THE PATHFINDER REPORT

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CHARTING THE COURSE

All Fun and Games until Someone Loses an Eye

By Mitch Siegler, Senior Managing Director

In this season of political nuttiness, it's odd that we're just now hearing the term "kakistocracy". We looked it up so you won't have to. It's from the Greek "kakistos" meaning "worst" and it means "government by the least qualified or most unprincipled citizens." Seems fitting for the state of our American politics, huh?

In this corner, in the red trunks, is a fellow frequently described as obnoxious, hot-headed, egomaniacal, embarrassing and misogynistic. And you should hear what they say about his barber! In the other corner is his opponent, who gains style points for hair (but gives some back for her pantsuits). She also ranks low on the trustworthiness scale and operates as though the basic ground-rules don't apply to her, her inner circle, PAC (er, foundation) and computer servers.

On one level, it's mildly entertaining – when you can bear to watch or read about it. Take heart, friends – it should all be over in just 59 days, but who's counting? The 2016 election seems to be shaping up as a giant mess and not one of the Pottery Barn ("you broke it, you bought it") variety. We'll all have to live with the consequences for years to come. Meanwhile, it's well before the election and we're seeing rather large cracks in our economic fine china, with obvious investment implications. Five examples:

1. Dysfunctional Lending/Financial Services Environment – Our banker friends report that bank regulators have never been tougher, especially with "high-volatility commercial real estate (HVCRE) lending, like for new construction. Higher capital reserves for this sort of lending is the order of the day and banks have been dealing with an unforgiving environment for some time, what with Basel III, Dodd-Frank and a myriad of other post-Great Recession rules and regulations. And that's before Elizabeth Warren gets out of bed. Private lenders have been stepping in to plug the hole – from "hard money" secured lenders displacing banks in real estate lending to a plethora of peer-to-peer lenders giving credit card companies a run for their money. These groups have higher rates and fees, of course, but they're offering credit to folks who might not get it otherwise. Some bright spots there but largely an indictment of the traditional financial services system and regulatory environment, which just aren't working like they should.

2. Weak Economic Growth and Decelerating Inflation – In late July, the Census Bureau reported that the Gross Domestic Product (GDP) grew at an anemic 1.2% annualized pace in the second quarter after adjusting first quarter GDP down from 1.1% to just 0.8%. Three straight quarters of sub-2% growth and a decelerating pace of growth. Taking a wider view, while GDP has declined over the past four years from 4.3% to 4.1% to 3.0% to 2.4%, inflation has plummeted in parallel – from 1.9% to 1.6% to 1.5% to 1.1%. This despite pallet-loads of helicopter money (Quantitative Easing is the official term). Safe to say money printing isn't working and may be exacerbating the situation. A pilot might call this stall speed. We believe the headwinds of an aging population and their attendant lower consumer spending, a reluctance among younger people to marry, have kids and buy homes and the macro environment in which central bankers worldwide are easing has a lot to do with this.

3. The Fed Seems Unable to Raise Interest Rates – Anemic growth and low inflation are hardly the recipe for higher interest rates, as we've been saying for ages. The futures market concurs – it puts the odds of an increase by December at just 50% and only 60% by March, per Bloomberg. Recall that in January, Fed officials were signaling four quarter-point rate hikes for 2016. Official validation of a protracted economic slowdown and a near-empty central bank toolkit – and this may just be the warm-up act.

4. Central Bankers Have Painted Themselves into a Corner – It was widely reported in July that former Fed Chair Ben Bernanke, a student of the Great Depression, met Japanese Central Bank Governor Haruhiko Kuroda and advised him to issue perpetual, zero coupon bonds that the Bank of Japan would buy. This – permanent zero coupon bonds – goes beyond über-low interest rates, quantitative easing and other forms of helicopter money. It's an awesome gift considering that the BOJ already owns 40% of Japanese government bonds. With perpetuals, Tokyo would be freed from the pesky details of ever having to repay the bonds. In a flash, Japan would have more breathing room to stimulate growth without increasing its already stratospheric debt levels and risking credit downgrades. Sure, it could work in stemming the tide on Japanese deflation, though free lunches are pretty hard to find and nothing else has really worked for the Japanese economy in the past 30 years. And across the pond, there are increasing concerns about the impact of Brexit ("new headwinds", according to a European Central Bank statement on August 19th) on the European economy.

