THE PATHFINDER REPORT

February 2018

IN THIS ISSUE

The initial closing of Pathfinder Partners Opportunity Fund VII, L.P. (the "Fund") will be held in March. The Fund will remain open until December 2018. Click here for more information on the Fund and to view a brief video about Pathfinder.

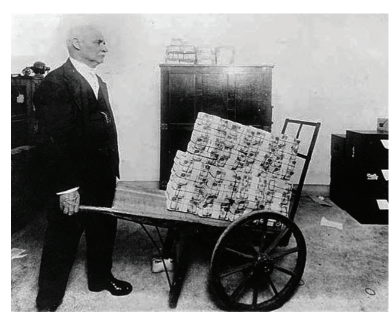
CHARTING THE COURSE

This Valentine's Day, the Gift of Inflation

By Mitch Siegler, Senior Managing Director

On Valentine's Day, the Labor Department released the January Consumer Price Index (CPI), a measure of inflation. The jump in CPI – .54% – was the highest level in five months and well above consensus estimates of .30%. The core rate, which excludes food and energy (who needs to eat or heat, anyway?) jumped .349%, also above forecasts. A dozen red roses or a box of Godiva® chocolates would have been nicer.

While we've become accustomed to a slow-growth recovery, anemic wage pressures and little inflation in the price of goods (held down for decades by low-cost imports and technology and more recently by declining spending by us aging baby boomers), the Valentine's Day news suggests that long-dormant inflation may finally be closing in on the Fed's 2% target. Traders took the news as a signal of higher interest rates ahead, with market odds of 100% for a rate hike on March 20-21, according to Bloomberg. The odds of rate hikes in September and December are now better than even money. Futures prices suggest the odds of four 2018 rate hikes rose from 17% to 23% after the Valentine's Day inflation news.



Optimists see inflation as a sign of a strong economy and associate it with faster economic and wage growth, rising stock prices and increasing values for real estate and other hard assets. For real estate investors, rising inflation suggests higher rents and less new supply (since inflation puts pressure on interest rates and construction costs, curtailing new development). Pessimists worry about out-of-control price increases and have nightmares of folks pushing wheel barrels of worthless banknotes down Main Street, a la the Weimar Republic.

For nearly a decade, we've seen slow growth and very low inflation, which many have thought unsustainable. That's because in the aftermath of the Great Recession, central banks flooded the system with money to stimulate hiring, production and economic growth. These central bank policies certainly contributed to an economic rebound but brought about inflation of asset values (from master's paintings and fine wines to equities and real estate).

We are now beginning to see the systematic unwinding of extreme global monetary policies that brought interest rates to zero (and below) and flooded the financial system with liquidity. Raising interest rates – referred to as the Fed 'taking away the punch bowl' to keep the party from getting out of hand is a central banker's go-to tool for keeping a lid on inflation.

Now, with the economy at full employment and average hourly earnings growing at a 3% annual pace in January, interest rates are still hovering near Great Recession levels. Jerome Powell, the new Federal Reserve Chair, is no fan of quantitative easing or super-low interest rates and testified during his Senate confirmation hearing that it's time for rates to rise.

A "normalized" rate environment likely means a federal funds rate of 2.75%, about double the current 1.25% to 1.50% target range. That suggests more than three 25 basis point increases this year, as the market is now coming to grips with. Witness the roller-coaster ride in stock prices and volatility the first couple of months of the year and the 50-basis point increase in 10-year bond yields from 2.40% on December 31, 2017 to more than 2.94% on February 15th – and the highest level in more than four years.

So, What's an Investor To Do?

At Pathfinder, we view inflation as an important consideration against the critical backdrop of supply and demand forces. We remain extremely bullish on value-add, Class-B apartments in our target markets because, very simply, demand dwarfs supply. Demand is through the roof, as evidenced by historically high occupancy levels (95%+, full occupancy in all our markets) and robust rent growth for the past several years. Millions who previously owned homes are renting apartments, a dynamic we believe will accelerate in the years ahead for numerous systemic reasons. And, the *2017 Tax Cuts and Jobs Act* creates fewer incentives to buy and more to rent, adding fuel to an already blazing fire.

