REAL ESTATE MARKET THOUGHTS | Q1-2017

Fund II now has two of its eight remaining investments "in the market" for sale. Plano Corporate Center in Dallas and the Offices at Pin Oak in Houston are being marketed by HFF and JLL, respectively. Both are seeing solid interest and we are optimistic about executing these dispositions. Capital contributions to those two assets by Fund II have totaled $3.54 million, and we expect to return solid multiples upon sale.

To date, Fund II has returned $13.3 million in distributions, equating to 58% of investors contributed capital, taking into account all distributions. Net asset value at the end of Q1 was estimated to be $18.5 million, which equates to a multiple of approximately 1.5 to date. Since several Fund II investments have not completed their business plans and have significant remaining potential for value accretion, we are estimating the multiple will exceed 1.7 when Fund II is concluded. Assuming successful disposition of the two assets currently in the market, we expect the amount of returned capital to approach 85% of contributions by the end of this year. At our annual meeting for Fund II in April, we provided partners an update of our estimated timeline for realization of the remaining Fund II investments and future distributions. Please feel free to contact us if you would like a copy.

Fund III completed its third acquisition in early May, purchasing a suburban office building in the Galleria (Uptown) submarket of Houston. This is the first acquisition we have been able to close in Houston since 2012, initially because values were (in our opinion) too high in 2013 and 2014, and then because owners were slow to accept the reality of much lower values after the downturn in energy markets. Transaction volumes for most types of Houston commercial real estate (CRE) plummeted in 2015 and 2016. It now appears that owners and lenders have adjusted, and Houston transaction volumes will increase in 2017, albeit at lower valuations. We continue to see reasonable opportunities in our ten target markets, although some, like Austin and Nashville are, in our opinion, fully valued at the moment. We also see opportunity in some niche product types, smaller data centers aligned in a diverse geographic network, as an example.

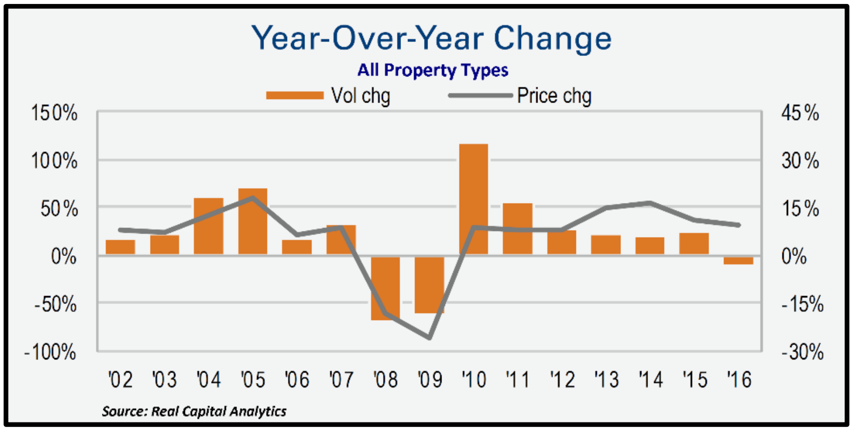
Determined readers can find our more detailed thoughts on macro-economic conditions below. Generally, we are cautiously optimistic about CRE fundamentals in the near term, but we have adjusted our underwriting metrics to build in more caution in the intermediate term, looking for defensive rent rolls in assets that still have longer term promise for meaningful upside. With this objective for early investments in Fund III, occupancy and in-place cash flows will typically be higher at the time of acquisition. One consequence of our more defensive approach is that Fund III has a higher cash yield, currently 6%, at this point in its life as compared to Fund II at a similar point.

Rising interest rates, at least on the short end of the curve, political uncertainty regarding fiscal policy changes and regulatory constraint on bank lending have created somewhat of a "pause" in CRE transaction volumes and value appreciation. What lies beyond the pause can't be known for sure, but our approach to finding value on a deal by deal basis includes carefully analyzing property and submarket performance details and should therefore continue to yield good investment prospects.

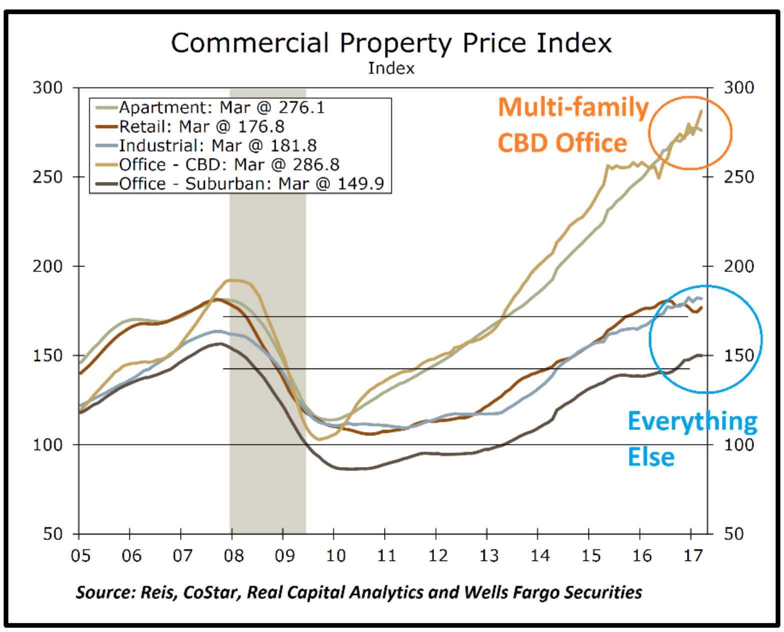
We view the "pause" as opportunity. Our credibility as a buyer gets us a prime seat at the table of sellers who must exit for various reasons, and the pause means there are less seats at that table. Hence, opportunity. Our pipeline is healthy, and we remain optimistic about the prospect for deploying Fund III's capital in profitable investments.

