The Pinkard Fund I

Investor Update July 2017

Market Update For Q2 2017

Good investors love periods of uncertainty because they produce more opportunities. Uncertainty by its very definition means that participants in the marketplace have a wider range of views as to what is currently happening and what is likely to happen in the future. This kind of environment is often created by conflicting data yielding different interpretations, but also data conflicting with logic. It makes investing hard but often fruitful.

This is all an introduction to pointing out that there is a real difference between some of the data and what is happening on the ground in the Washington real estate market. We are lucky that unlike stock investors, a good part of the value creation in our portfolio comes from granular work at the asset level that is meant to improve value independent of the market, but buying the right assets and asset classes at the right time is an important part of our investment thesis. In other words what we see on the ground has to line up with the data that we follow to give us the conviction to invest.

One of the prime examples of a real head-scratcher for us is the downtown Washington office market. The vacancy rate of 12.3% is the highest it has been in several years and there is seven million square feet of new office space under construction. Seven projects totaling two million square feet alone broke ground in Q2. Estimates are that the Class A vacancy rate will increase beyond 20% in the next 24-months pushing net effective rents down 5-10% (JLL). We have been looking at value-add opportunities in downtown because we like the timing of investing early in the recovery cycle. However, competition for tenants looks like it will increase over the next several years. That seems to be an oddity early in the recovery cycle. Why are developers continuing to build and lenders continuing to lend on these buildings in the face of such high vacancy rates? It doesn't appear as if this is going to end well. Twenty one developments presently underway had at least 50,000 square feet of vacancy in Q2. The bail out for some may be foreign investors who are continuing to buy DC office buildings at record prices. Do they know something that we don't or is this a global capital preservation move? There have been past cycles where foreign investment peaked right at the end of the cycle. This could very well be what is happening. Stay tuned.

The housing market is another conundrum right now. Housing prices have continued to rise in the region and affordable housing is becoming a priority for all of the area's local governments. Added to this is a shift in domestic migration over the past couple of years as more people are leaving the region than entering it (this does not include foreign immigration or domestic growth). We have written about this before. But if people are leaving, shouldn't housing prices fall reflecting slackening demand? Lot prices for new housing have been generally flat which makes sense given the demographic shifts mentioned above, and rezonings have fallen off. Homebuilder sentiment is negative, reflecting higher production costs, particularly lumber in the wake of US tariffs on Canadian lumber and the resultant disruption of the lumber markets.

Apartments are still being built at a robust pace, but here again, rents have been pretty flat in most markets. The continued apartment construction boom may be a reflection of low cap rates and strong capital markets because rents are not rising in most submarkets.

While this all may sound negative, opportunities will emerge for the cautious investor and there are some bright spots. For one, the Region is creating jobs (over 50,000 year over year as of May 2017) at a faster pace than predicted, and particularly office using Professional and Business Services jobs. Second, the growth in government IT spending across a number of different agencies is a priority of this administration and this Region is well positioned to benefit. There are other bright spots that look intriguing. We will continue to look for opportunities in the robust and recovering areas of this economy, and follow closely those areas where stress and opportunity may begin to emerge.