New supply remains constrained, because of severe barriers to entry (limited land availability, restrictions on growth, rising entitlement and construction costs and NIMBYism – a 'not in my backyard' attitude in many communities). And, virtually the only new supply being delivered is Class-A/luxury properties, unaffordable for many.

Real estate is a hedge against inflation because commercial leases generally have a rent escalator provision tied to CPI. Apartment leases are typically shorter-term, six to 12 months, so rents can be adjusted very quickly. And, since some tenants move out every month, apartment owners can adjust some rents immediately. Since rising inflation is generally due to rising wages, tenants should be able to pay the higher rents. Pathfinder's strategy of acquiring older, under-managed properties which haven't been renovated allows us to add value and design in a margin of safety.

The danger, of course, is that higher inflation leads to higher interest rates, which can also lead to higher capitalization ("cap") rates, which may reduce the future value of the property. At Pathfinder, we protect against rising rates by utilizing fixed-rate financing (capping one of our higher expense items in an environment where future rent growth may accelerate), completing the bulk of our costly renovations in the first couple of years (presumably at costs well below what they'll be down the road) and underwriting, up-front, for higher cap rates upon sale in five to seven years.

None of us, except a handful of central bankers, perhaps, can impact the rate of inflation – to say it's out of our hands would be a profound understatement. But, we can make informed investment decisions based on our inflation expectations. If you expect inflation to escalate, it may be time to sell your bonds. If you're partial to equities, consider a portfolio that's weighted to brands with strong pricing power. And, if real estate is your thing, consider strategies like ours, with shorter lease terms and the ability to add value by manufacturing income. A dependable and growing income stream can be as beautiful as roses and as sweet as chocolate.

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FINDING YOUR PATH

Millennial Housing Trends: The Renting Generation

By Lorne Polger, Senior Managing Director

Can you believe it? Over 75 million of them. Millennials have now surpassed Baby Boomers as the largest generation alive, according to the U.S. Census Bureau. But notwithstanding the size of their cohort, millennials still fall far behind Baby Boomers when it comes to homeownership.

Almost 80% of Baby Boomers own a home. Contrast that with an approximate 35% homeownership rate for the Millennial generation, according to the latest U.S. census figures.

Millennials, roughly aged 18 to 36, face many challenges when it comes to entering the housing market. In its predictions for 2018, Zillow noted that rising interest rates, low home inventory and escalating prices and high student loan debt will continue to make it difficult for Millennials to enter the homeownership arena. It's a huge generation just entering the market that want to become homeowners, but they can't get to the starting line.

I read through Zillow's most recent and very detailed *Consumer Housing Trends Report*. Among their conclusions? Post-recession, renting is more than a precursor to homeownership. It's become a lifestyle choice. Renters account for a larger share of American households than they have in decades, in part because of the unaffordability of homeownership and the lasting effects of the housing bust – but also because many people, especially Millennials, are choosing to rent instead of own.

When it comes to home buying, different demographic groups have different needs and challenges. Millennials – the largest group of potential home buyers – often rent while searching for a home to purchase. Their reality is that the buy cycle may prove for them to be long, frustrating and often unsuccessful.

Here are a few additional takeaways:

- Millennials comprise the largest segment of the rental housing pool.
- Millennials make up the smallest percentage of current homeowners.
- The median age of today's renter is 32; most renters earn less than $50,000/year.
- Apartments are the most popular home type for renters. Nearly two-thirds seek them out. Another 28% rent a single-family home. This number is up dramatically over the past decade.
- The median U.S. rent is $1,010, with a wide disparity by region:
  - $1,223 in the West
  - $1,169 in the Northeast
  - $974 in the South
  - $851 in the Midwest

Renters account for 37% of all households in America – that number is up significantly since 2005. This rise in renting is due in part to the eight million homes lost to foreclosure during the housing bust, which turned many former homeowners into renters.

Renting has changed, though. It's no longer a waystation waiting for the home purchase opportunity to come through. Many renters, especially Millennials, are actively choosing to rent their home rather than own it, often because it supports their lifestyle (which these days, often include multiple job changes, delays in marriage and geography moves). Others rent by necessity – largely due to insufficient income or savings for a down payment. As noted above, the typical renter household earns less than $50,000, which aligns with the top concern for most

renters: finding a place within an acceptable price range. As home mortgage rates continue to rise, this will present an even greater challenge.

