Real Estate Market Thoughts | Q3-2016

This is the first edition of Market Thoughts to be distributed in two different quarterly reports, Fund II and Fund III. So, if you are lucky enough to be a partner in both funds, you can spare yourself the nuisance of reading this twice and skip to the investment update section that follows. If you are not a partner in both funds, we ask your indulgence when we briefly reference activities on these pages which are not relevant to you. Both Funds have been active over the past several months. Fund II sold both properties previously reported as being under contract, with one closing in late October and the other in mid-November. If you are a Fund II partner, there should be a nice size check enclosed with this report. Fund III completed the due diligence for its second acquisition, a mixed-use property in Raleigh, North Carolina, the contract is now firm and will close on December 8th. In addition, Fund III accepted subscriptions and concluded its Second Closing in September welcoming seventeen new partners. As always, we are grateful for the confidence in our investment program shown by all of our partners.

Meanwhile, our investment team is excited about the anticipated opportunity to acquire properties in Houston for the first time in several years. More on that below. Our report next quarter will have our traditional recap of underwriting activity for the year, with some detail on the number of opportunities reviewed, underwritten and pursued. For now we will simply summarize by saying the volume in the pipeline is about average for this time of year, and we are confident that there remain interesting and profitable opportunities to deploy capital into value-add investments in most of our target markets.

CRE Market Conditions

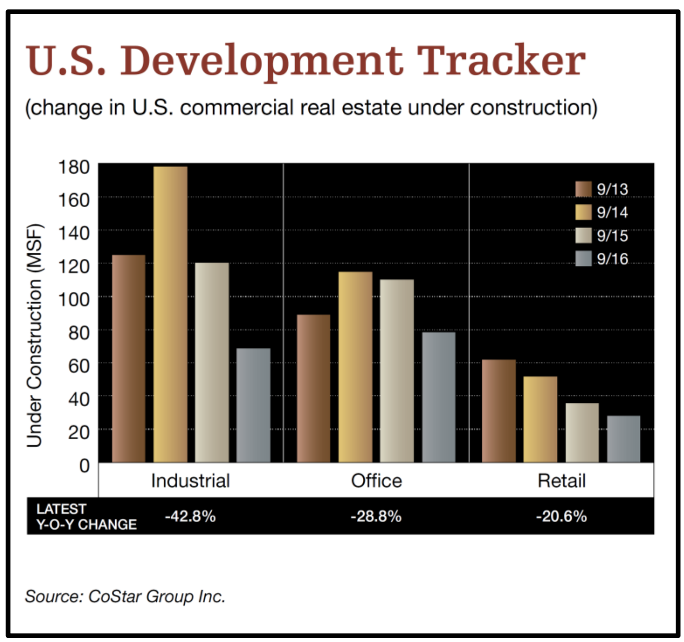
A Brave New World after November 8th. What Now?

The impact of the election is a great unknown, both for commercial real estate (CRE) as well as for the broader economy. Of course there are many opinions, and even some thoughtful and educated guesses. We have read many of these, and there is certainly no shortage of widely varying prognostications. No doubt our readers have absorbed much of this chatter as well, so we will avoid lengthy analysis here and just give you our general take on a few broad matters. Our opinions may have a short shelf life and are definitely subject to revision if the facts on the ground change!