5. Other Canaries in the Coal Mine – Jobless claims have been rising. Inventories are at their highest levels since 2009; the inventory liquidation sale that lies ahead will be deflationary and reduce the need for factory workers. Corporate profits have fallen for six straight quarters. Low interest rates pressure pension funds and retirees. Credit card delinquencies are up. Business bankruptcies are up 25% over the same period last year according to BankruptcyData.com. Employment growth is a lagging indicator and all of these factors suggest job growth will slow in the months ahead. And that's before any election-related economic uncertainty.

As the Sergeant on Hill Street Blues would say, "Let's be careful out there." Cause you wouldn't want your investment portfolio to lose an eye.

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FINDING YOUR PATH

The Darwinian Theory of Real Estate Investing

By Lorne Polger, Senior Managing Director

I just spent a week in the Galapagos Islands with my kids. It was a beautiful trip and a photographer's paradise. The uniqueness of the many species that populate the islands, along with the lack of predators result in an amazing, close up experience with the animals. As you may know, the Galapagos Islands were where, in the early 1800s, Charles Darwin began to develop his theories on evolution.

Darwinism is a theory of biological evolution based on the precept that all species of organism arise and develop through natural selection. The natural selection process then increases the individual members of the species ability to evolve to better compete, survive and ultimately reproduce.

I believe that real estate is also based on evolutionary cycles, albeit ones not based in nature or natural habitat. Instead, real estate cycles are typically created by human nature, economic and monetary policies and worldwide events. Ultimately, just like Darwin's theories on biological evolution, investors and developers who adapt through a down cycle are better equipped to compete and prosper, and ultimately survive.

I've lived through three down cycles now during my professional career, probably more than that during my lifetime. Let's examine this last one, because in many respects it typifies all cycles. Here are three factors that I observed:

1. Human nature, which typically includes near equal elements of fear and greed/optimism;
2. The basic law of supply and demand; and
3. Monetary policy, which can either accelerate or decelerate the pace of a real estate cycle.

Human nature. Let's start with greed and optimism. In order to either invest in or develop real estate, you need a certain measure of both. Optimism that the project you are investing in will be successful and ultimately pay you a commensurate return for the risk that you are taking (that's the fear element). Greed as well, in that you strive to make the investment as great a success as possible.

When held in check, they work pretty well. In the beginning of this current cycle, optimism and greed were generally reigned in – there was still a measure of fear as you still looked over your shoulder at the train wreck behind. You remained cautious about what might lie ahead. Some still felt the welts and bruises.

In the middle of the cycle, you looked backwards and forwards. Sure, you got hit before, but boy, look how the train is moving now. Better jump on.

Now, in the latter part of a cycle, for some, optimism and greed begin to exceed rational thought. Fear is a distant memory. Overbuilding occurs. Yields get compressed. Over leveraging occurs as some safeguards on debt are reduced or removed. Financial engineering takes over in order to achieve target yields, in lieu of assessing actual fundamentals. We are now in the latter part of this cycle. Deals are getting done with financial engineering, not because of sound economics; they're getting done because there is a surplus of capital and not enough places to put it. When left out of balance, things get out of control. Those who remain disciplined survive (and even prosper) but certainly live to see another day. Those that don't lose their shirts. Some don't survive.

Supply and demand. I first learned this concept in Professor Mike Bird's Economics 101 class at Colorado College 35 years ago and I've been using it on a daily basis ever since. Simply put, when demand outpaces supply, prices rise and when supply outpaces demand, prices fall.

For much of this cycle, we've had excess demand in rental housing. Demand across office, industrial and retail were somewhere in the range of flat to slightly increasing. That has not been a typical cycle when demand usually rose across the board as the cycle progressed. Given the scope of the last downturn, that's probably a good thing. And perhaps as a result, it does not appear that we overbuilt (oversupplied) during this cycle. Lots of cranes in the air since 2010, but the vast majority have been tied to hospitality, housing and medical uses. Not a lot of spec office or retail centers this time around. That's a protective element for the downside of the next cycle.