Today's rental market is closely tied to two young and diverse generations: Generation Z and Millennials. These two generations comprise the largest share of households renting in the past year. As noted earlier, today's typical American renter is 32 years old and unmarried – think Millennials. Millennials are waiting significantly longer to marry and having fewer children than earlier generations. The majority of Millennials are repeat renters.

Although many renters are single, the majority live with others, and most often this includes a family member. Single renters, who either have never married or are divorced, opt to rent, likely because they value mobility or prefer the renting lifestyle, or for financial reasons (the down payment is too large a hurdle with a single income or they're servicing substantial student loan debt). Two-thirds of single renters never consider buying. Families with children in the household who currently rent their home, however, are more likely to consider buying.

Three other Millennial drivers also suggest that demand for rental housing will remain strong.

Jobs

Though it might seem obvious, proximity to jobs is the top priority for Millennials in their housing search. The propensity of Millennials to job hop (the average Millennial has four different jobs during their first ten years out of college) and more fervently pursue career opportunities outside of their home cities suggest that home ownership may not be the way to go. You can give 30-day notice to your landlord, but it can be tough to sell a house in 30 days.

Affordability

Because many Millennials are still paying off mountains of student debt and are confronted with stiff competition to buy in a low-inventory real estate market, affordability is key. Of the Millennials who are looking to buy homes, Zillow's study showed that many are bypassing the concept of the starter home and looking for larger homes that fit into their budgets. This suggests that they may wait longer, in some cases, much longer, to buy that first home.

Experiences

Cities that invest in downtown renovation, public spaces, transportation, dining and entertainment will attract Millennials looking to live near places to commune (i.e., gather with friends, eat, drink and exercise). Those investments are attractive to both owners and renters. The hip/cool element of some of the cities that Pathfinder targets (including Denver, Portland, Seattle and San Diego) is tangible, and apartment amenities have moved light years in this direction, offering community experiences that were not even thought of five or ten years ago.

Zillow's 2018 real estate predictions back this up, pointing out that more affordable entry-level homes will likely be farther from the urban core. As a result, over time, Millennials and other first-time home buyers will likely flock to the suburbs for a greater variety of homes at lower prices.

Rents have risen steadily over the past few years, while incomes have remained largely stagnant. Given these market dynamics and low mortgage rates, purchasing a home has again become increasingly attractive – so long as obtaining the down payment and qualifying for the loan aren't insurmountable barriers.

For the Millennial generation, the confluence of these factors (relatively low wage growth and rising rents limiting one's ability to save for a down payment, rising home prices and interest rates limiting one's ability to qualify for a home, later marriage, job hopping and increased mobility) suggest to us that they will be the "rental generation" for the foreseeable future.

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GUEST FEATURE

How Driverless Cars and Ride-Sharing Services Will Fundamentally Change Real Estate

By Scot Eisendrath, Managing Director

Driverless cars are barreling down the road, there's no doubt about it. Heck, in Pittsburgh you can already hail a self-driving car through Uber, and Ford recently announced that they're on track for a fully autonomous vehicle by 2021. The widespread acceptance of ride-sharing shows no signs of slowing down. It's been said that the combination of autonomous cars and ride-sharing could be the single biggest change to our society since the internet.

I see forecasts of when driverless cars will rule the roads – from ten to 20 years out – but with all the money and brainpower being spent by the world's most innovative companies (Google, Intel, Apple, Uber, Lyft, Tesla, Volvo, Ford, Mercedes-Benz, the list goes on and on), my money is on sooner rather than later. There are naysayers out there, those that love the driving experience as well as their cars and trucks, and those that just plain refuse to believe that the technology is on our doorstep. Driverless cars and ride-sharing services not only will have a profound impact on our society, but they will also have a profound impact on real estate. I compare the skeptics to the holdouts a decade ago who were sure that Amazon and the internet would never make much of a dent in brick and mortar retail. It's coming, folks, and the winners will be those who embrace it and take advantage of the change.