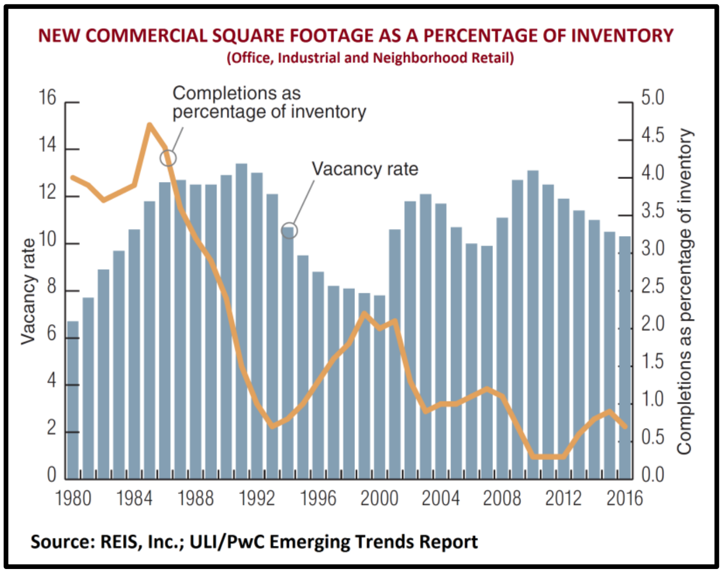
There is consensus that significant reforms will be coming to the tax code. Some of those changes will impact CRE. The three most likely areas of impact are carried interest, depreciation and more broadly pass through (passive investment) income. Carried interest structures are common in real estate partnerships and joint ventures. There is a carried interest structure in both Fund II and Fund III, stipulating that after all the limited partners have received their 9% cumulative compounded preferred return and a return of all of their capital, the general partner receives 30 cents of every dollar distributed thereafter. Equally important to our limited partners, several of the joint venture structures at the property level have carried interest provisions wherein Fund II or Fund III receive a carried interest if the property performs over a defined return threshold, and those additional distributions are passed through to the limited partners of Fund II and Fund III. Heretofore, because most properties are owned for more than one year, carried interest income has been taxed at the capital gains rate, or in some cases the slightly higher 1250 gain (recapture) rate. President-Elect Trump has said he wants to eliminate capital gains treatment for carried interest, which would considerably increase, up to the ordinary income rate, the tax liability for investors that receive carried interest from a real estate partnership. This could significantly impact the structure and incentives in the CRE industry. There is some discussion that changes to carried interest taxation may be more targeted towards hedge funds and shorter term trading strategies as opposed to CRE. Way too early to tell, but we think there could be a pause or period of caution while some buyers who would potentially be affected wait to see how things evolve. If so, such a pause is more likely to be in the value-add and opportunistic CRE investment strategies where the carried interest structure is more prevalent. Most core buyers do not use joint venture structures and are frequently tax exempt pension funds or REITs, so activity in core strategies is less likely to be impacted.

With respect to CRE Deprecation, House Republicans actually have a plan to allow deduction of the full cost of purchasing a building in the first year, likely generating a large loss that could be carried forward using existing net operating loss carryforward rules. This is commonly called "Rule Expensing". Some lawmakers have also suggested eliminating interest expense as a deductible expense. Philosophically, we are in favor of reducing or even eliminating under the right circumstances the leverage subsidy, given the excessive leverage in both the US and Global economies. However, it is hard to conceive of such a radical change actually surviving the deliberative process in Congress. But boy would there be some interesting conversations, and bedfellows! It is a pretty good bet though that depreciation schedules for CRE and other capital investments will get tweaked in a manner that results in a greater frontloading of deductions, but also hard to see the political path to a full cost deduction in year one. One likely result of completely front loading depreciation would be a higher volume of transactions, so presumably our friends in the community of intermediaries would be very much in favor of such a change.

Currently, income from partnerships, such as LLPs and LLCs, flows through to partners (pass-through income) and is taxed at the partner's marginal tax rate if it is ordinary income and 20% if it is a capital gain (25% for 1250 gain). Both Trump and House Republicans have proposals that would create a single rate (Trump 15%; House GOP 20%) for pass-through income. Terrific for limited partners in a real estate partnership! We'll see………………odds are that several changes will occur, investors will adapt, and the net impact when taken together will be more muted than any of the individual components might suggest. However, the direction of change, on balance, appears to be positive for the CRE investment climate. Perhaps not surprising, given Trump's lineage.



Last quarter we touched on the early signs of declines in the amount of new space under construction nationally. That trend became more apparent in the third quarter, most likely because regulatory constraints on lenders continued a pattern of decreasing availability of new construction loans. All major CRE product types are being impacted. See chart. NAIOP, a national CRE trade association, produces a semi-annual Sentiment Index, a forward looking survey of its members. The index for September 2016, while slightly positive overall, has declined by 6.3% since February 2015, reflecting an expectation that the CRE market is approaching a “period of slowing growth.” The index component with the most notable declines is capital availability. The composite score for availability of debt declined by 3.5%. Although the trend is downward in direction, the overall score is still positive, which indicates that survey respondents expect capital to remain available. Another interesting comparative view of the supply dynamic can be seen in the nearby chart that compares new supply as a percentage of existing inventory to the vacancy rate. In the previous two cycles, new supply continued to rise until there was an observable upturn in the vacancy rate. However, in the current cycle, new supply has shown a marked decline while vacancy rates are still improving (declining). Perhaps we are about to witness a big upturn in vacancy. More likely, in our view, the capital markets are imposing a bit more discipline on the development community in this cycle.