Monetary policy. We've been in a zero-interest rate environment now for more than eight years. What happens when that changes? At the beginning of a cycle, the Fed tries to heat up the investing environment by lowering interest rates. When the cycle evolves and overheats, the Fed begins to cool it down by increasing rates. We are nearing the latter stage. What happens to the cost for the U.S. government to service $19 trillion of debt when there is a 50 basis point increase in the prime rate of interest? What if the increase is 150 basis points? The primary questions are when (not if) the increases will occur, how much will they be and what the ripple effects will be?

So where are we in the current cycle? Have we overbuilt across various sectors? So much has changed in such a short period of time; our need for physical office space has fallen off a cliff; Amazon has changed the retail landscape forever (which is why we are installing automated package drop systems in our apartment complexes); industrial uses may change dramatically with the legalization of marijuana across the country. All stuff that would have been difficult, if not impossible, to predict a mere 20 years ago. Yet, we are still well below historical norms in the development of new housing stock (rental and for-sale), office, industrial and retail properties across the country. This is an unprecedented element in a recovery period. Many studies show that our current pipeline of housing stock is not even close to meeting projected future demand.

Have we become sloppier in our underwriting for equity and debt? To the contrary, still feeling bruised and battered from prior mistakes, lenders remain stringent. Less regulated? With Basel III and Dodd-Frank, not in the least. So although we are showing all of the evolutionary signs of being near the top of a cycle, we are not seeing signs that the downturn, this time, will be significant or longstanding.

Are we now nearing the end of a cycle? Well, we are seeing some signs of being near the top. Multifamily vacancies are staying near all-time low levels, but the rapid rise in rents has slowed significantly. Housing starts and homeownership rates remain near all-time lows. Office and retail vacancy rates appear to be stagnating. Does a train wreck lie ahead? I don't think so this time. Will there be some projects in trouble? Absolutely. Some interesting investment opportunities? Always.

My takeaway? Stick to the fundamentals, take some chips off the table to keep your liquidity in check, don't use financial engineering or excess leverage to goose yields, and just like Darwin's finches, live to see another day and prosper. Don't be the dodo bird.

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GUEST FEATURE

Where We Are in the Multifamily Development Cycle

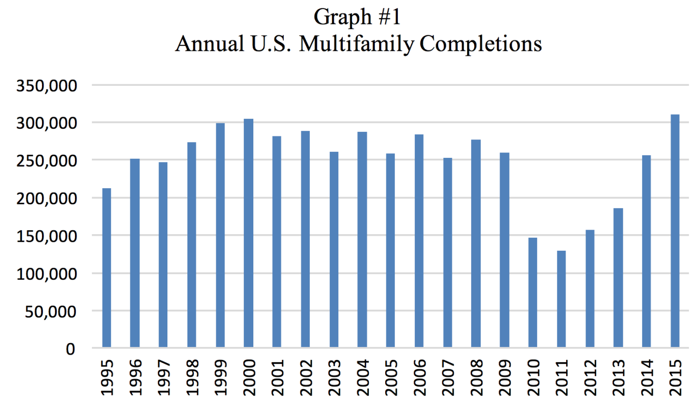
By Scot Eisendrath, Managing Director

Most apartment developers are keeping very busy. There are cranes in the sky and it's hard to find a general contractor, architect or other service provider without a backlog of business. There is chatter about too much supply, overbuilding and potentially reaching the peak of the current cycle. The fact that the second quarter of 2016 marked the fifth consecutive quarter where new multifamily supply exceeded net absorption of new units (per research firm Reis, Inc.) supports that fact.

There is also the alternate view that favorable demographic trends and fairly stable market fundamentals for the multifamily sector are laying the groundwork for an extended run for the apartment development cycle. Let's look at some key trends that support that hypothesis.