Driving preferences have already changed. I'm a big user of Uber and Lyft. If we are going out with friends, and everyone plans to enjoy some alcoholic beverages, I'm the first to offer to grab an Uber. When I travel, if I can get around economically and efficiently, and avoid the car rental pickup and drop off, ride sharing services are the way to go.

I see it with my kids, too. When my daughter recently turned 16, I was so excited to get her a car. When I was 16, like so many of my contemporaries, I was thrilled to get the freedom of a driver's license. I'm blown away by the fact that I see the brand-new Jeep we bought our daughter spend more time in our driveway than on the road. She drives to school and other functions, but when it comes to going out with friends, the preferred method of transportation is still her parents (probably has something to do with the law in California that kids can't drive with other teenagers until they've had their license for a year). My son, 13, is the same. We recently had a conversation about what type of car he may want when he comes of age (a low mileage Jeep?), and he said "Dad, I don't need a car, I'm just gonna take Uber".

So, we've peered into our crystal ball and identified the top five effects of driverless cars on real estate (especially residential real estate):

Real Estate Prime for Redevelopment – Think of all the prime real estate occupied by businesses that may be affected by autonomous cars – parking lots, auto repair facilities, car dealerships, gas stations, self-storage facilities and hotels, to name a few). One of the virtues of driverless cars is that they should be safer than cars driven by humans, which means fewer accidents, which means less of a need for auto repair facilities. Think about the fact that there are currently 125,000 gas stations in the U.S. The trend is already toward electric vehicles, and that should increase with driverless cars, which will help to free up premier (corner) real estate in our cities. Another potential impact is that there should be less of a need for self-storage space, as autonomous cars will free up a portion of the garage space in existing homes, apartments and commercial buildings for storage space. I've read that demand for lodging could also go down as people may choose to sleep in their cars during longer

road trips. You get the point, the impact to many businesses will be extreme, and that should affect their underlying real estate.

Parking – Parking is a big one that will affect existing residential projects and parking garages in urban areas (see #1, *Real Estate Prime for Redevelopment*) as well as parking in new developments (see #5, *Zoning and Land Use Will Evolve*). There is approximately 144 billion square feet of parking in the U.S., which represents up to one-third of the total real estate in some cities. It is estimated that self-driving cars may free up to 61 billion square feet (42%) of this real estate to be redeveloped or repurposed into a higher and better use. Consider that the average new home is 3,000 square feet with a 500-square-foot garage (14% of the total space). In newly constructed homes and apartment buildings, garages and parking spaces may one day be non-existent, or at least smaller. We are already seeing that in the urban areas of some forward-thinking cities, such as Portland, Oregon, Seattle and Washington.

Suburban and Outlying Markets Should Become More Attractive – Since effective commute times will be reduced, commuting distance may matter less in the decision-making process of home buyers and renters. If you can start your work day when you get into your car, as opposed to when you get into the office, an extra 15 or 30 minutes in the car is less painful. Make phone calls, hold meetings, eat breakfast, read the news, surf the web – no limits on what you can do. Autonomous cars will give people the ability to do other things while they are commuting. By making suburban locations more attractive via easier commutes, there may potentially be a shift in residential property values from those in urban areas to those in suburban areas.

Construction Costs May Decrease – It is estimated that by 2025 driverless trucks will provide annual savings of $100 to $500 billion in reduced delivery expenses. This should help reduce the cost of delivering construction materials. In addition, according to a report by CBRE, in the Washington D.C. area each additional parking space in a residential development increased the overall cost by 25%. Factors such as these should bring down construction costs and make building more efficient.

Zoning and Land Use Should Evolve – At Pathfinder, we recently entitled three parcels of land in San Diego County for multifamily developments. The process was painful. The underlying theme we heard by the groups which opposed our developments were a lack of parking provided for, and additional traffic generated by, our residents. I firmly believe today's zoning requirements are archaic and we're looking in the rearview mirror when we make urban growth decisions based on these criteria. The days of providing one parking space for each bedroom should be behind us. Requirements like these, which don't reflect the way people live and work today (and certainly not in the future) only leads to increased housing costs when unaffordable housing is already a huge challenge. Eventually, the tide will turn, and parking requirements will be reduced to reflect the requirements of our changing society. This will lead to higher-density developments that are less costly to build, which should eventually provide some relief to the housing affordability crisis.