One last note on the potential for the election to have an impact on CRE. Transaction volumes were already slowing this year as compared to 2015, which we have previously reported on. A case can be made that uncertainty regarding tax policy perhaps until mid to late 2017 may slow CRE transaction volume further. If so, conditions may therefore give rise to a window of buying opportunities if bidder pools shrink and sellers are still compelled to sell. Stay tuned.

As referenced in the introduction above, our acquisition team is optimistic that we will once again be able to acquire assets in Houston at compelling prices. We have not acquired any properties in Houston since 2012, because values became stretched, and then when the downturn began, owners were reluctant to sell. That later problem remains widespread to this day, but signs of a thaw are appearing. So we thought this would be a good time to provide a brief summary of conditions in Houston.

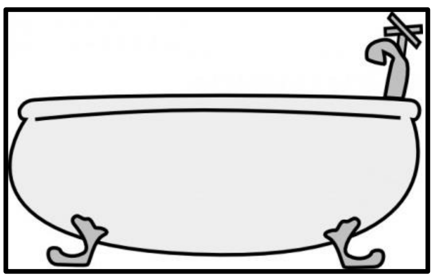
MEDIAN AGE, 20 MOST POPULOUS U.S. METROS

Metro Area	Median Age	Metro Area	Median Age
Houston	**34.1**	Chicago	37.0
Riverside	34.1	Seattle	37.0
Dallas-Fort Worth	34.7	New York	38.1
San Diego	35.5	Philadelphia	38.6
Atlanta	36.1	Boston	38.7
Denver	36.2	San Francisco	38.9
Phoenix	36.3	St. Louis	38.9
Los Angeles	36.4	Detroit	39.9
Washington, D.C.	36.6	Miami	40.9
Minneapolis	36.9	Tampa	42.1

Source: U.S. Census Bureau, American Community Survey, 2015

The bottom in employment for the Houston MSA appears to be in. The rig count has increased more than 150 rigs over the past five months and announcements of layoffs by upstream energy companies are much less frequent. While payrolls could certainly be trimmed further by certain companies, evidence is appearing that companies are approaching the "right size" including the posting of small but positive profits in the third quarter by the large oil field service companies, like Halliburton and Schlumberger. However, the Houston economy is likely to bump along the bottom for some time, and while modest job growth has resumed, having barely avoided negative territory on a year over year basis, the jobs that are being created are generally less remunerative than the scores of high value, high compensation jobs that were lost as the upstream energy industry contracted. In the 12 months ending September 2016, approximately 20,100 jobs were created according to the Texas Workforce Commission. The low point of the current downturn occurred in May, when the year over year gain was just 3,200 jobs. The Houston area does retain many long term advantages. Population growth remains strong at well over 100,000 new citizens per year, and Houston has the lowest median age of any of the 20 largest MSA in the US. See chart on the previous page. The median age in Houston is 34.1 years. The median age for the nation as a whole is 37.8 years. Houston is also the most diverse city of the 20 largest metros. Weaknesses include a relatively low level of educational attainment and a large uninsured population.

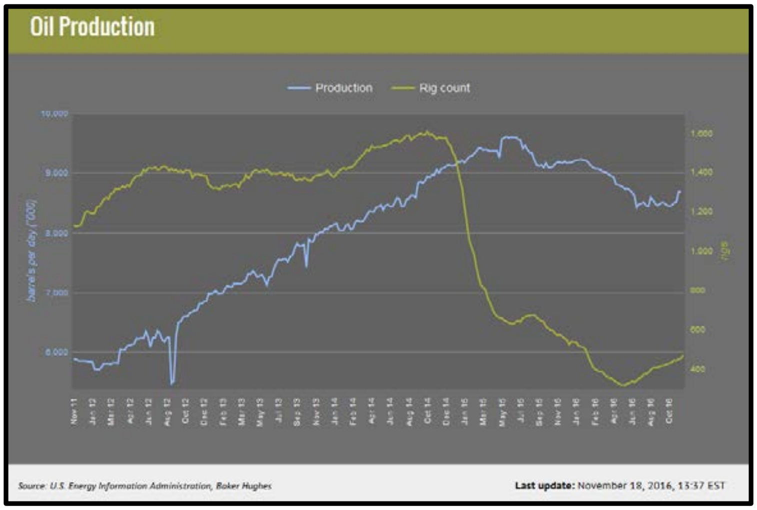
So when will Houston's economy recover in a meaningful way? Most local economists are calling for a slow and gradual recovery. Patrick Jankowski of the Greater Houston Partnership (the regional Chamber of Commerce) is predicting a "bathtub" shaped recovery, calling for a "wide bottom, then quick rebound." Perhaps he is right, and he is not specifying exactly when the quick rebound part occurs, but he is confidently saying the worst is over. What could give rise to a quick rebound? A stabilization of oil prices in the $55 to $65 range would go a long way toward lighting the fuse. The massive shale deposits in the Permian Basin in West Texas can be profitably extracted at prices in the mid $30's, which is why the Permian is the center of activity at the moment, drawing by far the lion's share of new drilling rig deployments. Most of the other large North American shale deposits are profitable if prices stabilize in the mid $50's.