CRE Market Conditions

Prices gains are moderating and transaction volumes are falling across all CRE product types and the majority of geographies. Rents are still rising for both office and industrial, but at a slower pace with industrial, primarily driven by e-commerce, outperforming office. Transaction volumes and rent growth vary widely across different markets. Are we forming a top? And where is pricing relative to previous cycles? Are we, as some fear, at unsustainable valuation highs? The short answer is we are indeed at all-time highs significantly above the previous cycle peaks for multi-family and CBD office values and MAY be forming a top for those two specific product types. They are certainly "crowded trades." HOWEVER, values for all other property types **NOT** in those two categories are near their respective previous cycle highs reached in 2007, with industrial and retail slightly above previous high water marks, and suburban office slightly below. The nearby price index chart clearly illustrates this dichotomy. The chart is derived primarily from the Moody's / Real Capital Analytics Commercial Property Price Index (CPPI), which is a national index of the four primary property types (office, industrial, multi-family and retail). This is the index that is frequently reported in the financial press. Usually it is the composite index reported, which aggregates all property types together and masks the significant relative value differences between the property types. Also, because it is value weighted, the CPPI index tends to be skewed toward the highest quality properties in the larger markets.

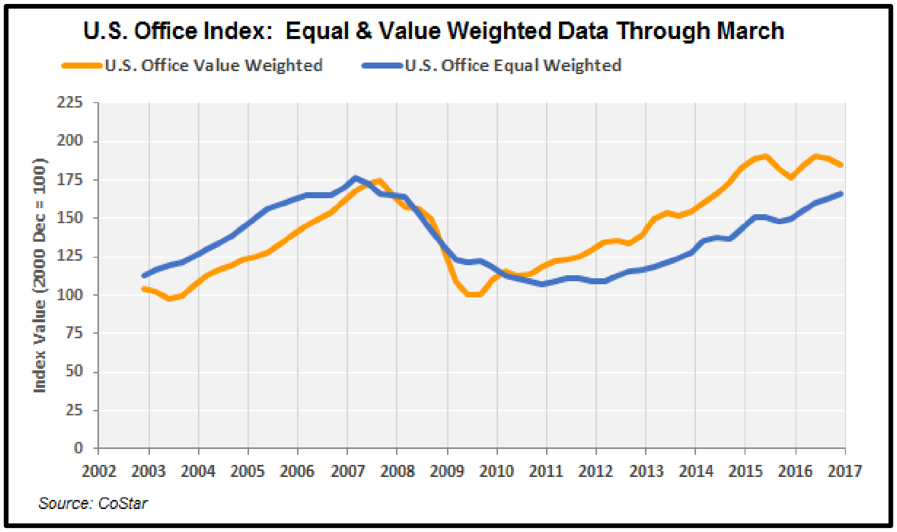


Source: Real Capital Analytics

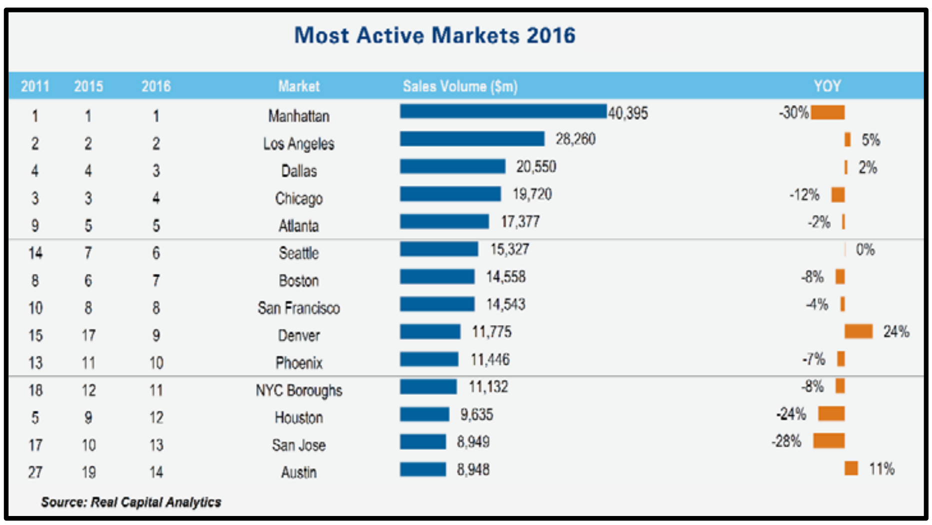


Source: Reis, CoStar, Real Capital Analytics and Wells Fargo Securities

Another source of CRE data to which we subscribe is CoStar, which publishes a number of indices tracking a broader set of properties. CoStar breaks down pricing data into two distinct categories, value weighted and equal weighted, which are reported for all four major property types. The value-weighted index is influenced by larger transactions, similar to the CPPI. The equal weighted index is broader as it gives equal weighting to the more numerous smaller transactions. We have included a chart of the two US office indices on the next page. We last reported on these valuation indices to you back in Q2-2015, and predicted that the two office indices, at the time showing a significant gap, would "converge again as this cycle matures, primarily by virtue of catch up on the part of the equal weighted index." Well…………….since then the value weighted index has fluctuated but is essentially flat, up 2 from 183 to 185, and the equal weighted index has risen steadily from 143 to 166, a gain of 23, and closing the gap between them from 40 to 19. Phew!! The broader equal weighted office index is still about 9.5% below its previous peak in Q2-2007 of 176. It is up 55% from its trough of 107 in March 2011, while the value weighted office index is up 85% trough to peak.