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ZEITGEIST – SIGN OF THE TIMES

California Rent Control Proposal Fails to Advance

As California's population continues to grow and new home building has failed to keep pace, rents have risen dramatically over the past several years. The Costa Hawkins Rent Housing Act – a 1995 bill which sets limits on cities' rent control policies – was up for repeal in the State legislature in January but failed. The bill protects a landlord's ability to raise rents once a tenant moves out and prevents cities from establishing rent control on apartments built after 1995. A similar repeal effort failed in the Washington state legislature in February.

Supporters of the repeals point to drastically increasing rental rates and believe rent control could help make housing more affordable for low income residents. Opponents believe additional rent control measures will exacerbate an already critical housing crisis by further disincentivizing new development. The California repeal died after members of the Assembly Housing and Community Development Committee failed to support the repeal, including Democrat Jim Wood. "I'm concerned that the bill does nothing to increase the supply of housing and may in fact have the opposite effect of discouraging new construction during a time when we need it the most," Wood said.

(Editor's Note: Ultimately, rental rates and housing shortages are a supply and demand issue and with more people moving to California than new housing being built, rents are projected to continue to rise in years to come. We believe there are better approaches to solving the state's housing crisis including streamlining new development and placing reasonable restrictions on short-term rentals, which removes housing stock for residents.)

Housing in the Aftermath of the Great Recession

Forbes recently reviewed the U.S. Census Bureau's American Community Survey ("ACS") data from 2008 and 2016 to understand how the real estate recovery following the Great Recession was distributed within the 51 largest U.S. metro areas. Below are the findings at a national level for the period 2008 to 2016:

- Average median home value grew from $254,000 to $266,000, a 5.3% increase.
- Average rent grew from $757 to $923, a 21.5% increase.
- Supply of housing units increased by an average of 7.4%.
- Vacancies decreased by an average of 9.6%.
- Renter-occupied units increased by 19.3% while owner-occupied units increased 1.1%, indicating a shift from homeownership to renting.

The national data doesn't tell the entire picture, however, because none of the 51 metros surveyed mirrors the national averages. Instead, each of the U.S.'s four major regions – the Northeast, Midwest, South and West – tells its own story. The West – to no one's surprise – saw a drastic drop in vacancy (-19.4%) coupled with the highest absolute home prices and rents, both rising at the fastest rates (8.1% and 25.2%, respectively). The Midwest saw similarly low housing growth (4.0%) and falling housing prices (-0.8%). The Northeast has seen the lowest rate of housing growth (3.6%) and is the only region that experienced increased vacancy (6.6%). The Southern metros added the most housing units (10.9%) with the greatest increase in numbers of renters (28.5%).

The Southern California Housing Squeeze

In January, the California Association of Realtors ("CAR") reported a 91% or $239,000 rise in Southern California single-family home prices over the past 69 months. Mortgage rates have averaged 3.8% over the past three years and, according to CAR, the 30-year fixed rate mortgage will rise to 4.6% in 2018. And even if you have the financial wherewithal to absorb the higher purchase prices and rising interest rates, good luck finding a home that fits your criteria in a drastically supply-constrained market. At the start of 2018, SoCal had just 27,550 homes for sale, the lowest for-sale inventory in five years. To top it off, the *2017 Tax Cuts and Jobs Act* caps mortgage interest and property tax deductions, further reducing the advantages of homeownership in the Golden State.

With the homes becoming less affordable, would-be buyers are being squeezed out and forced to rent. This cycle is keeping vacancy rates extremely low (think "full") and pushing rents even higher. These affordability issues are expected to continue as construction costs continue to rise and the state's new housing development pipeline struggles to keep up with demand.

TRAILBLAZING: THE ARGYLE, FEDERAL WAY (SEATTLE), WA

It's All Within Reach

Federal Way – a diverse, working-class city within the Seattle metropolitan area – is located on the western shoreline of Washington's Puget Sound, the second largest estuary in the U.S. Conveniently located two blocks from Interstate 5 (the major highway serving the Pacific coast) between two of Washington's largest cities (Seattle and Tacoma) and minutes from the Seattle-Tacoma International Airport ("Sea-Tac"), it's no wonder that the area has adopted the slogan "Federal Way: It's All Within Reach."

