The Pinkard Fund

Investor Update   October 2017

Market Update   For Q3 2017

Despite the daily histrionics in the White House, the real estate landscape in Washington is business as usual. The local economy is settling into this new normal which does not appear very different from many other periods. Employment is growing in Washington more rapidly than the rest of the US. Year over year job growth through August 2017 was 67,600, led by a robust private sector. This exceeds the consensus estimate by 50%. The concerns of dramatic downsizing of the Federal presence have abated as Federal employment in the region has fallen by only 1,000 jobs in the last year. To put this in perspective, the region has lost 19,000 federal jobs since 2010. The positive job growth is remarkable given the lack of participation from the Federal sector, but more so because of the historic correlation between job growth, office absorption and the amount of Federal legislation that is passed. Two surprises in the upside to the regional economy include the passing of a Federal budget with notable growth in defense spending, and secondly, a return to a more normal legislative environment where bills actually do get passed.

Not surprisingly, the housing market continues to remain strong. Prices on For-sale housing prices have risen for most product types in most sub-markets and the average number of days on the market has fallen significantly. The rental market continues to absorb a generous supply of new product and rents continue to rise, albeit slowly at 1-2%. Some submarkets, particularly in DC and Tysons Corner have seen a retreat in rental rates. We view this as a supply rather than demand problem. The complex social issue of affordable housing has become a bigger one across all of the region's juridictions which tends to happen during extended strong housing markets. Increasingly, the pressure to produce affordable housing falls to the private sector, thus generating economic challenges for developers as they wrestle with mandated affordable housing requirements.

Local economist Steve Fuller has been speaking out for several years about the region's chronic undersupply of housing based upon the large number of workers who commute to the the region but do not live here. There will continue to be excellent investment opportunities in the housing space across housing types, particularly in those that can creatively address the affordable housing conundrum.

The office building market presents an entirely different dynamic. This product type has changed more in the last five years than in the preceding thirty. Newmark recently issued a thought piece that suggested 40% of the existing office stock was obsolete. JLL reported that more office buldings have been converted to other uses in the last 2.5 years than in the previous 10. All of this is being driven by tenant demand. Today's tenants want a more relaxed, open, and collaborative environment. Companies have found they can reduce the amount of space per employee, as long as they have some space for employees to "chill out". While tenants are providing these spaces, expanded kitchens, lounges, meditative spaces, etc., owners are also providing more amenities as well such as fitness facilities, conferencing centers, barista bars, collaborative spaces and more. As tenants downsize, they can afford to pay higher per square foot rents, and move to more modern buildings that have floor to ceiling windows, few columns and higher ceilings, and of course, more amenities.

Developers are increasing the supply of new buildings to accommodate today's tenant, particularly in Downtown DC and Tysons Corner, but construction costs have risen. Rents will be high for this product and the depth of demand has yet to be tested. Older building will capture the bottom of the market or be converted to other uses. We have been selectively buying "A" quality buildings with the right "bones"and updating and amenitizing them to meet the needs of today's tenants at a significant discount to new construction. This strategy is less risky for our investors, and provides meaningful upside.

In a world where all asset classes are fully priced, investing is challenging. We have to remember that trees don't grow to the sky. While we have always had a value tilt to our investing (below replacement cost acquisitions), we are ever more focused on those aspects of investing that are secular, not cyclical, such as urbanization and the effects of ecommerce and our ability to fundamentally change the profile of each asset. If they ever do come, higher interest rates will present a challenge to valuations. We are preparing by working on the aspects of value creation that we can control. It's not glamorous; in-house we call it "grinding".