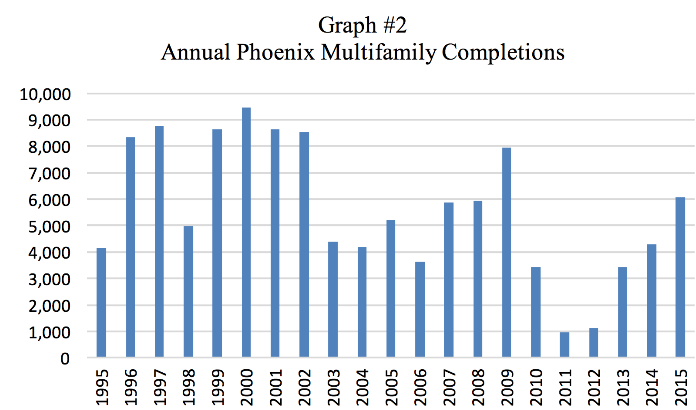
<u>Supply</u>

Average apartment completions in the U.S. over the past 20 years have been roughly 250,000 units per year (see graph #1). Average apartment completions in the U.S. since 2010 have averaged approximately 200,000 units per year. While there is significant construction today, most of that is "catch up" for a period when the U.S. was undersupplied by 350,000 units based on historical averages. That does not take into account population growth over that period of time, as well as demographic changes that have led to a nation that favors renting over owning a home.



Source: nmhc.org, U.S. Census Bureau

Consider Phoenix, a market that in past cycles has been plagued by over-supply, where we see very similar dynamics. In Phoenix over the past 20 years, apartment completions have averaged approximately 5,700 units per year, but since 2010 the average has been about 3,200 units per year. So, based on historical averages, Phoenix has been undersupplied by about 15,000 units (see graph #2). Again, these numbers don't fully account for the phenomenal population growth (#4 in the nation in 2015, adding 370,000 new residents since 2010) and superior employment growth (#2 in the U.S. for 2016 at 3.2%) that Phoenix has experienced.



Source: Marcus & Millichap Research Services, MPF Research

And while there is significant supply in the pipeline, apartment deliveries are projected to peak in 2016 or 2017, which is evidenced by a slowdown in permitting activity over the past couple of quarters. This slowdown in permitting is likely related to tightening credit, which is discussed further below.

Demand

As noted above, over the last few quarters the supply of new units has outpaced demand. However, the vacancy rate has only risen slightly, and is still at a very healthy 4.5% nationally as of the end of the second quarter (having risen from a low of 4.2% in the second quarter of 2015, according to Reis, Inc.) In addition, while rent growth appears to be slowing, we are still seeing solid rent increases, including 4.1% in the first quarter of 2016 compared with the prior year, according to Axiometrics, Inc. The fact that rents are still increasing and we are not seeing declining or flattening rents yet is of course a positive sign and illustrates the strength of multifamily demand.

There are factors at work driving apartment demand. A primary driver of apartment demand is job growth, and our economy has been producing in excess of 200,000 jobs per month. Second, because of the recovery in the general economy, household formation has been strong, averaging over a million new households per year. Third, and we don't want to beat a dead horse, but millennials are a huge population cohort and many are renters by choice. That's because of student debt loads, a desire for mobility and other factors; many will likely continue renting later into their adult life than earlier generations. That's borne out by the data –we've become a renter nation with a homeownership rate that has fallen from above 69% in 2004 to a recent 62.9%. With roughly 125 million households, that's more than 7 million renters that have been added to the U.S. rental pool in just over a decade.

Financing and Regulatory Pressures

There have been recent regulatory factors affecting construction financing that has made it much more difficult for developers to get loans to fund development projects. While 12 months ago construction loans with 65-70% leverage and limited recourse were commonplace, developers today are faced with a tightening credit environment demonstrated by more loans with leverage ratios of 50-60%. Because of more stringent post-recession banking regulations, in particular High Volatility Commercial Real Estate (HVCRE) rules, which affect regulatory capital requirements for lenders for higher risk construction and development loans, lenders' appetite for construction loans has been diminished, leading to higher interest rate spreads, and lower loan levels relative to total construction costs, making financing apartment developments costlier. This may lead to good projects that are in the planning or proposed stages never getting built, which will also regulate supply in the short term.