Last spring, Pathfinder made its third investment in Federal Way with the acquisition of Argyle Apartment Homes ("Argyle"), a 1984-vintage, 160-unit apartment community. Argyle is located on five acres and includes 13 residential buildings consisting of 81 one-bedroom/one-bathroom units, 49 two-bedroom/one-bathroom units and 30 two-bedroom/two-bathroom units averaging 792 square feet. Each unit contains a private entry, wood-burning fireplace and spacious private patio. Amenities include a playground, covered parking, pool and recently renovated clubhouse, business center and fitness center.

Argyle provides an ideal living environment for the surrounding community's large working-class population. The property is located a few blocks from the Transit Center & Park and Ride, providing bus service to nearly every destination within the Seattle metro area, and a half mile from a future light rail stop that will connect local residents to Sea-Tac and downtown Seattle. Argyle is also near major retail including the Commons, a 740,000 square foot regional shopping mall, and several parks including Steel Lake Park, Town Square Park and the 84-acre Celebration Park.

Kitchen – Before Renovations

Kitchen – After Renovations

Our business plan is to implement professional management, remedy deferred maintenance items, renovate and modernize the unit interiors and common areas, rebrand and refresh the marketing and add several amenities (including an expanded gym, BBQ area and pool lounge) – all while embracing and enhancing the property's southern-style architecture. To date, we have transitioned to our preferred management company, commenced work on deferred maintenance, completed our first apartment interior renovation and are working with our designers and architect on the common area renovation plans. We anticipate completing common area renovations in mid-2018.

Tucked back amongst the evergreens, Argyle provides residents an opportunity to live in a tranquil setting centrally located near the best of what Seattle has to offer: quality housing, employment centers, dinning, shopping, entertainment and recreation. At Argyle, and in Federal Way, it's all within reach.

Seattle: Did you know?

Space Needle Makeover: Seattle's iconic landmark is in the midst of a $100 million makeover. The project will take several years to complete and includes lots and lots of glass. The open-air observation deck will have glass benches and tall glass panels, which will replace the existing safety wire. The landmark restaurant, SkyCity, is being redesigned with a new see-through rotating glass floor, glass dining tables, glass chairs and glass floor-to-ceiling windows. As you dine you will be able to look just beyond your plate to a view 500 feet below – hold onto your fork!

Photo Credit: SpaceNeedle.com

The Washington State Convention Center Expansion: Plans to expand the Washington State Convention Center will add 1.2 million square feet of exhibition and meeting space, a 30-story residential tower with 428 units, a 16-story office building and new retail and public space. With a cost around $1.6 billion, the project is the largest in Seattle's history. The project is scheduled to break ground later this year, with an estimated 2021 completion date.

Photo Credit: Seattle Design Commission

The New Rainier Square Tower: This 850′ mixed-use skyscraper will complement the existing 514′ Rainier Tower and, when completed, will be the second tallest building in Seattle after the Columbia Center. The 58-story tower will include ground floor retail, office space and 200 residences on the 41st through 58th floors. The project's 722,000 square feet of office space is already fully leased to Amazon.com – one of the biggest leases in Seattle history. The building is currently under construction and could open as soon as 2020.

Photo Credit: RainierSquare.com

NOTABLES AND QUOTABLES

Progress

"Behold the turtle, he makes progress only when he sticks his neck out."

- James Bryant Conant,
American chemist

"The best way to predict the future is to create it."

- Abraham Lincoln

"If you can't fly then run, if you can't run then walk, if can't walk then crawl, but whatever you do you have to keep moving forward."

- Martin Luther King, Jr.

"Without deviation from the norm, progress is not possible."

- Frank Zappa,
American musician

"Discontent is the first necessity of progress."

- Thomas Edison

"If there is no struggle, there is no progress."

- Fredrick Douglas

"He who is not courageous enough to take risks, will accomplish nothing in life."

- Mohammad Ali

"I can't change the direction of the wind, but I can adjust my sails to always reach my destination."

- Jimmy Dean,
American country singer

"The secret of change is to focus all of your energy, not on fighting the old, but on building the new."

- Socrates

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