Similar patterns can be seen for the other property types, although, the spread between value and equal weighting for industrial is much narrower in the current cycle. Also, it is crucial to remember that different markets are at different stages in the CRE cycle. We have periodically showed you the "property clock" which illustrates how different markets (cities) have some degree of non-correlation. Most recently it was included in the Q4-2015 report. We also reported on a CBRE study of office rent correlations between markets (Q3-2015) which concluded that markets have varying degrees of correlation from strong to weak, although correlations tend to be stronger during national recessions. (Please feel free to request copies of any previous *Market Thoughts*) Adding to that list of market variance illustrations, the nearby chart shows the variance in year over year changes in transaction volumes (all property types) between markets. You can see that the change in transaction volumes varies widely from down 30% to up 24%. Our objective first and foremost is to preserve capital, and diversification amongst markets is among our most effective tools for risk mitigation.



Most Active Markets 2016

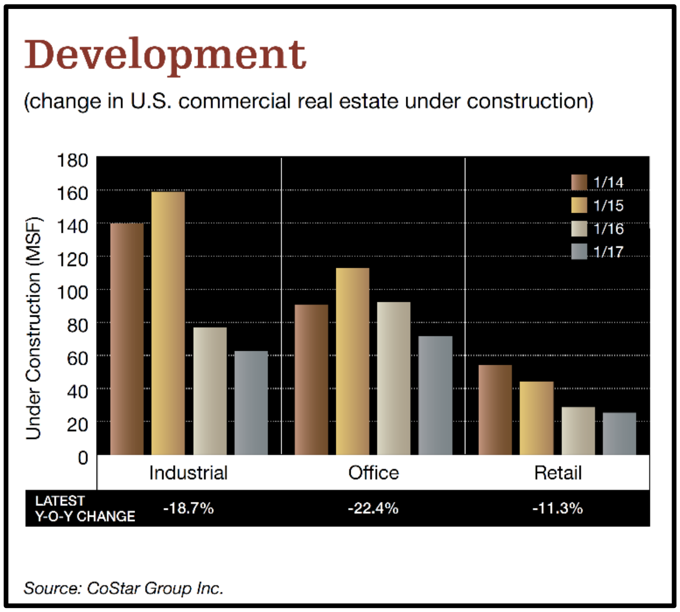
2011	2015	2016	Market	Sales Volume ($m)	YOY
1	1	1	Manhattan	40,395	-30%
2	2	2	Los Angeles	28,260	5%
4	4	3	Dallas	20,550	2%
3	3	4	Chicago	19,720	-12%
9	5	5	Atlanta	17,377	-2%
14	7	6	Seattle	15,327	0%
8	6	7	Boston	14,558	-8%
10	8	8	San Francisco	14,543	-4%
15	17	9	Denver	11,775	24%
13	11	10	Phoenix	11,446	-7%
18	12	11	NYC Boroughs	11,132	-8%
5	9	12	Houston	9,635	-24%
17	10	13	San Jose	8,949	-28%
27	19	14	Austin	8,948	11%

Source: Real Capital Analytics

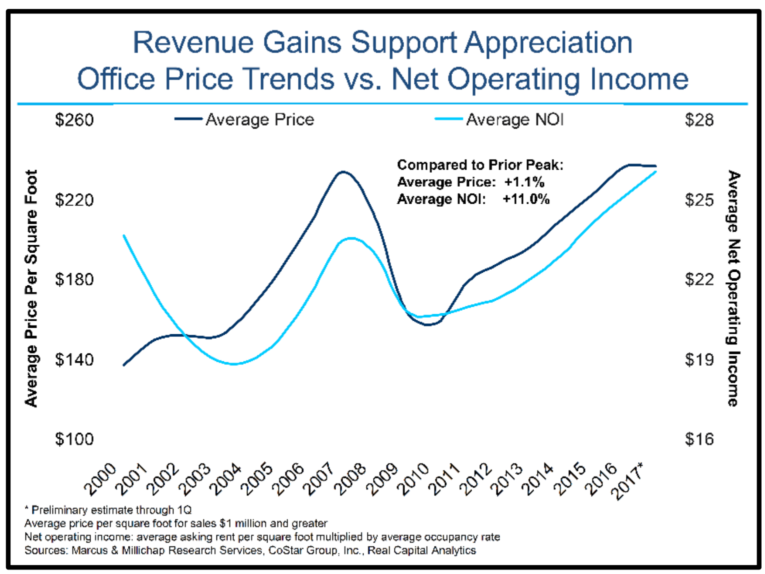
What does all of this recent data mean? Our take is that CRE investors are pushing back on crazy hot valuations but still have capital to deploy and are therefore looking in places where prices make more sense.

Where do things go from here? That is a function of supply and demand fundamentals, investor appetite and availability of capital.

As measured by a year over year comparison of total square feet under construction, additions to inventory continued to slow in both office and industrial on an aggregate national basis in Q1-2017. See nearby chart. The majority of new development is concentrated in just a handful of markets, presenting a reason for caution in those markets. According to CBRE data, office completions averaged 9.4 million square feet per quarter in 2016, continuing to run as they have for the entire recovery below the long-term average of 12.4 million square feet per quarter, measured from the (1995) inception of the CBRE data series. Supply and demand statistics vary by source and methodology, but regardless of whose numbers you look at, office completions exceeded absorption for Q1. The NAIOP Office Space Demand Forecast, which has a pretty commendable track record, is a joint publication of research conducted by the NAIOP Research Foundation and Dr. Hany Guirguis, Manhattan College, and Dr. Joshua Harris, University of Central Florida. The forecast calls for office demand to average 10 million square feet per quarter in 2017 and 9.3 million in 2018.



