SORTIS CAPITAL

MID-YEAR 2023 UPDATE

THE STATE OF COMMERCIAL REAL ESTATE

BY PAUL BRENNEKE

TABLE OF CONTENTS

Commercial Real Estate is Headed For a Crisis Worse Than 2008, Morgan Stanley Analysts Say

USA Today April 7, 2023 (Full Article)

Commercial real estate is in trouble. Why you should be paying attention

CNN March 27, 2023 (Full Article)

Bank Crisis Could Cast Pall Over Commercial Real Estate Market

NY Times March 22, 2023 (Full Article)

Commercial real estate faces a brutal combo of higher rates, tighter lending, and looming debts - and the fallout could be disastrous, Goldman strategist says

Apr 19, 2023 (Full Article)

Commercial Real Estate Market Is a Ticking Time Bomb for Small Banks

Apr 03, 2023 (Full Article)

EXECUTIVE SUMMARY

It has been a while since I did a full-scale blog entry. My previous one, the 'COVID-19 Investment Strategy', was March 24 of 2020 and focused specifically on the impact of the Pandemic. In hindsight, I got a lot of things right (and a few things wrong). That research and subsequent blog during the first few weeks of the Pandemic informed our Pandemic Investment Thesis over the next several years leading to eight consecutive quarters that averaged over 10% in our Sortis Income Fund and a dozen distressed acquisitions in our Sortis Rescue Fund that have grown multiples in value.

As the Founding Partner at Sortis and responsible for investment strategy, I constantly shape our investment thesis by analyzing data and identifying trends. At the beginning of the Pandemic in March 2020, I would get calls from our investors hourly about my thoughts on the market. Then like now, I tried to be the voice of reason and not have a knee-jerk reaction while forecasting the impact of the Pandemic on the world in general and real estate. That led to a lengthy blog post on the Pandemic's effect on the economy and real estate markets. This time, I intended to write a Q1 2023 investor letter to address real estate market concerns from investors. However, as I scanned the headlines during my research, I realized I needed to go more in-depth with facts to counter what I believe is skewed information (or at least skewed headlines).

The first quarter of 2023 was almost as interesting as the Pandemic, with SVB failing quickly, followed by Signature Bank, the takeover of Credit Suisse, and First Republic. The press wants us to believe that the banking system and commercial real estate, in general, are doomed. We talk with investors daily, some of whom expressed concern about the commercial real estate market. This concern signaled a timely market update discussing our current investment thesis.

