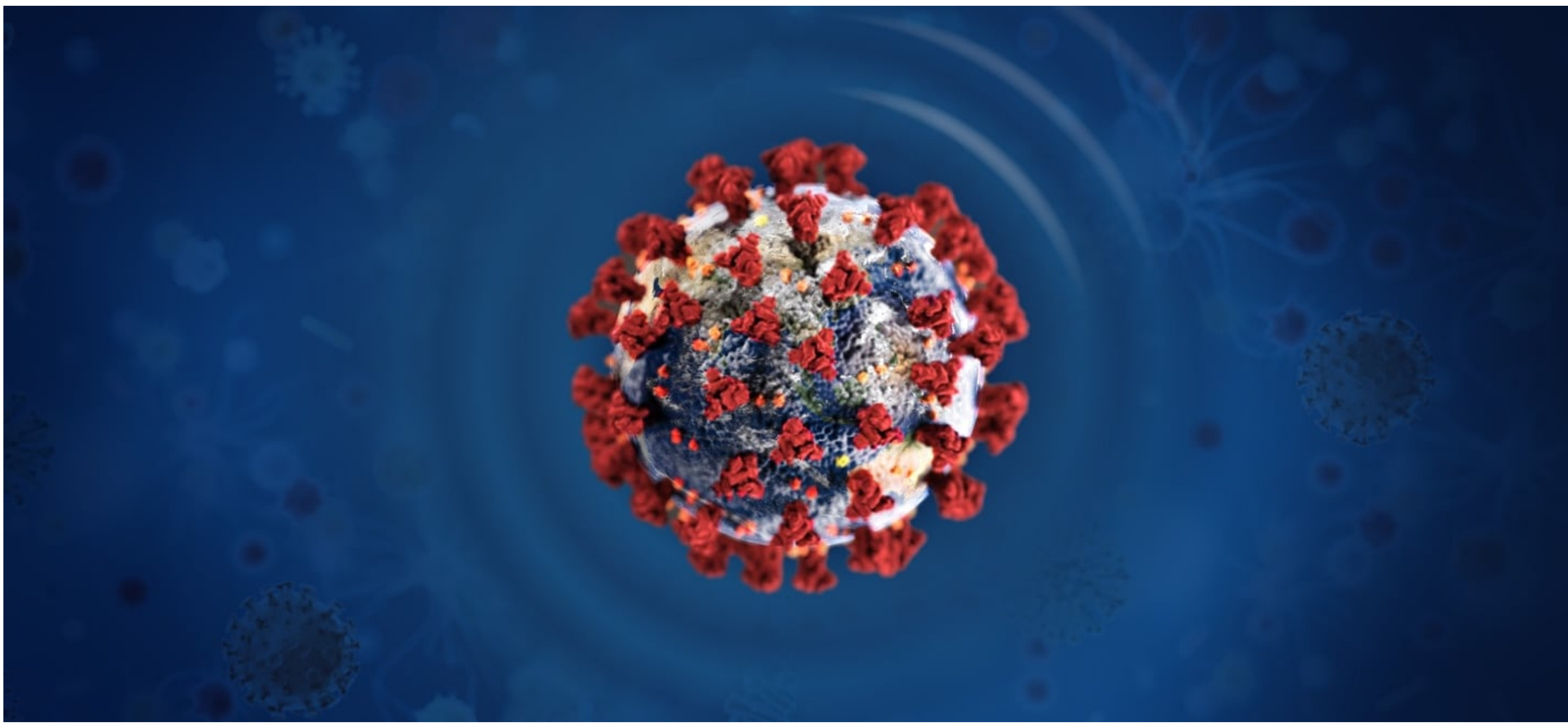
SORTIS®



COVID-19 Investment Strategy

March 24, 2020

Forward from our Executive Chairman

As the COVID-19 situation evolves, I wanted to share our status at Sortis Holdings and our thoughts on the impact to the markets and our three funds based on research and communications to date with partners, investors, borrowers and other experts. The sudden turnabout in US and world economic fortunes is without historic parallel. We hope the recovery from this proves to be the same. First and foremost, the health of our employees, investors and their families is our number one concern. We are working remotely, which we are well equipped to do with our business model. Up until this January when we consolidated to a single location, we operated out of several offices and still have a number of remote employees, so we have had plenty of practice. We have no debt at a company level, no leverage in our funds and we have significant liquidity to place if and when the time is right. I think we are uniquely positioned to not only survive, but to prosper in the current climate.

