The Pinkard Fund

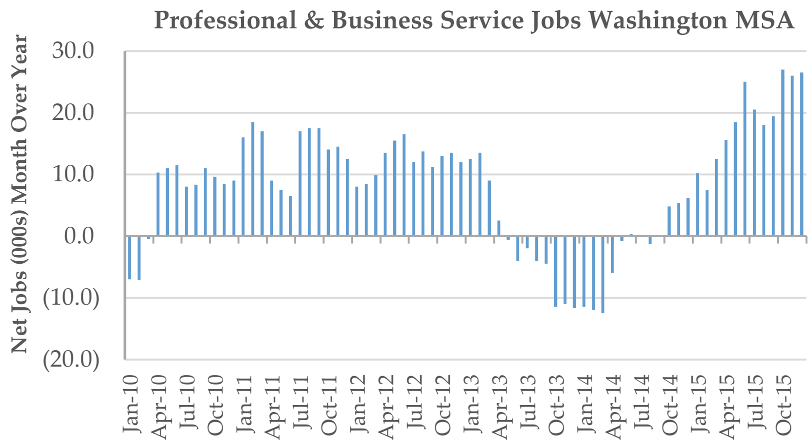
Investor Update April 2016

Market Update For Q1 2016

The astute real estate investor needs to incorporate trends in capital flows, property markets, job formation, demographics, cultural evolution and more to establish a view of which investments will perform the best over time. It is a challenging enterprise for sure, but it is also one that good investors love to take on. In this letter we will touch on several of these areas that affect the way we look at investments: the capital markets, job formation in the Washington region and the back-to-the-city movement, giving both our view and that of market observers we respect.

Recently, I attended a conference with about 50 high level real estate practitioners. When asked whether there was a greater chance of real estate cap rates rising or falling over the course of this year, there was near universal agreement that falling cap rates were more likely. Spending too much time predicting interest or cap rates can be a fool's errand, but the reasons behind the predictions are instructive. One factor keeping cap rates low is the flow of international equity into gateway markets like Washington. According to JLL, "The offshore buyer pool remains strong and is growing, further expanding liquidity and competition in the U.S. market." The second reason this group felt rates would remain low is certainly correlated to the first. It is the global search for yield. "While a 4.4% average cap rate for Manhattan office properties may seem low based on historic experience, Manhattan cap rates actually look quite high relative to the 0.3% yield on an equally-weighted portfolio of 10-year German, Japanese, Swiss, and U.S. bonds."(2016 Real Estate Outlook, The Carlyle Group). We see the same demand for core property acquisitions continuing in the Washington region. While there is more talk about bubble pricing, we don't see much in the way of overbuilding, except in apartments in some sub markets, and capital structures remain conservative.

Of greater concern is liquidity on the debt side. While life companies and banks remain active players, Basel III reserve requirements have put pressure on the banks to a shift away from construction loans toward term loans which have a lower reserve requirement. In accordance with Dodd Frank, CMBS lenders will be required to hold on their balance sheets 5% of mortgages that they securitize starting in January of 2017. This will reduce CMBS issuance and will particularly affect B and C properties where much of the CMBS activity takes place. These regulatory measures are meant to take risk out of the system, but they will affect liquidity as well.



One part of the Washington story that we have discussed previously is the acceleration of job growth in the region. The accompanying chart shows the growth of Professional and Business Services jobs from 2010 to 2015. Professional and Business Services jobs are those that are most likely to be office using jobs, and are a leading indicator of office space demand. Looking at the above chart one would think that 2015 was a great year for office leasing. While net absorption of office space in the region did move slightly into positive territory, it did not reflect the positive job growth. Our experience in past markets indicates that it takes about 18 months for shifts in the job growth numbers to be reflected in the demand for space. We look for office absorption to pick up in late 2016 or early 2017.

The evolution of Washington DC over the last five years into a dynamic live, work, play environment has been truly extraordinary. We are now seeing the leading edge of the millennial generation having children and moving to close-in neighborhoods, buying new houses, renovating and pushing into new areas of the city that have not experienced significant development in a generation or more. Cushman and Wakefield captured the vibe in their First Quarter Retail Report.

> "Fueled by a surge of population growth that has been overwhelmingly driven by the millennial demographic, Washington, D.C.'s urban retail scene has evolved over the past decade from that of a few isolated pockets surrounded by urban blight to one of an emerging renaissance where high street meets cool street meets eat street. The District is now a microcosm of all of the major trends that are shaping urban retail in the United States today; an explosion of food and beverage related retail from small format groceries and trendy food halls to upscale and fast casual dining, the expansion of upscale and luxury retailers into new and emerging shopping districts and the rise of edgy, cool retail in new hip

> districts that have emerged in diverse, up and coming neighborhoods. All this, while still luring Main Street national credit retailers looking to find a place in the new Washington, DC: The Capitol of Retail Trends."

It is an exciting time to be investing in the Washington region with capital coming from all over the world, people coming from all over the world and employment opportunities expanding across the region.