Office demand is being driven by solid gains in office using employment, in particular technology, finance and professional services, which are outperforming overall employment gains nationally. That trend has for the past several years been more than offsetting the long term trend of office users stuffing more people into less space. Last quarter we highlighted the narrowing spread between growth in suburban office rents and CBD office rents. The spread between the two continued to narrow in Q1, likely a key reason we see capital flows shifting a bit from CBD investments towards suburban investments. Just as the supply is concentrated, office demand for Q1 was concentrated in a handful of markets as well. A chart from JLL on the next page illustrates the demand concentration. Again, data collection methodologies differ, and JLL tends to focus on larger assets and transactions, so the JLL figure of 3.6 million square feet of absorption is likely lower than the true national total when taking into account all properties. Amongst all of the data sources we track, the average Q1 absorption figure is approximately 5 million square feet. We show you JLL's chart in order to illustrate the concentration, and also to see if you notice anything about the list of cities that might be familiar, particularly the second through sixth?!



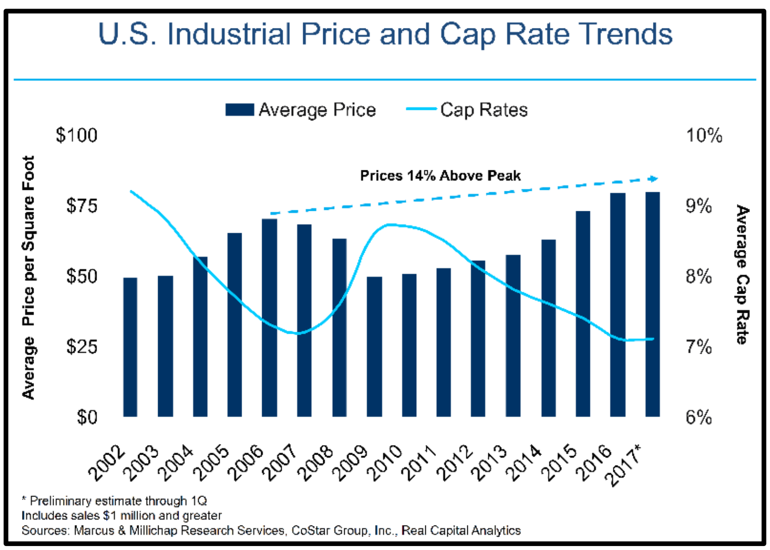
Market	YTD net absorption (s.f.)
Seattle-Bellevue	1,880,156
Dallas	1,759,904
Phoenix	926,790
San Antonio	569,774
Austin	514,005
Charlotte	379,220
Tampa Bay	310,639
New York	269,095
Baltimore	210,095
San Diego	195,924
All other markets	0
United States	3,640,569

Source: JLL

Our conclusion about the office market in general: with a cautionary nod towards a few markets, the risk of oversupply nationally in the office market is presently low.

Industrial demand has been powerfully propelled by e-commerce for several years with annual absorption regularly exceeding prior year comparisons since the beginning of the recovery. That trend abated in Q1, and for the first time since early in the recovery, the level of industrial deliveries exceeded net absorption. Perhaps an inflection point; however, the first quarter has historically seen the lowest demand, and most analysts are forecasting balanced supply and demand for the full year in 2017. AT 5% nationally, industrial vacancy remains at a cyclical low. Cap rates ticked up slightly for industrial transactions in Q1, but low transaction volumes carried over from the prior quarter and may not accurately reflect current investor demand. A high proportion of industrial absorption is coming from large distribution centers, driven primarily by the continuing evolution of e-commerce.

The new buzzword in industrial real estate, almost annoyingly overused at this point, is “last mile distribution.” Annoying overuse of the buzzword does not however make the concept less important. Very large, crossed docked warehouses, commonly referred to as big boxes, located in markets that are major distribution hubs represent “first mile” distribution. The common definition of “last-mile industrial” is the facility from which products are delivered directly to the consumer. This last mile of distribution to reach the rapidly growing on-line consumer is the subject of intense focus by experts at major on-line retailers and third party logistics (3PL) companies. There are many factors at play, and a fairly high level of uncertainty as to what models will ultimately work best to optimize the balance between minimal delivery times and cost. At present, there are quite a few on-line retailers and 3PLs leasing space in smaller, often older and definitely more infill (urban) warehouses. It appears that this trend will remain strong for the near and intermediate term. Over the long run it could be impacted either positively or negatively by a number of factors including drone delivery, autonomous delivery vehicles and the overall evolution of on-line product sales and consumer demand. James Breeze, national director of industrial research for Colliers International points out in a piece published by NAIOP that companies are “working to assess the full cost of moving products through their supply chains and whether having an urban



warehouse will lower those costs." Transportation costs and warehousing costs are fairly transparent and easy to analyze. "Inventory carrying costs, however, are not easily captured, because these costs are spread throughout financial statements."

Most strategic forecasters argue that we will reach at some point an equilibrium between on-line retail and "old line" retail (a.k.a. bricks and mortar). A few claim we are rapidly approaching an optimal omni-channel balance, pointing to clear evidence that previously pure on-line retailers are rushing to open brick and mortar stores. For our part, we think that equilibrium is still years away because of the speed of further technology advancements (e.g. 3-D printing) and the aforementioned search for the optimal logistics models.

Summarizing the above - for both office and industrial, it appears that the market has shifted from generally undersupplied since the beginning of the recovery to a balanced supply demand equation for now. So what about availability of capital?