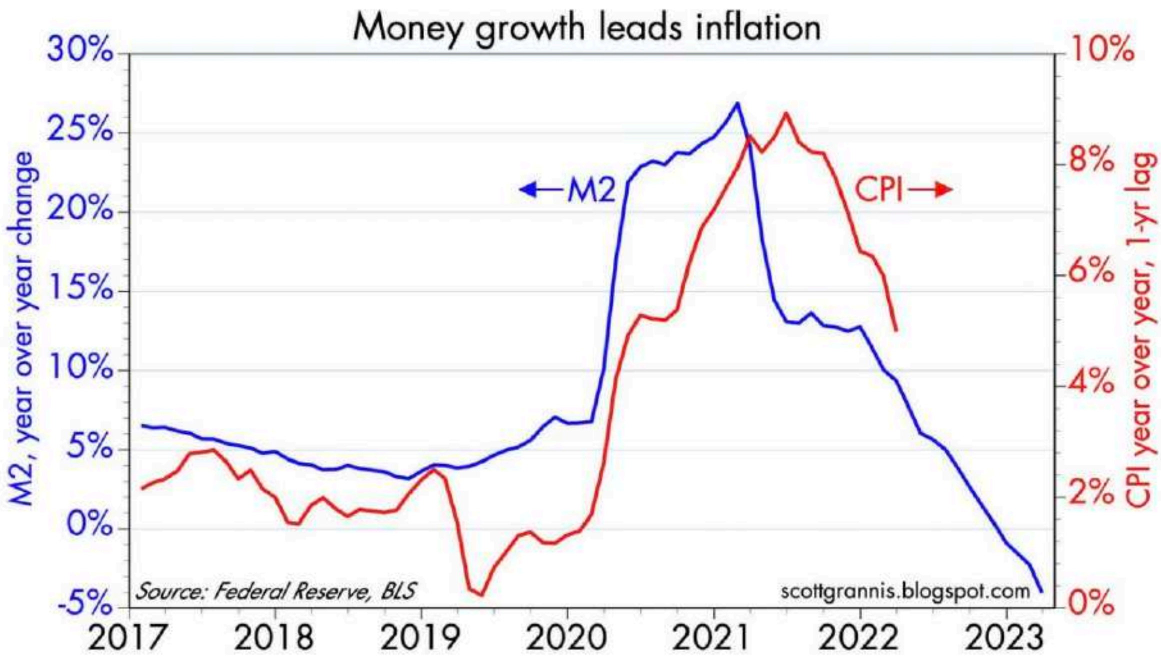


Figure 1: The growth of M2 through the Pandemic

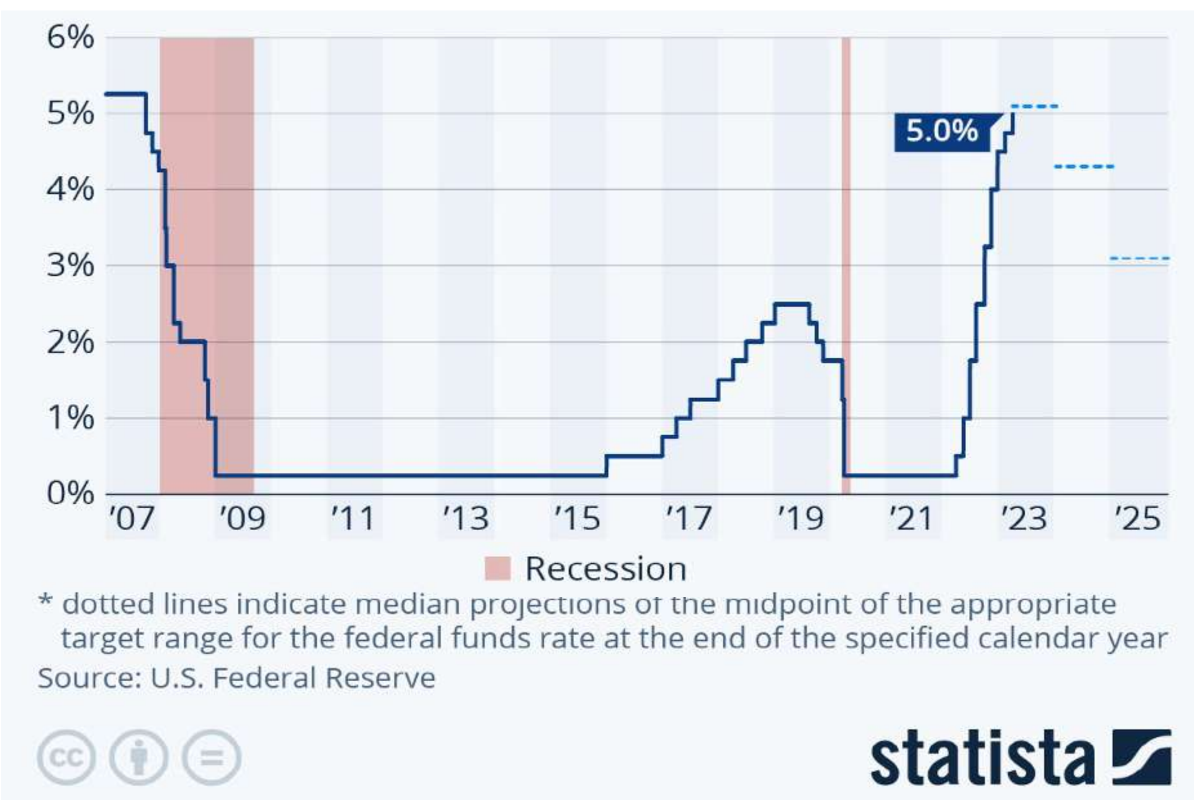
I typically start my day with an hour or so of research, scanning the same headlines that many of you see but digging deeper to see if any new facts emerge to inform our thesis. I recently had the pleasure of conversing with Barry Sternlicht, CEO of Starwood Capital, about the state of the world and commercial real estate, which provided some additional insights. Over the past several weeks, I gathered data from several sources, primarily reading the gloomiest commercial real estate headlines I could find. As a result, I am more convinced that our investment thesis continues to be solid and in line with where we see the trends going forward.

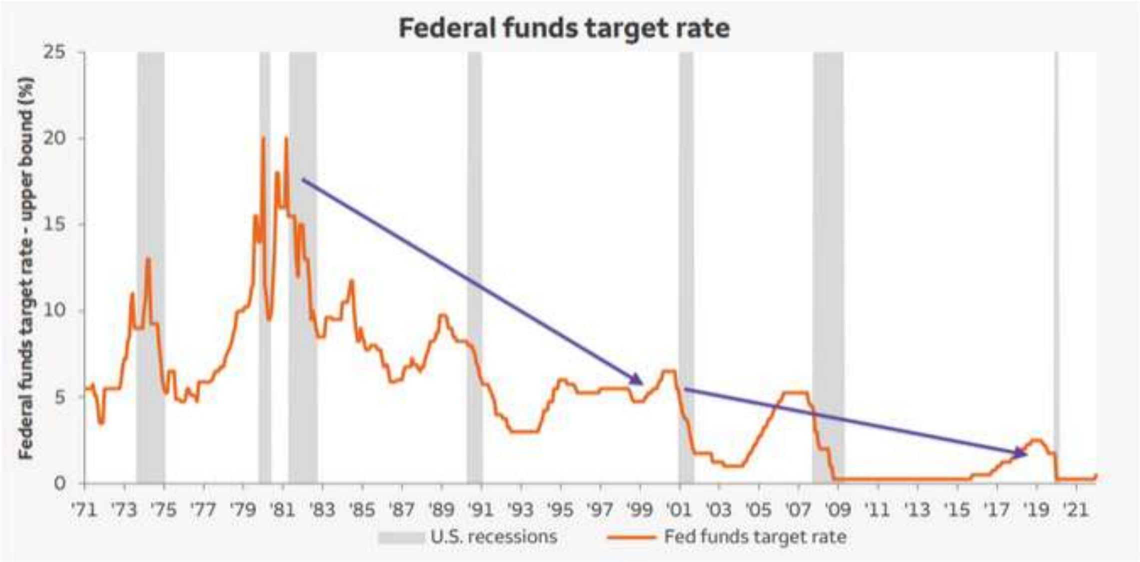
The growth (or reduction) of M2 is what I watch to get a read on what will happen with CPI. Figure 1 shows that M2 had incredible growth from 2020, starting at a little over $15T peaking $21.7T in July of 2022. It started moving downward with the rate increases and is $20.8T as of March 2023. You can also see how closely CPI tracks M2 with a lag of several quarters. There is every reason to believe this tracking continues with inflation continuing to soften.