We certainly do not pretend to be medical experts, nor do I think anyone can be certain how this will play out in the number of cases and deaths. We can only hope and pray for the best as we have all of the preeminent medical professionals in the world working on a solution. We do have an opinion about the length of the business shutdown and the ultimate economic impact that the crisis situation will cause. This document expresses our current analysis on the impact to markets for alternative assets and primarily real estate. As this fluid situation evolves, so will our positions.

I think James Bullard, President of the St. Louis Federal Reserve Bank, said it best, "This time, as the coronavirus cloisters millions of Americans and shuts down the U.S. economy, it should instead be saluted as an investment in public health that lays the groundwork for a rapid rebound."

At Sortis, we are focused on being patient and not having knee jerk reactions as we are just weeks into this crisis. While this is a terrible human tragedy, there will be business opportunities that present themselves as we come out of it. I want to personally acknowledge and thank our investors for the $5M plus of investment over the last several weeks as a show of support given our track record. If we can balance the protection of our investors capital with providing much needed liquidity to our markets, then we will have been successful.

Hoping You and Your Family Stay Safe and Well,

Paul Brenneke
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P.S. The following analysis is lengthy, and I realize in these trying times you have other priorities. If you prefer, you can focus on the short strategy outlines for each of our three funds showing how we plan to navigate the current challenges. If you prefer video, I would suggest this short interview with Barry Sternlicht, CEO of Starwood Capital. I know him personally, have partnered with him on several deals, and think he is one of the best distress investors of all time. I would also recommend this video from Bill Conerly, a Forbes economist who happens to live in the Portland area.

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COVID-19 Overall Economic Impact

Private equity and real estate have a different score card than the public markets as the stock market indices are only one data point in our analysis. It is important to remember that the stock market is not the economy and the market is not causing trouble, it is reflecting perceived trouble. Real Estate does not see the same volatility as the public markets, which allows us to take a more patient and measured approach. The lack of near-term volatility in real estate does not mean we are complacent - we are wary of the potential challenges and opportunities ahead and aim to be extremely proactive. As I told an investor yesterday, we have not even been through a full payment cycle yet, so we need to remain patient and informed with the data while making decisions in this quickly evolving environment.

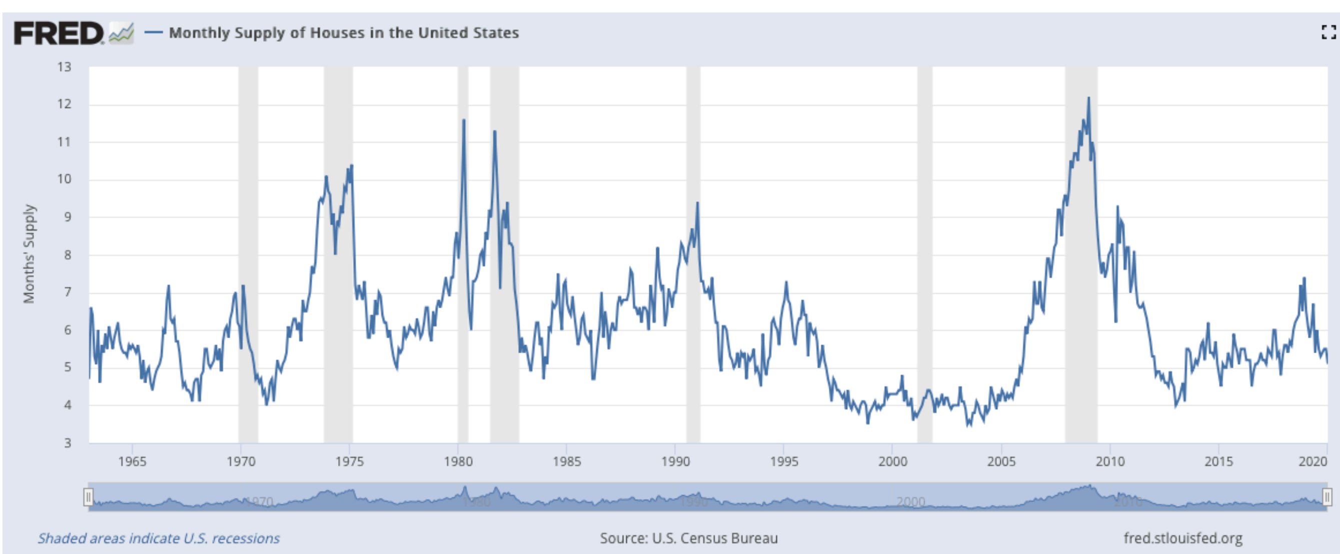
The public markets are going through a volatile knee jerk reaction to COVID-19 and related media coverage. We are closely watching the Weekly Jobless Claims Report, which jumped to 281,000 last week off of 50-year historic lows in the low 200,000's. The total number and duration of job losses will define this event and this is the earliest data set that we will see in this crisis. While the volatile movements in public markets are extremely impactful, they do not tell the whole story or help us project how this situation plays out.