Money Center and regional banks continue to be active providers of CRE debt capital; however, they are noticeably more risk adverse. Total commercial bank origination volume in 2016 was approximately $330 billion up slightly from $311 billion for 2015 (CBRE). However, the growth rate of bank CRE assets is continuing to decelerate. At the end of 2015, bank CRE assets were growing at a year over year clip of almost 11%. The month over month change in May 2017 had fallen to less than 7%. See nearby chart. Bank origination volume will likely be flat or modestly down in 2017. Regulators have for some time been stepping up pressure on banks to reduce their risk tolerance. Bank lending is now more focused on stabilized assets, and construction loans are much more difficult for banks to originate. HVRE or HVCRE, which stands for "high volatility (commercial) real estate", is the buzzword for banks at the moment. It is derived from the implementation of BASEL III, the international bank capital and liquidity standards that arose out of the Global Financial Crisis ("GFC"). The Federal Reserve is requiring US banks to adopt the standards effective 2018, and in some instances 2019. There are a number of technical parameters defining what loans must be classified as HVRE, but suffice it to say that most banks want to avoid an HVRE designation at all costs! If a loan fails the test, it will be subject to a 150% risk weighted capital requirement, which is an increase from the previous 100% requirement, a significant financial burden and disincentive. Even worse, the rule dictates loans are required to stay designated as HVRE until the credit facility is converted to permanent financing, sold or paid in full. You can check in, but you can't check out!

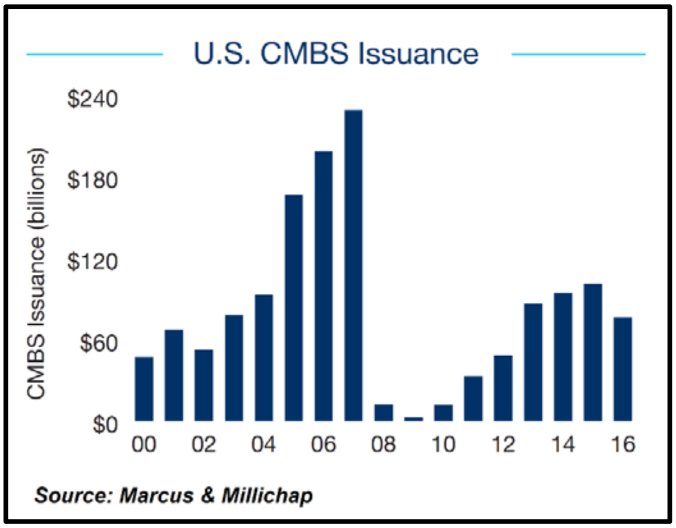
CREDIT MARKET DATA

	Current Bank Assets ($ billions)	1-Week Change (1)	4-Week Change (1)	Year over Year Change Current	Year over Year Change at Dec. 2016	Year over Year Change at Dec. 2015
Bank Lending						
Commercial and Industrial	$2,096	-17.77%	2.61%	2.01%	7.24%	11.35%
Revolving Home Equity	$394	-2.29%	-6.75%	-7.34%	-6.94%	-4.49%
Residential Mortgages	$1,753	4.25%	8.75%	3.55%	5.77%	4.46%
Commercial Real Estate	$2,022	3.87%	***6.87%***	***8.63%***	***9.68%***	***10.89%***
Consumer	$1,367	-0.07%	-0.79%	5.43%	7.65%	6.29%

(1) Seasonally Adjusted Annual Rate

Source: Freddie Mac, Federal Reserve Board and Wells Fargo Securities

Our conclusion from the data above is that growth in bank lending is expected to be quite slow, or perhaps negative for 2017. Anecdotally, in a recent meeting with a major money center CRE lender we were told that their originations YTD are way below prior year and budget. If bank lending this year is expected to be flat, what about other sources of CRE debt capital? 2016 originations of securitized (CMBS) loans totaled $76 billion, which was markedly down from $101 billion in 2015. See nearby chart. Debt market participants are forecasting CMBS originations to be between $60 and S80 billion in 2017. The midpoint of that forecast range would represent another slight decline in annual CMBS originations. The number of origination shops has continued to shrink due to consolidation and disadvantages facing smaller shops compared to economies of scale enjoyed by their larger peers, in particular, the new risk retention (skin in the game) rules that are more easily absorbed by large originators. Maturities of existing CMBS loans will peak in 2017 at approximately $130 billion as the so called "wall of CMBS maturities" crests. This peak in existing maturities is a result of the massive volume of 10 year loan originations in 2006 and 2007 at the peak of the previous cycle. Unlike predictions from a few years ago, the wall of maturities did not produce the expected surge in market stress or CMBS refinancing volume. A large portion of the 2017 CMBS maturities are expected to be refinanced with debt funds. 2018 CMBS maturity levels drop to only $21 billion. CBRE reports from the mortgage bankers' convention in March that: "Life companies are active with fresh allocations and very healthy appetites. Target 2017 production is expected to be $75 - $80 billion compared to 2016 production totaling a record of approximately $75 billion. The "Relative Value Proposition" is compelling and is driving more fixed income capital to commercial mortgages. Additionally, new "Risk Based Capital" changes for corporate bonds will likely further benefit mortgage allocations."



Meanwhile, investors are piling money into real-estate funds. Global fund managers had a record $237 billion available to invest in commercial property at the end of last year, according to data firm Preqin, up from $229 billion at the end of 2015 and $136 billion at the end of 2012. Based on this barometer, there does not appear to be a shortage of equity to invest in CRE.