In my Pandemic blog post, I talked about eventual inflation and the rise in interest rates that would follow. Well, we got the inflation, and the rate hikes followed, but we are through the worst of things on the rate front. Interest rate hikes have done their job (and maybe some), as we see in the inflation reports that are, for the most part, lagging indicators, including the May 10 reports showing continued easing.

As shown in Figure 2 below, rates have peaked, and we will see reductions later in 2023 and 2024, dropping rates into the 3% range, which is sustainable in the near term. Anecdotally, we have seen a downshift in inflationary pressure for goods and labor over the last six months in our purchasing group at Sortis Holdings, our operating platform with a dozen hospitality businesses and over $100 million of revenue.

Figure 2: Fed Fund Target Rate Projecting into 2025





Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data from March 1, 1971 to March 31, 2022. For illustrative purposes only. Fed = Federal Reserve.

Figure 3: The Fed's Tendency to Overshoot Interest Rate Increases

Now that rates are peaked with the 25 bps raise in May, the question is, will we have a soft, hard, or no landing? By the way, 'no landing' is new to me, but I read that 'no landing' reference several times in my research. The simple answer is that it depends on your perspective, as this is one of the most bifurcated markets in history. Typically, commercial real estate asset classes move up and down generally in sync, albeit some slightly better or worse than others. However, the Pandemic caused very unusual dynamics that have the classes on their own tracks for very different reasons, not all directly related to interest rates. We will dive into more detail on each asset class later in the blog, which is key to our overall investment strategy.

I saw this in a 'No Landing' article and had to throw it in. This scene from the movie Airplane is a classic and exactly what I feel like the Fed is doing.

- If you own office buildings other than a few outliers that can attract new tenants in today's environment, you are in for a hard landing.
- Remote work is "a bunch of bullshit," according to Sam Zell, the outspoken real estate magnate known for his colorful language. "One of the biggest lies in the world is that people working from home are more productive than people working in the office…". Regardless of how Sam Zell feels about Remote Work, Flexible Work is here to stay…unfortunately this time, Sam Zell is wrong, and the Office market has shifted for the foreseeable future. We need to ride that wave versus swimming against it.
- As for the economy, I will go out on a limb and predict a soft landing with no more rate increases and a slowdown from mid-to-late 2023 that may fall into recession territory.
- The slowdown/mild recession should not come with the number of job losses seen in the past recession because the circumstances preceding this one are so atypical. For example, some industries (hospitality) are still ramping up while Tech over-hired during that time.

- This quote from Marc Rowan, CEO of Apollo Management, sums it up pretty well, "Even if we have a recession in formal name, I doubt we're going to have the kind of recession we've thought of historically with massive shifts in unemployment. I think we're having a non-recession recession.". That is well said, and I agree, although I'm not sure about the new term 'non-recession recession.'
- I do not believe we will see much more overall value contraction in other real estate asset classes. Still, we will see great individual buying opportunities from distressed sellers due to financing issues.
- We will also see an excellent lending environment with many banks and other lenders on the sidelines (bodes very well for our Sortis Income Fund).
- Rates will start coming down later in 2023 and 2024 to counteract the mild recession but will NOT go back to zero quickly. We are good with that, as zero rates make everyone look smart, while higher rates reward better business plans and operators.
- The impact of the recession will be completely different than the Global Financial Crisis ("GFC") as it will primarily be felt by institutions rather than the consumer. The most prevalent asset Americans own in the bottom half of the country's wealth distribution is home equity, and we do not see that being impacted much, if at all, in the near term. This should allow the consumer to help power the economy through the headwinds we face.
- The banking system will not crater due to commercial real estate, as the headlines suggest. Of course, lenders will take losses on office loans and possibly other over-leveraged assets, but it will be a fraction of the losses in the GFC, and the banking system is in much better shape than it was in 2008/2009.

Rates have never gone up this fast, leaving the market and those that hold floating-rate uncovered CRE debt a little shell-shocked, including many of the large national real estate owners. It does not matter how good the underlying asset performs; adding 5% to the interest rates in less than a year will significantly impact cash flow if you have floating-rate debt. Coupling this with a pullback in lending due to potential macroeconomic headwinds will make refinancing debt due in 2023 much more complex and expensive.

This will force the sale of some assets with insufficient equity to refinance without a capital injection, further causing the pricing to fall. We are already seeing this happen and properties being returned to lenders. Capitalization rates have already started to adjust for this new world moving up almost 100 plus BP on average, but still well below the fed increases. If these rates and spreads stay through 2024, we will continue to see an increase in CAP rates as more sellers capitulate and sell into a challenging market.

