The Pinkard Fund

Investor Update July 2018

Market Update For Q2 2018

Here we are late in the cycle with the freshly passed Tax Cuts and Jobs Act of 2017 providing a lift to the economy. It's still early days, but the investment climate in the US has responded positively. After-tax corporate profits have risen due to lower tax rates, wages are rising, and the unemployment rate is falling. These are all good signs for the economy, and the hope is that we can squeeze a couple more good years out of this cycle. Of course, nobody wants to make a big move right at the top of the cycle, but who knows when that will be? Additionally, market participants are the ones who advocate staying invested to avoid getting in or out at the wrong time. They use the terms "risk on" and "risk off" to govern investment behavior. The current climate would certainly be risk off.

From a real estate perspective the calculus is a little different. That's because the asset class is illiquid and market moves are glacial compared to the stock market. The challenge in real estate is that while interest rates and cap rates are not totally correlated, the asset class is very interest-rate sensitive, particularly on the long end of the curve. While the tax cuts appear to be good for real estate investors in the short term (REIT performance led all other asset classes in Q2 performance), in a time of full employment the stimulus it provides can be inflationary. That appears to be happening. The Fed plans to continue to raise rates as CPI growth exceeds the Fed's target. The good news is that despite the rate-raising program, long term rates have not risen as much as some predicted.

So where does the active real estate investor deliver returns in such an environment? The answer is by "doing it the old fashioned way", by creating value at the property level. This requires a good investment basis, a solid capital improvement plan, and a savvy approach to market dynamics (meaning you can't just follow the herd). At the end of the day increasing net operating income (NOI) and cash flow at the property level is the goal and requires a comprehensive approach to both income and expense management. Higher NOI means higher value, even going into the teeth of rising interest rates.

Let's look at the four major investment real estate food groups: apartments, industrial, retail and office. In the current environment the investing herd continues to pursue apartments and industrial properties, driving values up and cap rates down. Apartments are still sought after investments as the movement to urban nodes continues. Industrial real estate is hot, as e-commerce disrupts brick and mortar retail, placing the emphasis on logistics where goods are delivered directly from the warehouse to the home, bypassing the retail store. Retail and office are out of favor. On the retail front e-commerce, which is only about 10% of retail sales, is projected to grow. Major retailers like Sears are on the ropes as their models can't compete with Amazon and other online retailers. The office market has been going through a right sizing movement for the past 10 years, and experiencing major changes in the way work gets done due to new technologies. More office buildings are obsolete today than ever before. Older buildings with deep floor plates, low ceiling heights, too many columns, etc. can't compete effectively for today's tenants.

Investment appetite is robust for apartments and industrial, but prices are high. Office and retail are out of favor, and prices are low. There is no surprise here. The contrarian investor should be able to find good value in the retail and office sectors, but must be careful. There are retailers and retail locations that won't be disrupted by e-commerce. Obvious examples are the fitness and restaurant sectors, but there are others. After all, e-commerce is only 10% of retail sales and many bricks and mortar retailers will not only survive but thrive. On the office front quality buildings are still selling below replacement cost. Like retail, the way in which we are using office space is being transformed. One example is the evolution of the tenant space from private offices to open floor plans. Another is the growing expectation that high quality buildings will provide multiple in-building amenities: conference centers, tenant lounges, fitness centers, all Wi-Fi enabled. Buying buildings that have "the right bones" and delivering the environment that today's tenants need should be a profitable exercise.