MACRO-ECONOMIC CONDITIONS

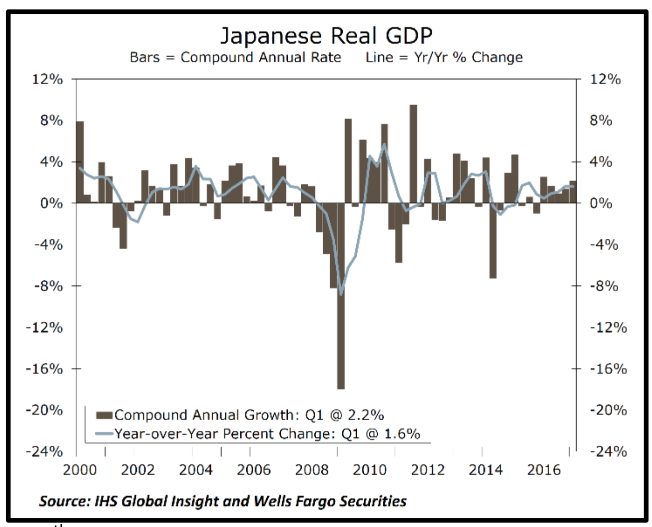
This quarter we are going to play a little game of "good cop, bad cop" or if you prefer, you may call it "fake news vs. real news!" You decide what to call it and for that matter, which side you are on. We won't tell you which side we lean towards, but our frequent readers can likely guess. Hint: 2 "trumps" 1.

The case for rising inflation and therefore rising interest rates:

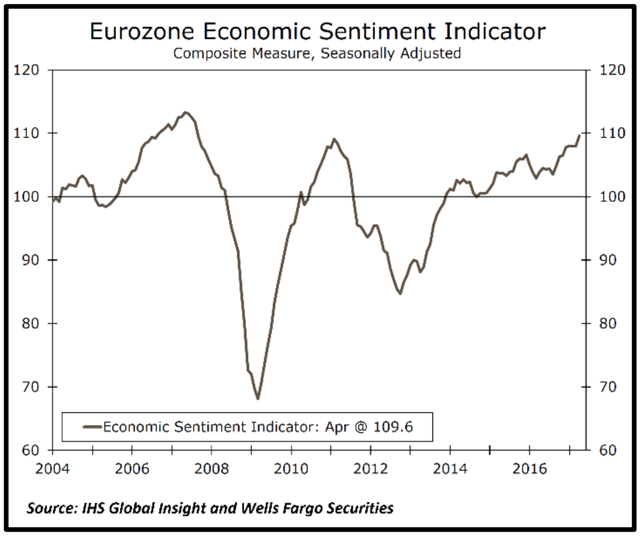
Robert Kaplan, a member of the Federal Open Market Committee (FOMC), the rate setting committee of the Federal Reserve, in a May interview on CNBC predicted two more 25 bps rate hikes in 2017 and the beginning of the reduction of the Fed's balance sheet by year end. He predicted the Fed's $4+ trillion balance sheet would ultimately be reduced by the end of the asset liquidation program to an amount "with a 2 handle." Kaplan does not see any bubbles. He did say the Fed was previously concerned about a potential bubble building in CRE, but in his view there have been a sufficient number of things done from a regulatory standpoint to tamp down any CRE overheating. (See discussion and stats above regarding bank CRE lending). Kaplan's expectations regarding rate hikes and the Fed balance sheet are consistent with the market consensus. One would presume that the Fed would not continue a policy of monetary tightening if it believed that inflation risks were diminishing. Indeed, most analysts expect US GDP growth to exceed a 3% annual rate in Q2 and clock in comfortably over 2% for all of 2017, notwithstanding Q1's revised 1.2% figure.

The IMF global forecast released in April affirmed that the global economy is improving and that economic growth across the world should be 3.5% this year, up from 3.1% for 2016.

Growth in Asia appears to be accelerating. China, the world's second largest economy in nominal terms (1st when measured by purchasing power parity (PPP)) has stabilized at a growth rate between 6.5% and 7% (see nearby chart), and recent statistics for Chinese fixed-asset investment and industrial production exceeded market expectations. Long term income growth of China's 700+ million middle class consumers should be a bulwark for global demand. Rising debt in China is a concern, as evidenced by Moody's recent cut in China's sovereign credit rating, but most analysts argue the debt remains manageable.



China's central bank (PBoC) is out well ahead of the Fed and has been reducing the size of its balance sheet as a percentage of GDP since 2012 without stalling out the country's growth. Japan, the world's 3rd largest economy in nominal terms (4th using PPP), recently posted its 5th straight quarter of positive growth, which is a longevity record for the current recovery. This is impressive as uninterrupted growth in Japan has been difficult to sustain. See nearby chart. Furthermore, the Tankan index of Japanese business sentiment, which has a reasonable degree of correlation with Japanese GDP growth (Wells Fargo), strengthened further in the first quarter. Acceleration in global economic activity is leading to strength in Japanese exports.