Surplus of Luxury Apartments

If you take a close look at the new supply being delivered, it is highly concentrated in the Class-A, high-end luxury segment, and located mostly in downtown urban locations. The fact that land prices and construction costs have increased significantly over the past couple of years, coupled with increased, more complex and costlier government regulations, the only apartments that can really be delivered economically are Class-A. This has created oversupply in one segment of the market and undersupplied the balance of the market. In fact, according to Costar, the June 2016 vacancy rate in Class-B apartments is 3.3%, while the vacancy rate in Class-A apartments is 6.7%. While it is difficult to build affordable apartments in today's environment, there is definitely pent-up demand outside of the downtown urban cores and a need for more choices for renters at different price points.

In conclusion, while we have had a few good years in the multifamily development arena, it appears we have solid market fundamentals and positive demographic trends to support extending the current multifamily cycle for a couple more years, especially as to Class-B and suburban apartments.

Scot Eisendrath is Managing Director of Pathfinder Partners, LLC. He is actively involved with the firm's financial analysis and underwriting and has spent 20 years in the commercial real estate industry with leading firms. He can be reached at seisendrath@pathfinderfunds.com.

ZEITGEIST – SIGN OF THE TIMES

Development Costs Soar across the U.S. Stifling New Home Construction

A recent study conducted by leading real estate gurus John Burns Real Estate Consulting ("JBREC") reveals that increased environmental regulations and rising development costs are making it increasingly difficult for developers to build affordable homes. The study surveyed more than 100 U.S. home building executives who gave specific examples of new home construction costs and delays that didn't exist a decade ago. A few:

• Stormwater Pollution Prevention Plan compliance costs have skyrocketed and can now total $5,000+ per home.

• In at least seven markets surveyed, builders mentioned that fire sprinkler installation in both townhomes and single-family homes now adds between $5,000-$10,000 per home.

• In California, building and impact fees now exceed $120,000 per home in some Bay Area municipalities and builders have reported $4,000-$8,000 per house in additional City fees over the past decade, with studies underway to raise them to $20,000+ per house.

• Most planning and permitting offices are considerably understaffed, causing costly delays in the planning, permitting and inspection processes.

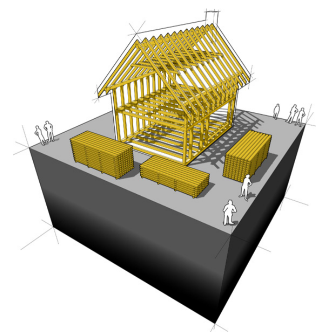
• Builders everywhere report much longer delays and escalating costs associated with hooking up utilities for their new communities.

• Energy code costs – a relatively new category – were reported as $2,500+ per home with several builders in various states reporting $8,000+ per home.

Data from this survey provides a frightening perspective behind the cost overruns and delays that are being experienced at new home projects across the U.S. Additionally, these findings imply that the ever-growing demand for affordable, entry-level housing will need to be met by the resale market or won't be met at all.

Love the One You're With
Home Improvement Spending Hits Record Levels

In a recent forecast from the Harvard Joint Center for Housing Studies and real estate consultants John Burns Real Estate Consulting (JBREC), spending on home repairs and remodeling is expected to exceed $300 billion in 2016, surpassing the record of $285 billion set in 2007 during the housing boom.



An unusual housing recovery characterized by extremely low for-sale inventory (often leading to price appreciation and bidding wars) is the biggest factor driving this trend, as the number of for-sale listings as a percentage of occupied households in the U.S. has hit a record low this year. Other factors include a more arduous home buying process – in terms of loan approvals, credit checks and other formalities – and the fact that U.S. homes are simply getting older. According to census data analyzed by JBREC, homes built more than 30 years ago currently make up 65% of the nation's housing stock, a significant uptick from 47% in 1995.

JBREC predicts that this trend will continue and spending on home repairs and remodeling will grow faster than new residential construction through 2019.