Weekly Jobless Claims

As you can see from the graph above, the two previous recessions had major 'events' that have been compared to COVID-19; 9/11 and the Lehman collapse, which both came at a point when we were already well into a recession and were not the cause of the recession. There was already significant job loss for a prolonged period with rising weekly jobless claims of 400,000 and 460,000 and unemployment of 4.9% and 6.1% respectively. Much like 9/11, the Coronavirus event hit swiftly, but at a time when we were at record low unemployment of 3.5% and weekly jobless claims in the low 200,000's. The 2008 recession was a year plus underway with steady job losses prior to Lehman collapsing. While we will see significant job loss in the near term, primarily in hospitality and travel related industries, we are coming off a much healthier economic base than when these two previous events struck. The hospitality and travel related industries make up 10% of the jobs and less than that in wages. While every recession is different, a review of the previous recessions can be helpful to inform us of the possible depth and duration of the current crisis.

The 2001 recession is blamed on a popped bubble in the public markets culminating in March of 2000, and some would add that Y2K and accounting scandals played a part. 9/11 exacerbated the recession by causing a shut down in the economy for a brief period of time resulting in additional job losses (primarily in leisure and hospitality) that continued to occur until June of 2003 peaking at 6.3% unemployment. Those jobs were lost due to structural issues with the economy and the losses occurred over a period of years. The additional stimulus post 9/11 softened the blow and some even believe it may have been part of the reason for the overheating from 2003 to 2006 causing the Great Recession.

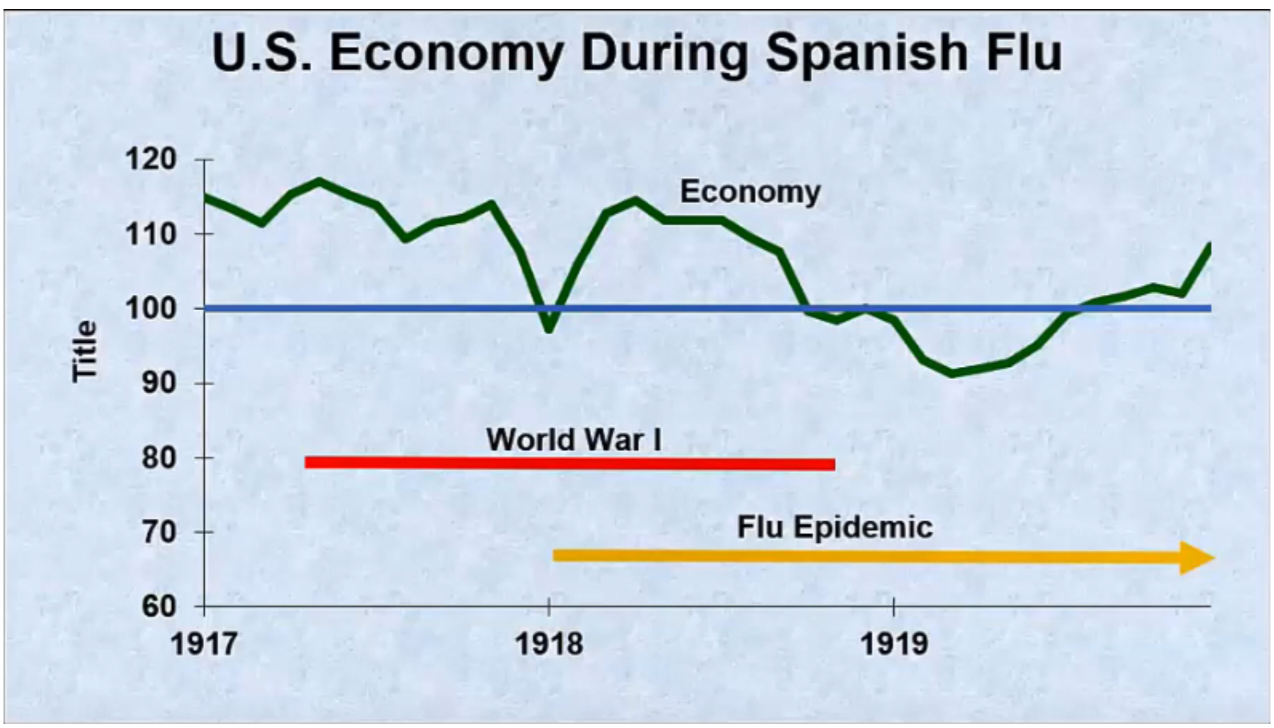
The Great Recession (2008 – 2009) was clearly a popped bubble. In that case it was the collapse of the housing market starting in 2007 with the public markets following. This downturn remains fresh in all our minds as it was the last time we saw a recession and the deepest since the Great Depression. Job losses started in 2008 and continued through late 2010 totaling 8.8 million jobs. The Lehman Brothers collapse was an event caused by the recession. While the Lehman collapse exacerbated the problem, it was not the trigger for the recession. With the benefit of hindsight we can now see the huge supply/demand imbalance in almost all real estate categories. New housing starts averaged over 2 million annually from 2004 to 2007 ballooning inventory to a peak of 11.8 months of supply in October 2008 as seen in the graph below.