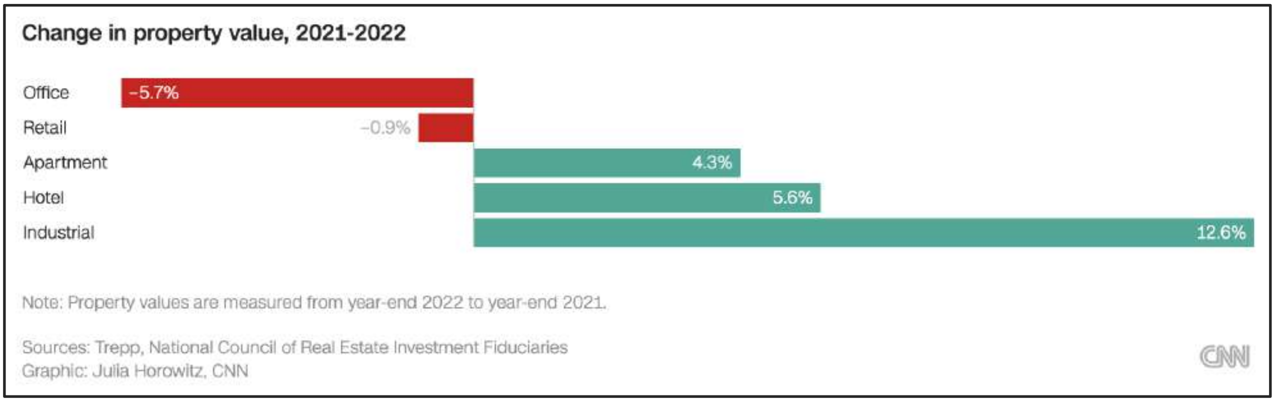


Figure 4: Even as Office was losing YOY other product types were winning

Fortunately, only a quarter of the office buildings have loans due in 2023. Lousy timing for those owners but not catastrophic for the industry. We could see steep losses of 20% to 40% if buildings are forced to sell into this environment. As a result, we expect to see a 5% to 10% correction on non-office real estate classes over the next 12 to 18 months.

Of course, it's important to remember that these are national averages, and every piece of real estate is unique. There has been a lot of variation in how different geographic markets have performed in this post-Pandemic economy. Figure 4 below shows the typical real estate cycle usually caused by an oversupply of products, leading the increased rates to slow it down, then ultimately, a recession. This current cycle is anything but typical, so much deeper analysis is needed by asset class and by region. Unfortunately, the Fed only has one lever as they cannot raise rates only on overheated asset classes.

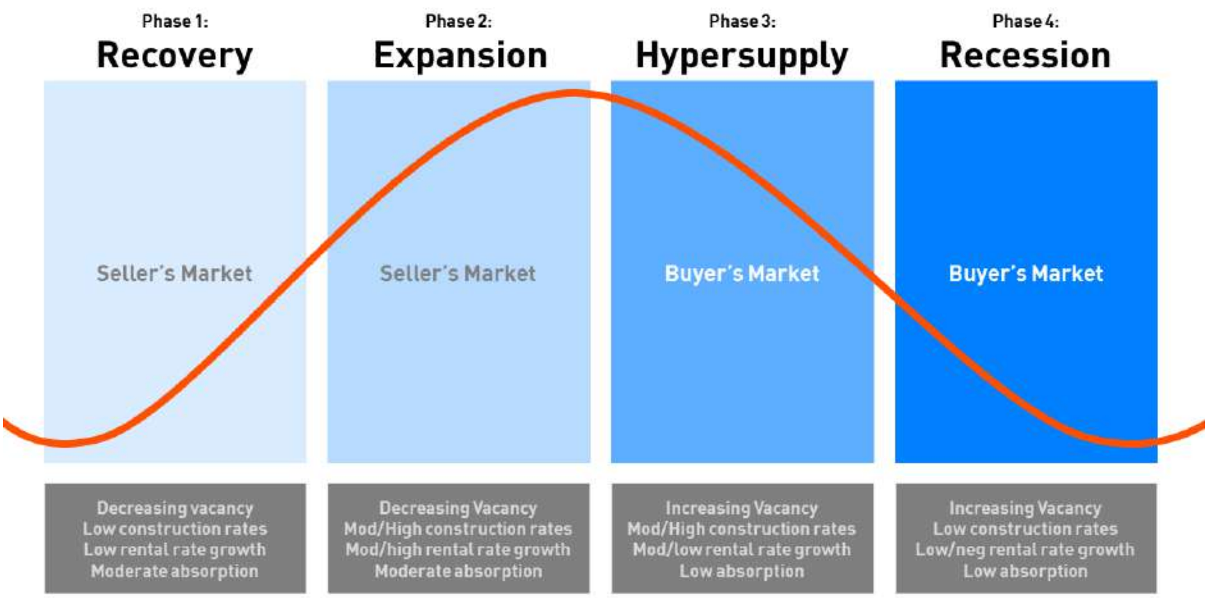


Figure 5: A much more typical real estate cycle shown here

One thing that's important to note is that, aside from office space, we are not seeing an excess of supply in the market. And with pandemic-related impacts on development pipelines and a slowdown in construction lending, this sets the stage for future appreciation in the real estate market. The losses in non-office real estate can be directly attributed to the Fed rate hikes (while office losses are a combination of both rates and pandemic-related factors). If operating fundamentals hold up as expected, we should start to see values rebounding for commercial real estate in 2024, with even better gains in 2025.