(Editor's Note: Home improvement retailers Home Depot (NYSE: HDT) and Lowe's (NYSE: LOW) are benefitting tremendously. The companies' stock prices are up 11% to 15% in the past year and more than 300%over the past five years. Also, increased environmental regulations and rising development costs likely contribute to the increased home remodeling activity. If fewer new homes are being built, you may have to just "love the one you're with.")

Homeownership Rates Dip but Household Formations on the Rise

Recent data released by the Census Bureau revealed that the homeownership rate in the U.S. has fallen to 62.9%, the lowest figure since 1965. The *Wall Street Journal* described this dip as "a reflection of the lingering effects of the housing bust, financial hurdles to buying and shifting demographics across the country".

However, an overall growth in household formation suggests that more Americans are moving out of mom and dad's house and moving into rental housing. Since the beginning of the 2008 recession, this ever-growing pool of renters has driven a steady increase in household formation in the U.S. In just the last year, renter-occupied housing units increased by a robust 967,000 (~2.2%). A chief economist at *Trulia* commented, "Household formation numbers suggest that if the decline [in ownership] is real, it is more likely due to a large increase in the number of renter households than any real decline in the number of homeowner households."

A growth in household formation suggests that more Americans have the confidence to strike out on their own, buy furniture and start families. At some point, many of these renters may want to become buyers, further exacerbating the shortage of affordable entry-level housing.

TRAILBLAZING: CEDARDALE APARTMENTS, SEATTLE, WA

Reviving a Well-Maintained 1980s-Vintage Apartment Community

Before

After

*Ahhh…*breathe in the fresh, rain-kissed air and rustic charm of the Pacific Northwest.

That's what we did last spring when we first visited Cedardale Apartments in Federal Way – a suburb just outside of downtown Seattle. We were enamored with the serene and secluded setting, mature landscaping, open space and beige siding.

Hold on…*beige* siding? (Well, okay, a few things needed some updating). However, we saw past the drab building colors and dated interiors, recognizing an opportunity to revive a 30-year-old apartment community in the Seattle suburbs. Our goal: to modernize the community while retaining its serene Pacific Northwest charm.

Cedardale is located on a seven-acre parcel and consists of 126 apartments, a mixture of one and two-bedroom units ranging from 608 to 905 square feet. The buildings were constructed from 1981-1983 as condominiums but none were sold. The apartment interiors, although dated, feature efficient floorplans, in-unit washer/dryer and private balconies or patios. The property is about three miles from Pacific Highway South (99) and Interstate-5, providing easy access to the area's major transportation corridors servicing Seattle, Tacoma and Bellevue. Residents also enjoy nearby restaurants, shopping centers and recreation facilities.

After our purchase, we completed some much-needed deferred maintenance, which included repairs to the property's underground drainage and landscaping systems. Additionally, we quickly pulled Cedardale out of the '80s with a fresh, lively exterior paint scheme and will be adding several common area amenities including a community dog park, fitness center and BBQ area as well as completely renovating the clubhouse and leasing center. We are currently updating the unit interiors by adding new flooring, lighting, paint, appliances and countertops and have renovated about 50 apartments to date (and continue to renovate four to five units per month). We hope to start construction on the common area improvements in early 2017.

As Seattle's job growth (67,000 jobs in the past 12 months!) continues, nearby suburbs like Federal Way are experiencing significant rent growth, which could continue for another few years. As fishermen on the Puget Sound have been heard to say, "a rising tide lifts all boats" and Federal Way (and Cedardale) are benefiting from Seattle's boom.

NOTABLES AND QUOTABLES

Life Lessons from Will Rogers, American Cowboy (1879-1935)

"Never squat with your spurs on."

"Buy land. They ain't making any more of the stuff."

"When a dog gets a bone, he doesn't go out and make a down payment on a bigger bone. He buries the one he's got."

"Never miss a good chance to shut up."

"Never kick a cow chip on a hot day."

"Good judgment comes from experience, and a lot of that comes from bad judgment."

"Always drink upstream from the herd."

"If you find yourself in a hole, stop digging."

"It takes a lifetime to build a good reputation, but you can lose it in a minute."

"Never slap a man who's chewing tobacco."

IMPORTANT DISCLOSURES

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