Taking one step back further to the 1980 – 1982 recession may give us additional insight. While there are various causes identified many would point to the energy crisis causing inflation that the Fed attempted to reign in with extremely tight monetary policy. This resulted in record high interest rates peaking at 21.5% in 1982, which effectively crushed the real estate market. The 1981-1982 was one of the longest recessions on record at 16 months. Entering these recessions, we also had a large supply imbalance in the residential housing market peaking above an 11-month supply.

We start to see a pattern here of housing led recessions being of longer duration and having much deeper impact. The length of the early 80's and 2008-2009 were much longer than 1991 and 2001 recessions. We already concluded that unlike public markets real estate moves slow - for better or for worse, and depending on the situation. Once you have too much real estate it is very slow to absorb. As you can see from the supply graph it took over 4 years to absorb from the 2008 peak back to a normalized 6-month supply in 2012. Real estate prices were high entering 2020, but that was primarily driven by the years of undersupply. In short, we do not see many similarities to the Great Recession, which was a housing led recession with massive over supply.

Looking further back to the 1918 Spanish Flu, we're able to look at the closest parallel to the COVID-19 crisis which triggered a nine-month recession and an approximately 9% drop in GDP as shown in the graph below (Source: Forbes, March 20, 2020.) The pandemic killed 675,000 people in the U.S. and 40 million worldwide in three waves over two years, primarily during the typical flu season. It was certainly a different era with much less globalization, but this brings to light a relevant data point – the devastating pandemic was followed by the famous Roaring 20's. We can remain optimistic that we will have a similar recovery.