Two contradictory themes are playing out post-Pandemic; 1) Certain classes are normalizing (reverting to Pre-Pandemic patterns), and 2) other classes have been permanently altered where, when, and how we use them. If you throw in the geographic winners and losers as part of this analysis, it creates a new set of trends and opportunities in addition to obvious challenges like Office.

Figure 6: The value trends are moving down heading into 2023

Figure 5 clearly shows that values are trending down, but the key is determining whether it is rate driven that will bottom out or a 'falling knife.' As with every cycle, even this unique one, supply and demand are key factors.

Hospitality, multifamily, and industrial all remain relatively strong and in balance from a supply/demand standpoint as we enter 2023. No signals point to large problems in any of these sectors, so the headlines related to gloom and doom in commercial real estate are overstated. While individual projects may have bad balance sheets due to the Pandemic or the use of too much floating-rate leverage leading to foreclosure or sale at a loss, the underlying operating fundamentals for each of these asset classes remain strong.

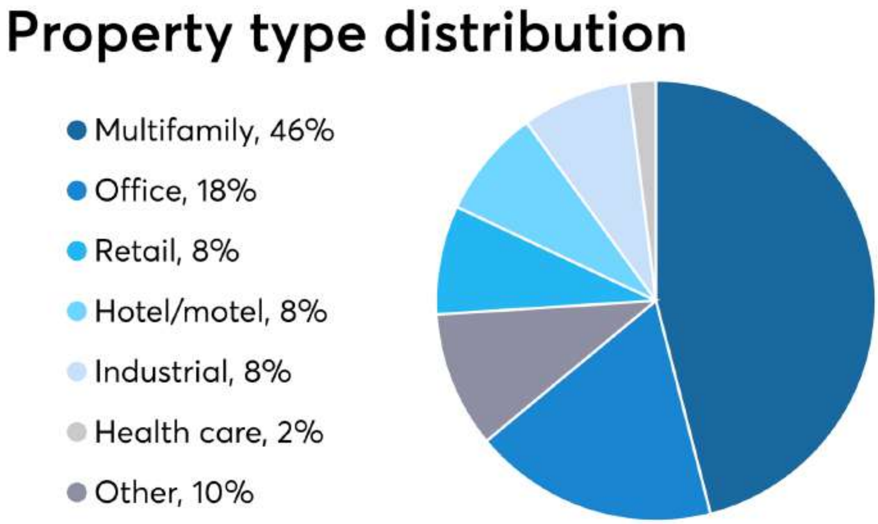


Figure 6: Shows the distribution of commercial real estate asset classes

The following is a summary of our thoughts on each asset class as we move through 2023:

Multifamily: Despite the cooling in rent growth, the multifamily asset class remains one of the best-performing sectors in commercial real estate. With high costs and chronic undersupply of for-sale housing, the shift in consumer preference for convenience and amenities continues to benefit the industry. As a result, the multifamily sector offers stable, attractive investment opportunities, and while valuations have moderated, the fundamentals for strong performance remain. In spite of good fundamentals, Multifamily is a leverage play, and it will be challenging to get cash flow until we see lower cost of leverage.

Single-family rentals and build-to-rent: The single-family rental sector has become a massive institutional asset class, attracting record investment. These categories benefit from similar fundamentals as the multifamily industry, offering renters more space and amenities without the hassle of homeownership. The build-to-rent sector creates new supply in constrained environments, stabilizing the housing market. This sector also greatly benefited from low rates, and it will be tough to earn outsize yields in the near term.

Office: The Pandemic caused an outsized impact on the office sector, with many companies implementing remote work policies. While hybrid policies are expected to be the norm for the foreseeable future, high-quality, well-located Class A assets offering desirable tenant amenities continue to see good leasing and renewal momentum. Most other Office will suffer for the near term until the over supply created by WFH is resolved. Underperforming assets may be converted into other uses, but this will take time. More detail on the Office sector is provided below since this is the main challenge for the commercial real estate industry over the next several years.