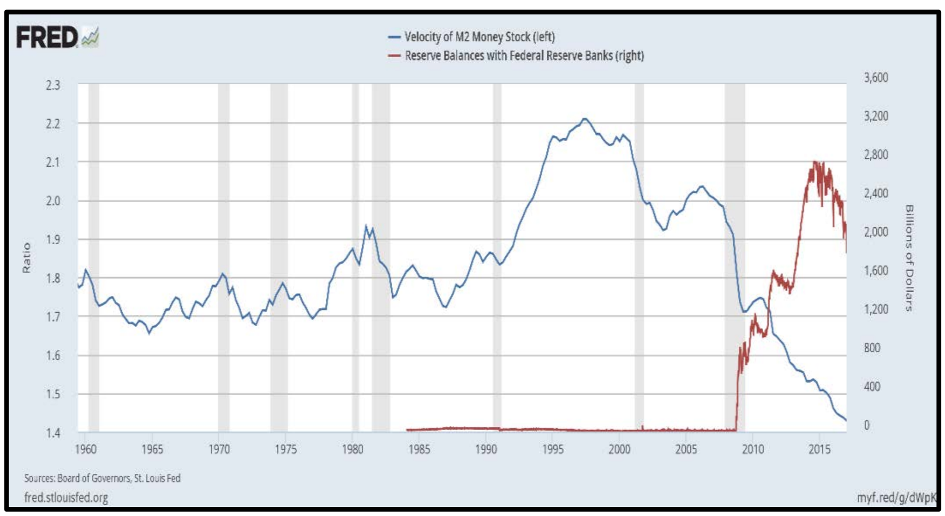


Source: IHS Global Insight and Wells Fargo Securities

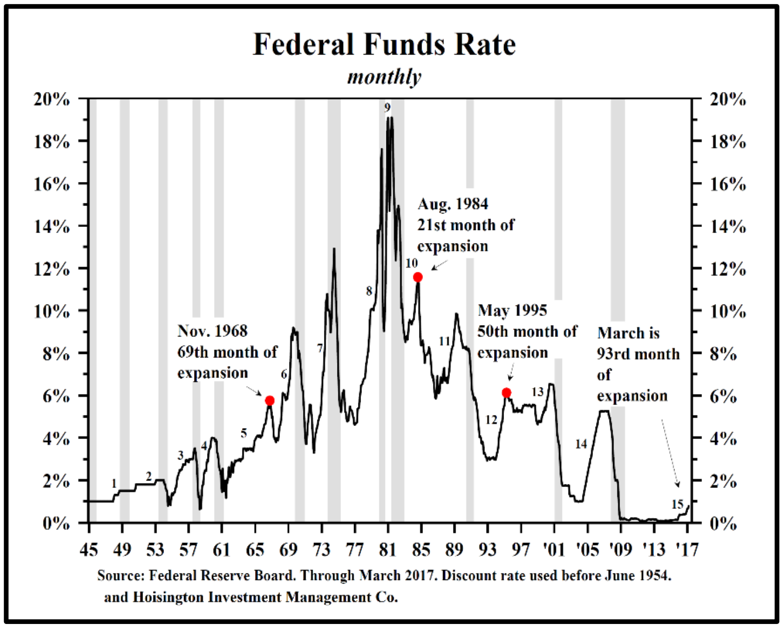
Sentiment in the Eurozone is up. The composite measure confidence indicator has been trending higher since 2014 and rose to a new cycle high in April. See nearby chart. Although, like the US, so called "soft" indicators (e.g. business sentiment, consumer confidence, PMIs, etc.) in the Eurozone have been out ahead of "hard" data (e.g. GDP, retail sales, etc.) for a few quarters. It would be hard to call overly positive Euopean sentiment a Trump effect, and there are potential headwinds from Brexit, but generally speaking, folks in the EU are optimistic at the moment.

The case for low inflation and therefore low interest rates:

Low Inflation Case 1 – Benign To briefly revisit a theme we discussed at length in our Q1-2016 report, we provide a nearby chart from the Federal Reserve Economic Database (FRED) updating the velocity of money (M2) and overlaying the amount of bank reserves held at the Fed. A year ago we reported that the velocity of M2, how many times a dollar gets spent per year, was 1.46, the lowest since 1950. Since then it has fallen further to 1.43. We concluded at the time that the absence of inflation in the face of unprecedented money printing was attributable to the collapse of velocity which had reached levels not seen since immediately after WWII. It does not appear that much has changed in the ensuing year. Economic commentator Marc Faber, admittedly somewhat of a pessimist (his newsletter is called Gloom, Boom & Doom!), recently echoed our theme that more money in the system does no good if the money is not turning over (velocity). Faber contends that pumping cash into the system serves only to elevate asset prices if people and companies don't invest it in new productive assets or spend it on an increasing amount of goods and services. Faber goes on to attempt a full take down of the wealth effect theory by arguing that asset holders benefitting from rising asset values won't spend the new wealth and therefore money velocity cannot rise. In his anecdotal example, he argues Warren Buffet will not buy another 50 hand tailored suits just because the value of his Berkshire Hathaway holdings goes up $1 billion.