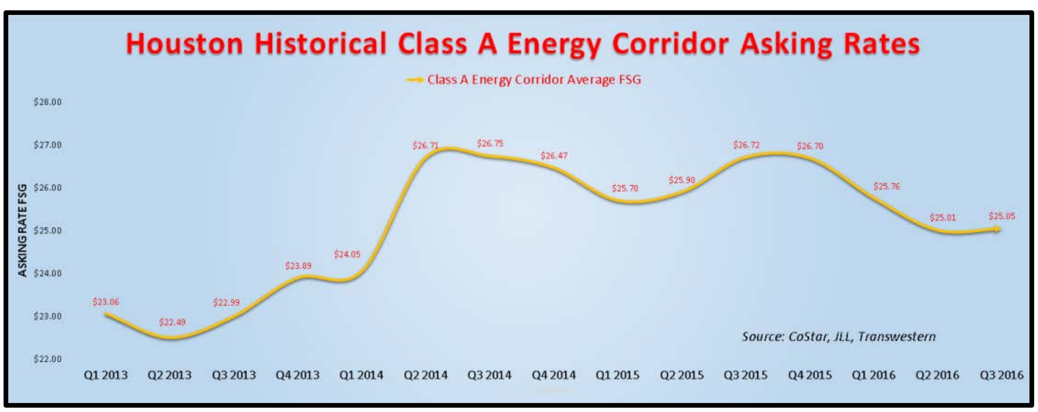
Houston provides much of the value-add activity in the well development cycle and will benefit greatly if the increasing trend in drilling activity accelerates. Wood MacKenzie estimates that the reductions in capital investment already made by producers along with deferred projects should amount to $1 trillion for the period from 2014 to 2020, representing approximately 3 million barrels a day of lost production by the end of the decade. Demand continues to grow modestly. We recently came across the nearby chart showing oil discoveries each year dating back to 1947. While we would caution against reading too much into it, particularly since many of the fields discovered decades ago are still producing prodigious amounts of oil, the chart is intended to visually illustrate

how the massive cut backs in capital spending have reduced new oil discoveries, ultimately impacting supply. There is a pretty clear trend, particularly the last six or seven years. At some point, that trend will lead to a supply shortage…………and that may be when we see the longed for "quick rebound."

It is also clear from our final chart comparing production and rig count, that the reduction in rigs is having an impact on US production. It also illustrates how much more efficient drillers have become when you compare the number of rigs required for 9 million barrels of production in 2012 vs. the number of rigs for the same 9 million barrels in 2016. Wow!



The Houston office market remains stressed, and will continue to trend downward for several more quarters. Sublease space now exceeds 12 million square feet and will take several years to absorb. Market wide asking face rents are flat year over year, but effective rents, after taking tenant improvement and free rent concessions into account, are down measurably. As can been seen in the nearby chart, certain submarkets like the Energy Corridor in West Houston are exhibiting declines in asking face rates, which are compounded by large concessions as well. Furthermore, the asking rates for large blocks of sublease space are by our calculation 22% below the direct asking rates. Direct office vacancy has risen to over 15%, and availability, which includes sublease space and space under lease but being marketed for future occupancy reached 22%. For the moment, Class B+ urban infill office seems to be faring best. We find ourselves fortunate that most all of our current Houston office properties fall into that category. Occupancy in the five properties (1 million square feet) we still own in Houston was 92.4% at the end of October, up slightly from 91.4% in the prior month, and down marginally from 93.3% in October 2015.



The Houston industrial market is faring better than the office market, mostly because the supply pipeline did not get as overextended. Rents are down 3.4% year over year according to Transwestern, but absorption remains strong at a year-to-date total of 8.8 million square feet, compared to 7.5 million at the same point last year and well above the 10-year historical average of 6.9 million. Sublease space is rising and will increasingly exert downward pressure on rents until the economy begins to improve.