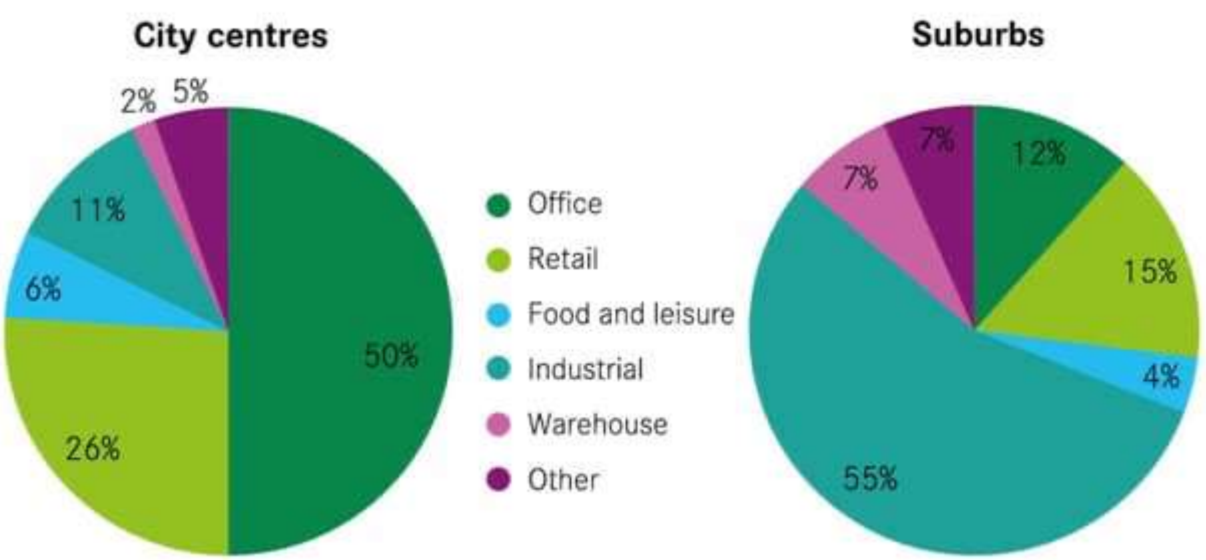


Figure 7: Shows the distribution of commercial real estate asset classes

Retail: Prime locations, community-centric shopping centers, and the retail mix heavily skewed towards services and necessities are performing well. Luxury malls are thriving, while B malls are in an identity crisis. These assets may be re-purposed and densified with new uses to enhance long-term performance. As the availability of desirable land for development decreases, there may be continued consolidation in the sector.

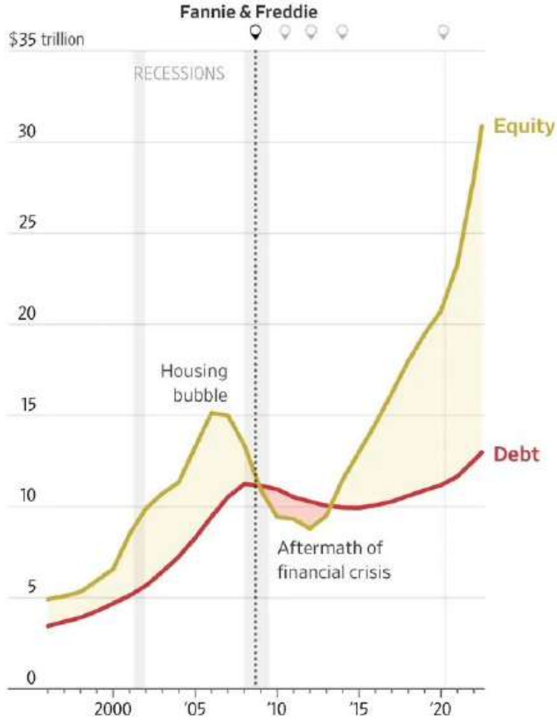
Industrial: The industrial asset class continues to see significant investment as a critical component of the global supply chain. As a result, net absorption remains good, reflecting robust demand for these assets. However, longer-term leases may present challenges in the face of inflation. Despite this, the growth of e-commerce and the favorable long-term supply/demand dynamic will continue to support investment and performance in the asset class.

Hospitality: The rise of short-term rentals and the growing acceptance of AirBnB among property owners are exciting developments in the hospitality space. "Revenge travel" has boosted consumer spending on leisure, luxury, and lifestyle travel, resulting in a record RevPAR for hotels in 2022. While analysts expect travel spending to moderate, it will continue to grow in 2023 and beyond, with a rebound expected well beyond 2019 results. Hospitality has historically not been as reliant on low CAP rates and cheap capital. All of these factors should make it one of the better performing asset classes over the next several years.

Niche assets: Niche assets are becoming increasingly popular among investors looking for specialty REITs and investment managers to access these unique asset classes. These assets, such as casinos and entertainment venues, production studios, and digital infrastructure, are supported by long-term trends but require experienced management teams to unlock their full value. For instance, the macroeconomic tailwinds behind production studios, such as increased content consumption and the convergence of technology companies and content production, drive unprecedented demand for studio and production space. The digital transformation also necessitates significant investment in advanced infrastructure, such as cell phone towers, EV charging stations, and data centers, to accommodate growing use and demand. As these asset classes mature, we expect more capital to flow into them.

OFFICE SECTOR MELTDOWN

Our research shows we need a deeper dive into Office and how the current circumstances might impact commercial banks and the real estate market. We talked about Office, so let us break that segment down to show how it fits into the commercial real estate market. According to the MBA, Office makes up 17% of the $4.5 trillion commercial mortgages or $765 billion in total office loans outstanding. For the sake of scale, compare this to the more than $5 trillion of equity lost in the residential market from 2006 to 20012 (see figure 8 below). Even if the whole office sector was wiped out, it would still be a small fraction of the household equity lost in the GFC.



Note: Single-family data includes one- to four-family homes with mortgages. Home equity is calculated from value of household and nonfinancial business sector.
Source: Urban Institute
Peter Santilli/THE WALL STREET JOURNAL

Figure 8: SFR Equity over last 20 years

It is also important to note who is losing that equity from the office sector. In the GFC, consumers lost their home equity, historically providing capital for economic growth. Residential equity powder is stable and dry, awaiting interest rates to come back in line so consumers can tap into it. Not that we do not feel bad for the holders of office equity, but it is a different ramification if giant private equity players lose an office building to their lender. The building will ultimately get re-acquired and re-purposed at a lower basis. Those losses are distributed to the investors, including family offices, institutions, pensions, and endowments.