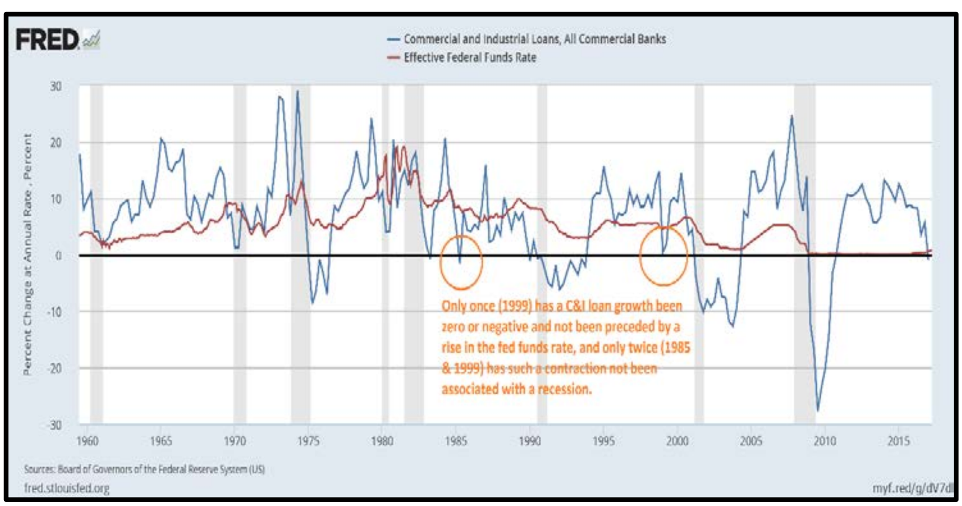


After an extended period of unprecedented stimulus, monetary conditions have actually been tightening since before the Fed began raising short term interest rates in December 2015. Now with the third hike in March of this year, short term rates are at 1%. Doesn't seem like much when put in historical context, particularly for our more "mature" readers. But after such a long period of 0% short term rates, perhaps 1% has a bigger effect than is currently apparent. And if so, wouldn't 1.5% be even more disruptive? The very smart folks at Hoisington Investment Management point out that 80% of all Fed tightening cycles in the modern era end in fairly short order with a recession. See nearby chart. Hoisington's recent newsletter said "In the past six months, the M2 money stock grew at a 5.9% annual rate, down from a 2016 increase of 6.8%, which is near the average increase in M2 since 1900. Thus, in a very short span, M2 has fallen from a trend rate of growth onto a slower path. The additional rate increase in March suggests that M2's growth rate will moderate further over the remainder of the year."



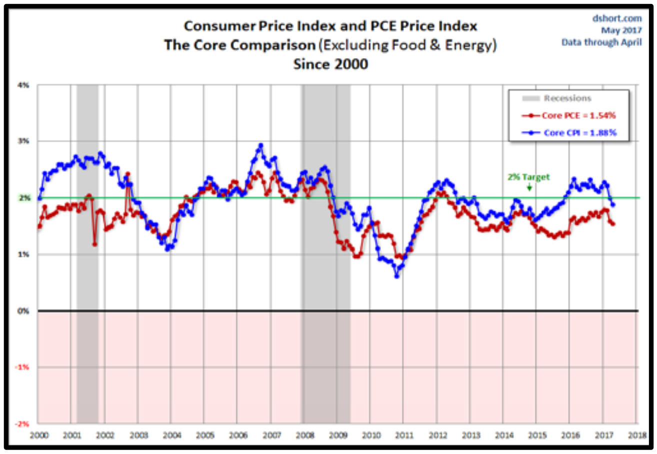
Look back at the Credit Market Data chart on page 9. Note the Commercial & Industrial loans at banks. Sharply negative for the week, and only up 2% year over year. That is noteworthy. Hoisington again: "Growth in the credit aggregates has slumped even more dramatically than M2, thus confirming and reinforcing the significance of the weakness in money. Growth in total commercial bank loans and leases slowed from an 8.0% rise in the first quarter of 2016 to 5.0% in the fourth quarter of last year. Although the figures for the first quarter are not yet complete and subject to revision, bank loans were essentially unchanged. Commercial and Industrial (C&I) loans, however, actually fell in the first quarter, a substantial turnaround from the 10.8% rate of increase in the first quarter of 2016."

We ran a quick chart comparing the growth in C&I loans to the Fed funds rate over time. From that chart we can observe that C&I loan growth has turned negative of late, and that is a fairly normal response to the beginning of a Fed tightening period.

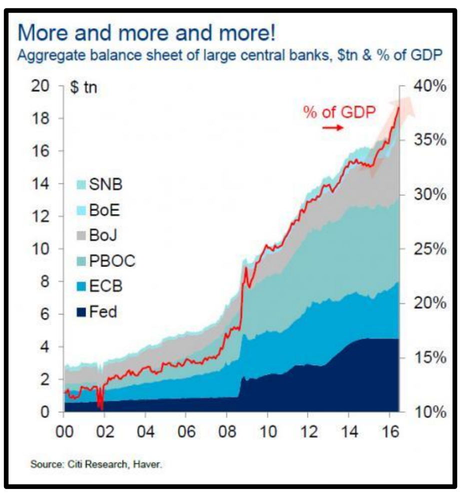


More interesting is the observation that only twice since 1960 has a zero or negative growth rate in bank C&I loans not been associated with either a very recent or imminent recession.

In the US, core consumer price inflation has fallen somewhat in the first quarter of 2017. In April, the year over year figure for core CPI fell to 1.9%, which was the first reading below 2% since Q4-2015. As can be seen in the nearby chart, both core CPI and the Fed's favorite inflation indicator, core personal consumption expenditures (PCE), are exhibiting a clear downward trend over the last several months. During public remarks in April, the head of the European Central Bank (ECB), Mario Draghi, very explicitly indicated that the ECB does not have near term plans to alter its easing of monetary policy being executed through an ongoing asset purchase plan (quantitative easing) that began in March of 2015. These remarks were made despite solid evidence of economic growth and lessening deflationary risks emerging from the continent. He specifically cited the absence of convincing, non-transitory data evidencing inflation above the ECB's desired target of 2%. Is Mario overly cautious, or does he see a different landscape than the Fed?



Low Inflation Case 2 – The Global Debt Bubble Bursts, Defaults Spread and Asset Prices Adjust Down Significantly Too gloomy for a lot of words, so mostly pictures here…………….except to say it might be good to own well located hard assets like real estate!



The first chart is an illustration of how much central bank money printing has occurred through the quantitative easing policies of all of the world's major central banks in response to the GFC. And then there is the US national debt, shown in the second chart. There is a great debate in economics about the impact and relative importance of the debt. As we have said in the past, a consensus has formed among economists around the notion that too much debt as a proportion of GDP is a drag on growth, but there is great disagreement about how much is too much and what the degree of drag is. We certainly don't know the answer to those questions, but there can be no doubt that our present policy course is a fast train towards finding those answers, perhaps the hard way. By the way, the comments added to the US national debt graph belong to Charles Hugh Smith, not us.