MACRO-ECONOMIC CONDITIONS

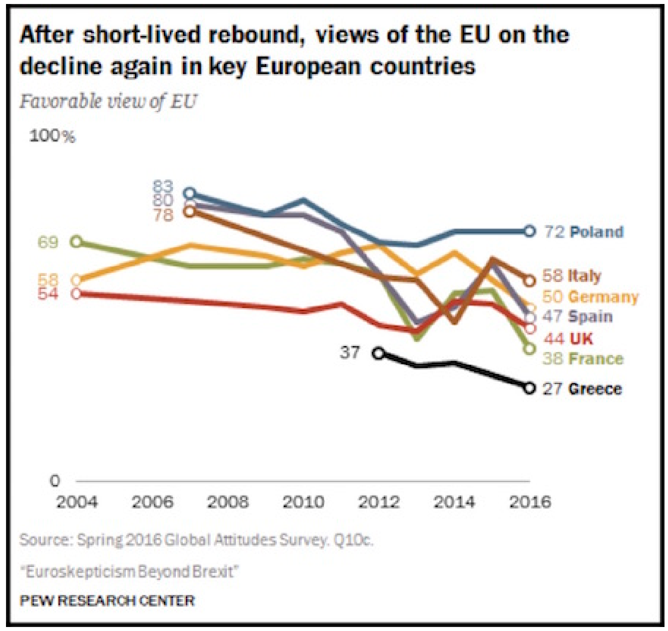
We must confess to having to rethink a few things informing our economic outlook after the election. Again the question is posed, what now? Frankly, there are too many opinions, especially regarding tax policy, to make any kind of definitive statement. Are interest expense deductions at risk? Possibly, but unfortunately, we are an over geared (beautiful British term for leveraged!) society, both in our consumer and corporate affairs, so it seems highly unlikely that we will go cold turkey on eliminating interest deductions either for mortgages or business expense. Some countries do, but not many. Slightly lower taxes, perhaps but maybe not, when taken as a whole, because even with significant spending and entitlement reforms, the US government simply must collect more revenue to address our long term demographic challenges. A shift in the *source* of tax revenues is very likely. A consensus on lowering corporate taxes has formed and will be acted upon in some fashion. Other ideas range from pushing the code more towards consumption taxes, read VAT, to axing major deduction categories. As opined on wistfully above, nuking the interest deduction might be a good idea philosophically because we would no longer be subsidizing borrowers and thus encouraging a culture of excessive leverage. Although it would obviously have a big impact on real estate, would it eliminate borrowing? No. The financial benefits of leverage, essentially an arbitrage of the differing costs of capital associated with varying degrees of risk, would still exist; however, the after tax returns of leveraged investments would no longer be juiced by the tax code. The philosopher king in us might like the idea, especially if it would lead to a slight "de-financialization" of the economy and less gearing and lower debt burdens. Not likely to happen though.

Another consensus has formed around infrastructure spending, as in we need a bunch more. Credit the Wall Street Journal for making the following observation: Japan has been spending like mad on infrastructure for almost two decades and has not seen higher growth as a result. Quite the opposite. Certainly some of the US infrastructure needs to be updated and expanded, but our observation is that most of the prosperous and well governed states in the US have pretty good infrastructure, and the "deplorable" infrastructure is often found in the states that are not governed as well, with some exceptions for sure. So who gets the new spending, and what type of "reward" system are we propagating? (Apologies for the parental screed.)

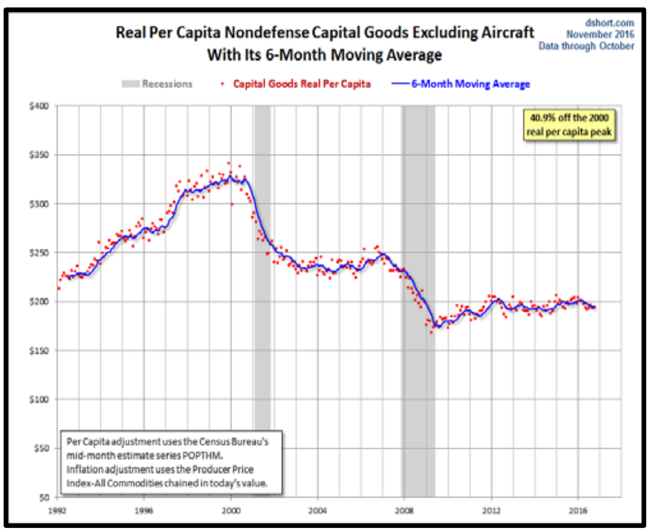
If we reduce or shift the tax burden and spend big dollars on new infrastructure, will we have bigger federal budget deficits? Probably, given the entrenched dynamics of the welfare state, even if Obamacare is improved. Remember, most transfer payments go to the middle class………….. Classic Keynesian economics would say that more spending, whether paid for by taxes or borrowed funds, boosts aggregate demand and will result in faster growth. That Keynesian axiom assumes that government spending has a positive multiplier, meaning that a dollar spent by the government results in more than a dollar of economic activity. Frequent readers of our Market Thoughts may recall that we are very skeptical of that assumption. Much credible research has been done over the past few decades on this subject, and there is now a great deal of conviction among a substantial number of economists that the multiplier for most government spending is negative. Count us in that camp!