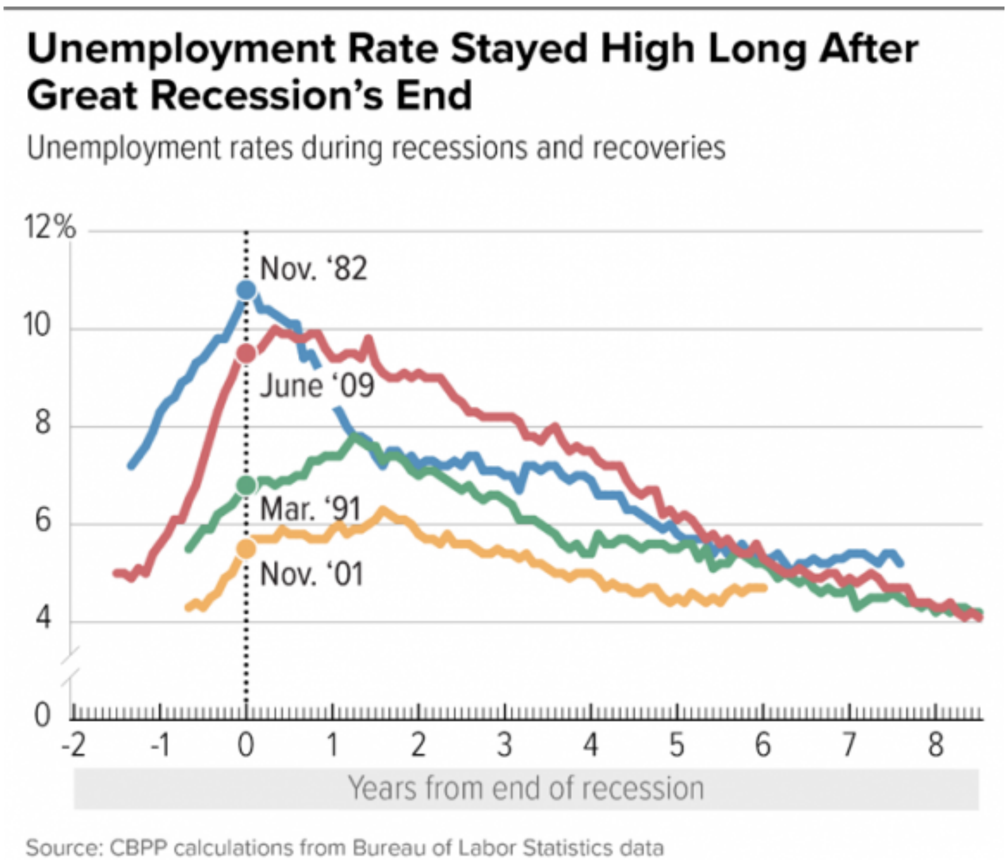


Source: Forbes, Economic Forecast Update March 20, 2020 For COVID-19, Coronavirus Impacts

Bill Conerly, Senior Contributor

The amount of economic damage from the COVID-19 event is going to be directly correlated to the duration of the unprecedented government regulated business shutdown. While I would not claim to be an expert on the expected duration of the shutdown, we are hearing to expect durations for the current shutdown of 30 to 90 days. We will certainly see a very large short-term spike in weekly unemployment claims, likely much higher than any single previous spike, but if we can start re-opening businesses in the next 30 to 90 days it is likely many of the lost jobs can be salvaged.

In recent history, we have not entered a recession without a period of job losses for at least a year prior as depicted in the following graph. This created an accelerating job loss build to a peak, which often was well after the end of the recession. Whatever the outcome of the COVID-19 crisis it will be unique with the losses occurring very quickly and in large numbers, which will likely be the real driver of the expected recession.