Office pricing has come down 20% to 30% on average from the peak so far and will start to create principal losses in 2023 for lenders. CRE principal losses on the higher end could range from $60 to $80 billion, primarily from office spread out amongst all types of lenders over the next 2 to 3 years as loans come due. If you include lost equity, that is a 30% to 40% reduction from peak pricing for office, which is entirely plausible. Bank loan loss reserves stood at $195 billion at the end of 2022, and banks are only 39% of the commercial loan market, so even these numbers are sustainable.

For those who are concentrated in the office market, this is catastrophic. It will be impactful and make headlines for the rest of us, but it will not crater the entire commercial real estate market or banking sector as headlines suggest. On the whole, Net Charge Offs ("NCO") and Non-Performing Assets ("NPA") are both still below 1% and well below the 8% plus range seen during the GFC. Of course, there will be equity losses in other sectors, especially in hotels that took the brunt of the pandemic impact, but losses to lenders will be nominal in other asset classes, with defaults expected to peak over the next year in the 2.5% range.

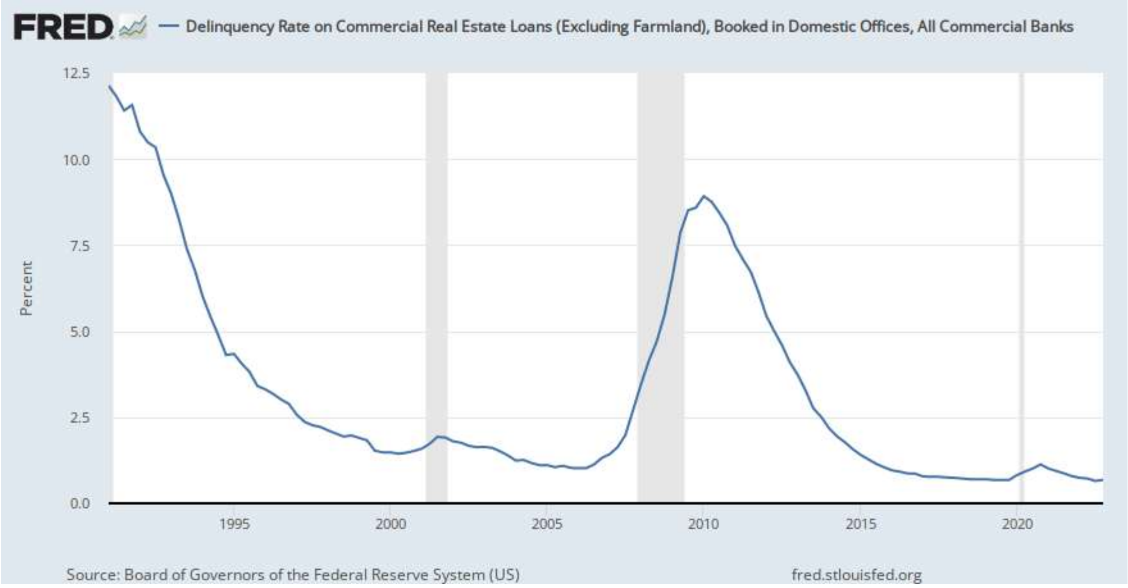


Figure 9: Default rates on commercial loans through Q1 of 2023

WHERE DO I INVEST BASED ON ALL THIS DATA?

CRE investment in the near term will be a difficult proposition until we see the end of rate increases and this phase of price discovery resolves itself. As shown in Figure 9 below, the volume of transactions declined in the last three quarters of 2022, ending Q4 below the 2015-2019 historical average. We expect this trend to continue through 2023 until the bid/ask spread tightens due to more visibility on rates, spreads, and macroeconomic headwinds.