Speaking of heretics, we are also in the camp which believes, generally speaking, that most borrowing simply brings future consumption forward to the present. Accordingly, an excessive amount of debt in any nation is a drag on growth. Economists debate what constitutes too much debt as a percent of GDP, but it is likely the US and most other large developed economies are already at or past the brink. These pages recently detailed how each unit of incremental debt incurred in China was generating an increasingly diminishing amount of incremental growth in output.

Instead of amusing you with our usual dive into global and US economic minutia, the analysis of which may all be irrelevant after the election, we thought it might be more productive to look at a few really big trends that are not likely to change in the era of Trump, or if they do, the change will be quite gradual. We will try to do this with more pictures and fewer words.



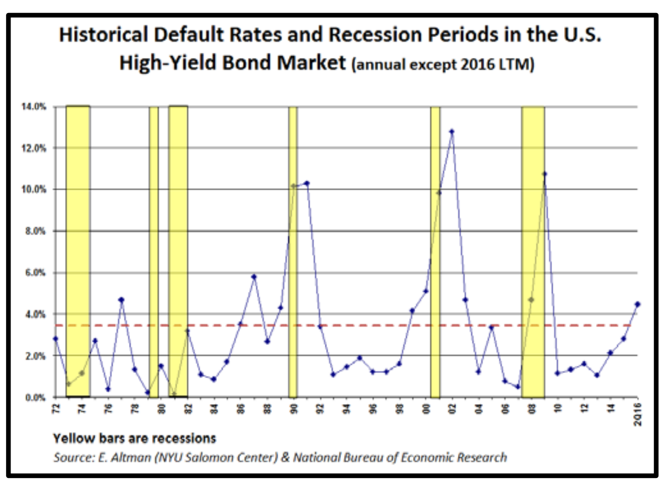
It's not just the Brits who don't like the EU. The Euro area's combination of debt overhang, difficult demographics and bureaucratic creep will keep growth slow. Immigration could help, but not many are comfortable with it. Germany may have successfully navigated the Greek shoals, but Italy is a whole other enchilada.



We won't repeat our recent diatribes on dismal productivity growth but will only mention it by saying that factors impacting productivity change gradually, and an election, no matter how course correcting it is, is not likely to change productivity overnight.

The new normal? Wow, look at this chart of durable goods orders in the US adjusted for inflation AND population growth. Kinda says it all, no?

Now don't panic with this next one, especially since a high percentage of the bond defaults were in the distressed energy sector, but most of the time the blue line gets above the dotted red line on this one, bad things follow shortly thereafter. And interest rates have moved up a bit since this graph was produced……………



So interest rates on the long end of the curve have moved up sharply, the curve has steepened and the Fed is highly likely to raise the short end by 25 bps in December. Where do rates go from here? Well, there is still a huge pile of capital around the globe with limited options. The Wall Street Journal uses Bernanke's term of a savings glut. The rise in the dollar is already tightening monetary conditions around the globe. We might see 3% on the T10, but our bet is it will fall short of 3% when it peaks, just prior to the next recession. Trump has two seats to fill immediately at the FOMC (Fed), and some more hawkish appointees could shift Fed thinking, but the FOMC still looks more like St. Peter's Square than the rugged Mountain West (doves…hawks….).

To finish on an upbeat note, at least in relation to your investment in Fund II or Fund III, here is another of the things unlikely to change much in the era of Trump, migration patterns between states. Take a look at this chart below showing migration patterns in the US. The darker the green shading, the more people are moving TO those states. Notice anything familiar? All of our target markets, save one, are in dark green states! In fact there is only one dark green state, Florida, we are not targeting or tracking.

Bada bing, bada boom!