I would strongly recommend reading the data, not the headlines, once we start to see unemployment numbers. We fully expect an unprecedented increase in the jobless claims over the next 30 days with projections ranging from 500,000 to over 5 million. Many businesses are deploying early layoffs as a way to survive, using unemployment compensation as a means to keep their employees afloat during the shutdown. This type of unemployment is unprecedented as it remains to be seen if it is acting as a furlough versus a permanent job loss.

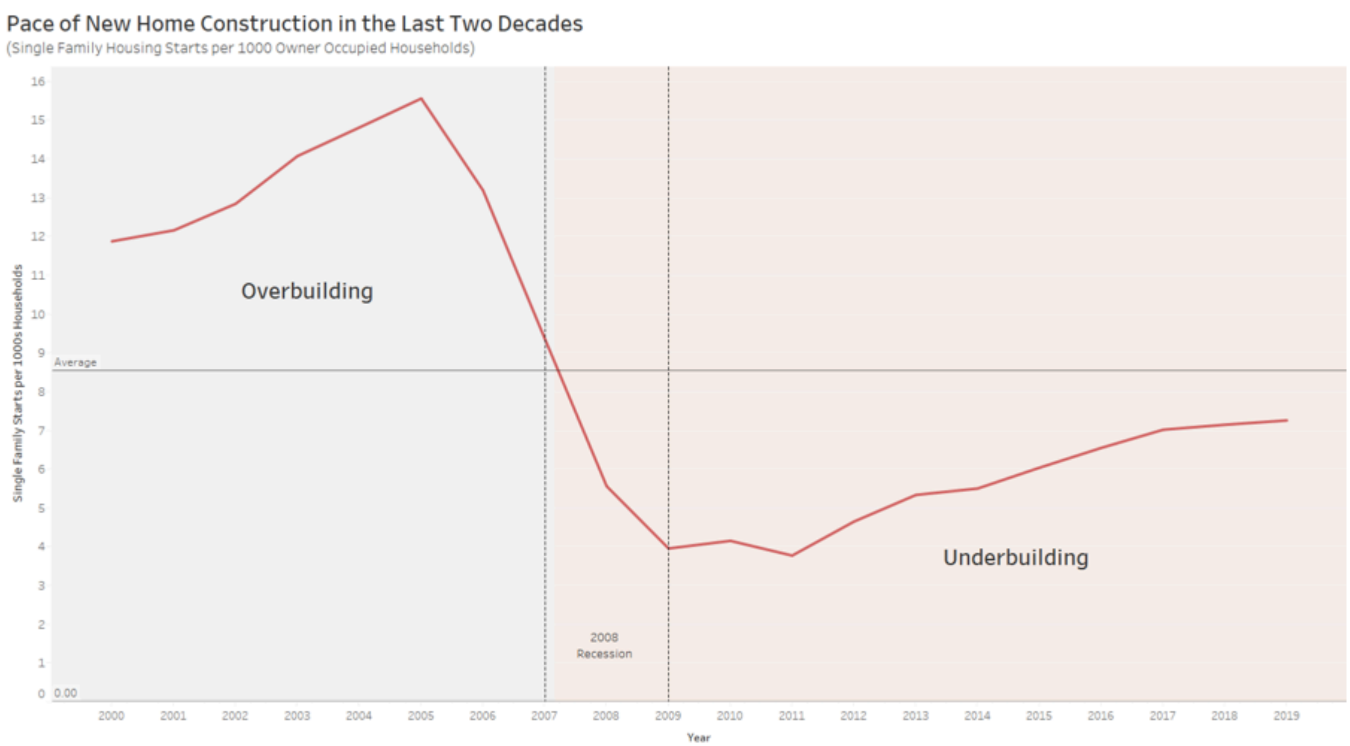
This is completely different than the Great Recession where jobs went away for 18 months prior to and several years after the start of the recession. It has much more similarity to 2001 recession and 9/11 event that had a dramatic shut down, followed by a period of uncertainty and closures. Growth restarted after 9/11 in a matter of months. The impacts did linger for another year before growth meaningfully picked up, but that eight-month recession was one of the shortest on record. Unfortunately, there will be significant attrition in small business. We remain hopeful that the record amounts of proposed stimulus will allow the strongest to survive.

