 Ronald Reagan stormed into The Oval Office with the pledge to restore America's leadership and power around the world. Thus began one of the largest increases in defense spending since World War II. Those of us in the Washington region were expecting a booming real estate market as increased federal spending led to new contracts, hiring and office space expansion. However, it took until 1983 for the cycle of passed legislation, appropriations, contract bidding, and ultimately, contractors hiring and taking office space to play out. We knew an expansion was taking place; it just seemed to take forever for the market to feel it.

The same delay phenomenon is happening in reverse today in the Washington region. From FY 2010 through FY 2013 federal spending on procurement fell by \$13.1 billion (16%). In FY 2014 spending on procurement rose by \$2.0 billion and should rise by a similar amount in 2015. Notwithstanding the more recent rise in spending, the effect of the prior cuts is what is being felt in the market today, and in our view will continue to be felt through 2015. Tenants continue to contract and the leasing market remains listless. The good news is that job growth in the region has been increasing steadily for the last six months, and a more balanced office market is predicted for 2016 and 2017. The outlier in all of this is the 2016 Obama budget which calls for a 16.1% increase in defense spending and other significant increases in discretionary spending. This would create a boom in the Washington market, but given the skepticism around here about Congress's ability to pass budgets, nobody is popping the champagne just yet.

While the property markets slowly recover, capital is as aggressive as we have seen it in some time. We have written about the search for yield before, thinking that cap rates couldn't fall much further. However, with the European Central Bank's buying spree of fixed income securities, bond rates in Europe have been pushed into negative territory. This combined with instability in the Middle East and other places in the world has brought capital to US real estate. Even the lowest cap rates in the US look good in comparison to negative bond rates in Europe and loss of capital in troubled areas of the world. Not surprisingly, in the last year over 50% of the office buildings sold in downtown Washington went to overseas buyers.

While there is an abundance of capital for stable, core real estate investments, the same is not true for more risky assets. There is great opportunity in these kinds of investments if one has

the stomach for the risk and the expertise to execute. The opportunity is to create core investments through entitlement, development and repositioning. However, even in the development arena buyers are accepting core returns as capital providers try to access the best properties and locations by taking on some development risk. We hear the term “build-to-core” frequently today yet that term was not part of the vocabulary just a few years ago.

With property markets tepid and capital markets on fire we are sticking to the basics by buying asset types that are early in the recovery phase and by manufacturing assets that can be sold at retail to core buyers.