While the number of jobless claims is important, our real focus in on duration prior to re-opening our communities. If we see businesses re-opening in 30 to 60 days the chance of the job loss being temporary, as often happens in a natural disaster, is much higher. Based on our analysis of this data, it is fair to presume we will have a short recession of 6 to 8 months. While the headline GDP loss will be high in Q1 and Q2 we expect to see recovery by the end of 2020. Certainly, if the shutdown lasts considerably longer it will inform our ongoing strategy. The pertinent question for Sortis is how will commercial and residential real estate be impacted, and will we see a repeat of the Great Recession? The short answer we believe is ‘no’. The reason is old real estate adage of supply and demand. The next sections go into more detail.

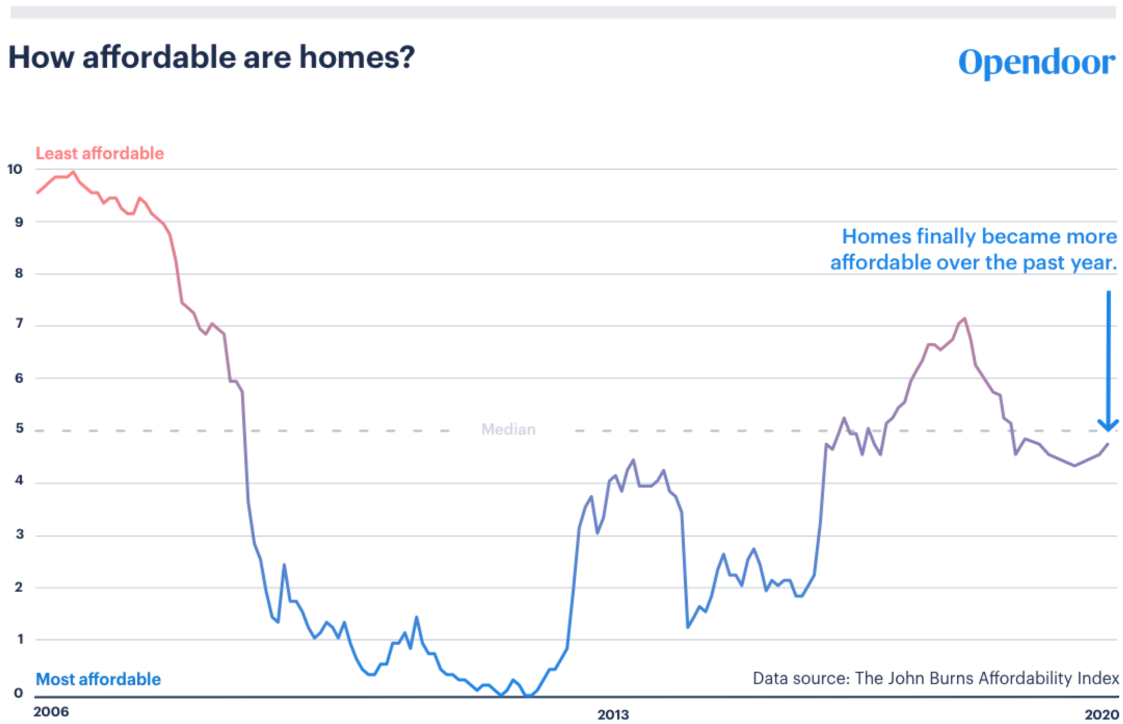
Residential Real Estate Impact

The first question that keeps getting asked – **"Is this going to be like the 2008 recession?"** The 2008 recession was driven by the collapse of the housing market. As discussed previously, we were grossly oversupplied going into the 2008 recession and working through that supply was what caused most of the pain. Additionally, the supply challenges caused a near collapse of our financial system which compounded the problems. It took 4 years from the peak until 2012 to get back to a normalized 6-month supply in the housing market. The record low production in housing during this 5-year period further exacerbated the downturn as the construction industry, typically a big driver of jobs/recoveries, was unable to add jobs for years. It is still referred to as the 'jobless recovery'.

Nationally, we ended 2019 at 3.0 months of total housing supply, which is below the 6-month equilibrium. The reason for this is simple: we have not been able to ramp up the production of housing anywhere near the amount built during the late 1990's to 2006 boom…and that is a good thing that will soften the expected impact here.



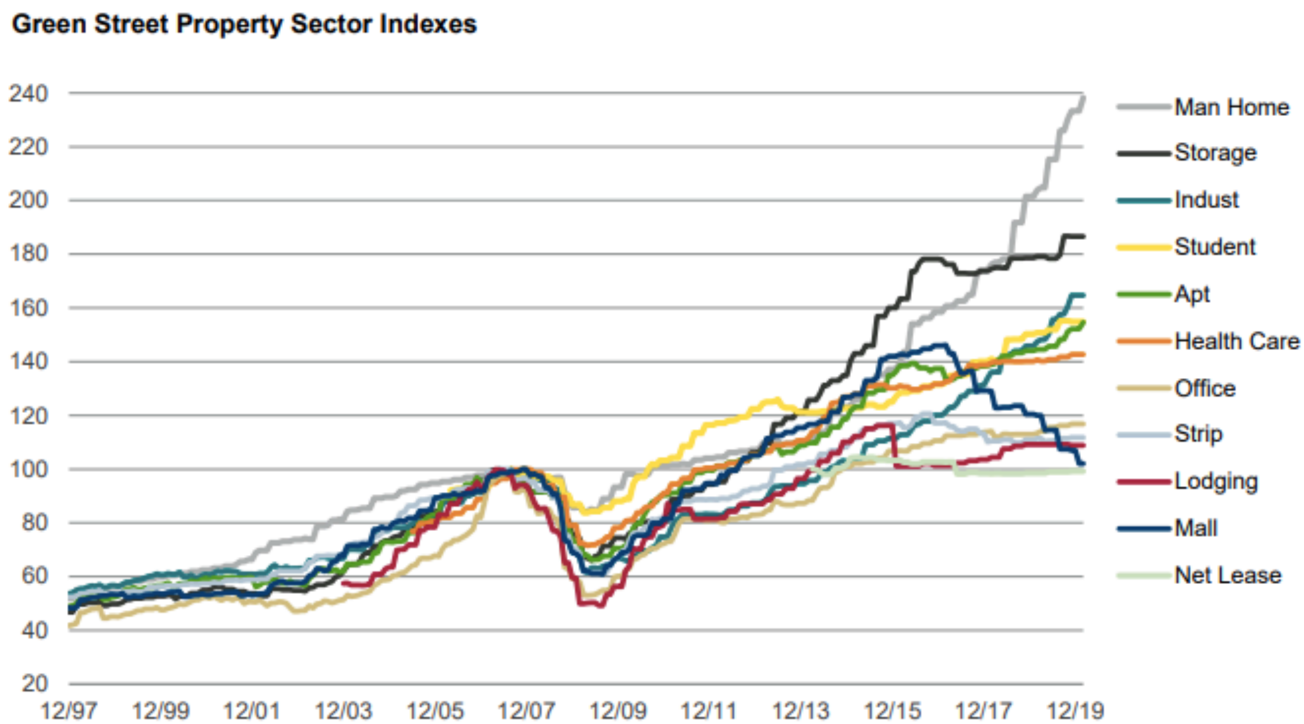
The graph above showing the last 20 years of housing starts tells that story as we have yet to reach normalized production levels 12 years post Great Recession. According to Realtor.com, 5.92 million homes were built between 2012 and 2019 and there were 9.76 million household formations. In the Northwest markets that Sortis focuses on, the ability to over supply is constricted due to land use regulations and geography. Regionally, housing supply is well below the national averages. There will be a short-term correction to pricing as demand is suppressed for a period of months, but we do not expect that to be significant or long in duration.



The other data point we watch in the housing market is affordability. As shown in the graph above using the John Burns Affordability Index, lack of affordability was flashing heavy red as early as late 2005 and continued to build for years until the Great Recession. The affordability issue started flashing light yellow last year, which was part of our decision to slow down fix and flip and construction lending and shift to commercial income property bridge loans. At the start of 2020, affordability had come back into line and should bode well for housing to hold up during this crisis.

Commercial Real Estate Impact

Presuming a moderate shutdown scenario, the commercial real estate market (with the exception of Lodging, Malls and Strip Retail) should come out of this crisis a little bruised, but not battered. On the plus side interest rates should be lower, which will make borrowing costs cheaper and may even drive cap rates down for better assets later this year as investors hunt for yield. The graph below is the most important take away to inform us about value. As you can see from the 'tech wreck' in the stock market in 2000, a severe drop in the stock market had little to no impact on CRE valuations. The Lodging sector that was directly impacted post 9/11, but there was no direct correlation between CRE and the stock market in the 2001 recession. Those valuation impacts were driven by supply and demand. You can also see that Malls, Lodging and Strip Retail were already struggling in 2019 and this crisis will greatly exacerbate those challenges.



All Property: retail (20%), office (17.5%), apartment (15%), health care (15%), industrial (10%), lodging (7.5%), net lease (5%), self-storage (5%), manufactured home park (2.5%), student housing (2.5%). Retail is mall (50%) & strip retail (50%).

Core Sector: apartment (25%), industrial (25%), office (25%), and retail (25%)

Health care: medical office (30%), senior housing operating properties (25%), senior housing net leased (20%), skilled nursing (15%), and life science (10%)

Since the Great Recession, the commercial real estate market has been dominated by institutional buyers now making up over one third of the $23 trillion dollar CRE market. This bodes well for staying power to soften the blow from an expected recession caused by COVID-19 as institutions typically use less leverage and have more reserves. The illiquidity of real estate forces patience as there is no high-speed computer trading or ETF mismatch driving prices by the minute. While there will be damage from missed rent payments and lost tenants, we do not expect a significant drop in value. Much of the damage will be offset by cheaper debt as we expect lending to be 50bp to 100bp lower than when we entered the crisis. We do expect a significant drop in transaction volume for at least the next three to six months before confidence returns and buyers re-enter the market. We do believe buyers will be back as over

10% of institutional portfolios are now allocated to real estate. There is a mandate to acquire properties and a need for yield in what will very likely be a yield starved environment.

While there are pockets of over supply especially in Hotels and Malls, there is not a supply issue for other products. Lenders have remained fairly restrained since the great recession and while there will be isolated issues, we do not foresee a market collapse of any kind. We believe that the short-term impact to office and multifamily will clear up within a year and lower interest rates will soften the impact. Light industrial and logistics will continue to be strong with the increasing shift to e-commerce. The most vulnerable will be new or vacant properties as leasing absorption will be very slow in the near term.

Hotels except for isolated properties will shut down for a period of time and will get severely punished in the near term. They should start bouncing back as soon as they are allowed to re-open similar to 9/11. We would expect to see them performing back at 2019 levels by early 2021. Many hotel markets were already over supplied (both Portland and Seattle) so this will exacerbate that problem and create some buying opportunities in the near term.

Development in all sectors already underway will likely continue forward even if we have a temporary stoppage of construction, but new projects will be difficult to finance in the near term. Lenders, especially banks, will be slow to re-enter until they have confidence that the market has cleared. This fast shut down will help any potential supply challenges versus the more typical recession of one to two years of slow burn while the growth in supply continues.

Sortis Fund
Strategies Redacted

Conclusion

It is clear that none of us have been here before - a modern day pandemic is uncharted territory, but we have been through multiple real estate cycles and learned to thrive in difficult environments. The roots of Sortis Holdings came from the rescue and recapitalization of MBank during the Great Recession. We know how to deal with adversity and feel we are well positioned to capitalize on any dislocation that arises. Every crisis is different, but we will use our past experiences to inform current decisions while generally remaining cautious until we begin to get more visibility. We welcome our investors' feedback and insights as we have all had unique experiences that inform our opinions. In closing we are open for business and extremely well positioned to not only survive, but to capitalize on the situation as it unfolds. More communication to follow as the situation unfolds.

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