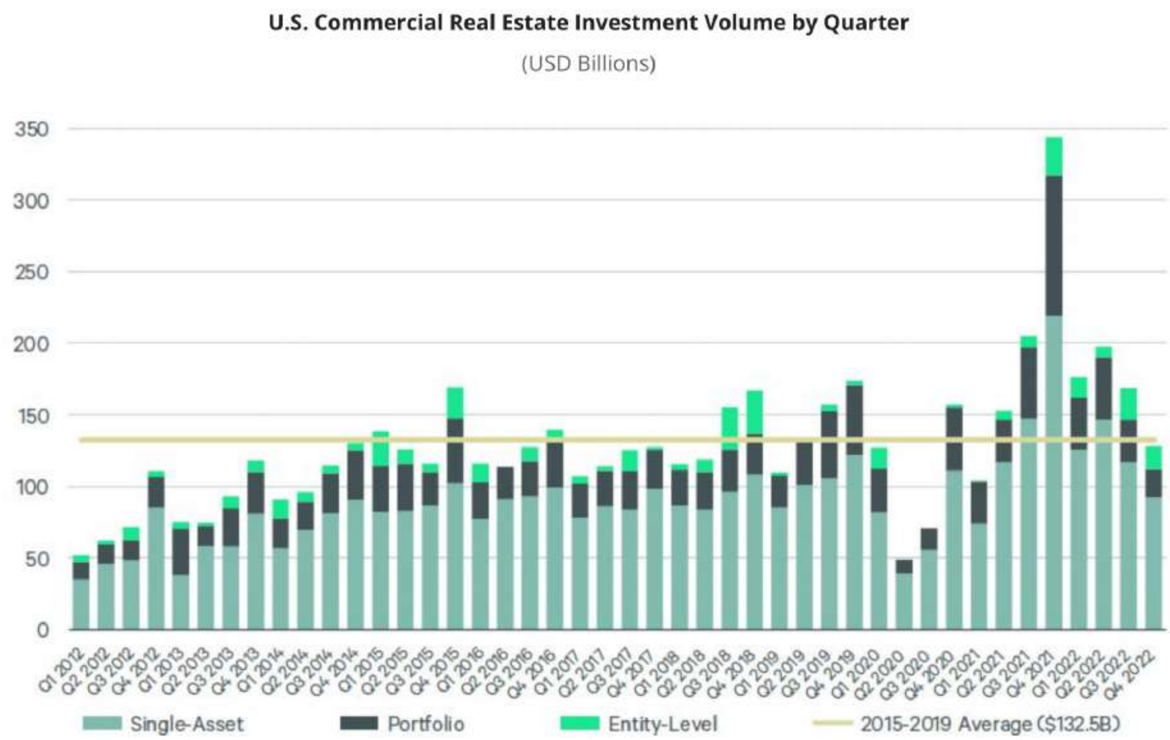


Figure 10: CRE transaction volumes continue to decline in 2022

With the current environment, it will be a difficult year to invest in commercial real estate unless you can execute distress investment. With few opportunities and plenty of capital chasing them, it will be that much harder for the typical investor to succeed. The real question I would pose to most investors is 'if' not 'where' should they invest in real estate equity. I would urge caution for equity investment but also add that this is a perfect storm for debt investment. It is not only defensive, providing an equity cushion but provides a good return in this uncertain environment.

DISTRESS INVESTING 101

'Distress Investing' is an often-used term in 2022 and so far in 2023. We have often heard 'that it isn't quite here yet.' Anyone who says that does not know where to look. Distress deals do not appear on your doorstep, especially as an individual investor. You search it out like tracking the elusive Black Rhino on safari. We have been underwriting dozens of distressed deals over the last 18 months, so we can be ready to act when the opportunity arises.

What exactly are we looking for? Simply put, great asset, bad balance sheet, good entry point, the Black Rhino of distress in this cycle. Anyone can find a bad asset with a bad balance sheet, but the art is identifying assets that are currently operating well (or have great potential) but are suffering from balance sheet issues due to the Pandemic, interest rates, or both. Finding these assets is tough enough, but that is when the real work begins. First, an 'Entry Point' needs to be identified, which can differ in every situation. It could be the first mortgage, 2nd mortgage, mezzanine, equity holder, or even the operator, depending on what kind of rights they have.

The elusive Black Rhino, one of the rarest animals to see on safari

Identifying the Entry Point is a skill that takes years of work dealing with hundreds of deals and opportunities. Often there is no Entry Point, and as good as the opportunity looks, walking away is the best choice versus getting caught in the wrong deal, which can consume incredible amounts of time and energy. The distress investment process takes understanding all the tools available in distress, including litigation, bankruptcy, receivership, and old-fashioned negotiating skills. These opportunities sometimes take months or even years, but when the catalyst arrives, you must be able to move extremely fast, or the opportunity disappears.

The many deals we were involved in during the GFC taught me that all the hard work in the world will not solve for having ready dry powder. Distress deals must move quickly and do not have time for a typical capital raise cycle of 60 to 90 days. This was my impetus in 2012 to start raising a fund to have capital ready. We worked on several incredible distress investment opportunities in the GFC, where most of the upside went to others when we did much of the work. I am OK with that result if those 'others' are Sortis fund investors, and we get our fair share as the fund manager.

That was a long-winded way to say that investing in distress is THE opportunity for the next 18 to 24 months. That is much easier said than done, as most investors and sponsors cannot deal with the complexity (and getting the rewards) of this type of investing. Putting a bid on a market deal that was previously foreclosed does not count as distress investing and will not be better than any other market opportunity. If you want to see a Black Rhino, you need to put yourself in the best position.

SORTIS INVESTMENT THESIS BY ASSET CLASS

Criteria	Office	Multifamily	Industrial	Retail	Hospitality
Fundamentals (1=Bad, 10=Strong)	2	8	7	6	8
Trends (1=Bad, 10=Strong)	3	8	8	6	8
Balance Sheet Stress (1=Low, 10=Hig	9	2	1	5	9
Competition (1=High, 10=Low)	2	1	1	3	7
Sub-Total Score	**16**	**19**	**17**	**20**	**32**
Sortis Capability (1=Low, 10=High)	7	7	5	8	10
Total Score (Higher is Better)	**23**	**26**	**22**	**28**	**42**

Figure 10: Sortis Q1 2023 rating by asset class of the market opportunity

Multifamily is always a safe choice but heavily dependent on interest rates. With interest rates 100BP above CAP rates, it will be tough to make decent returns. It is certainly safe but not necessarily very rewarding. We will have to see interest rates and CAP rates start to head back down again to signal the window is open for Multifamily.

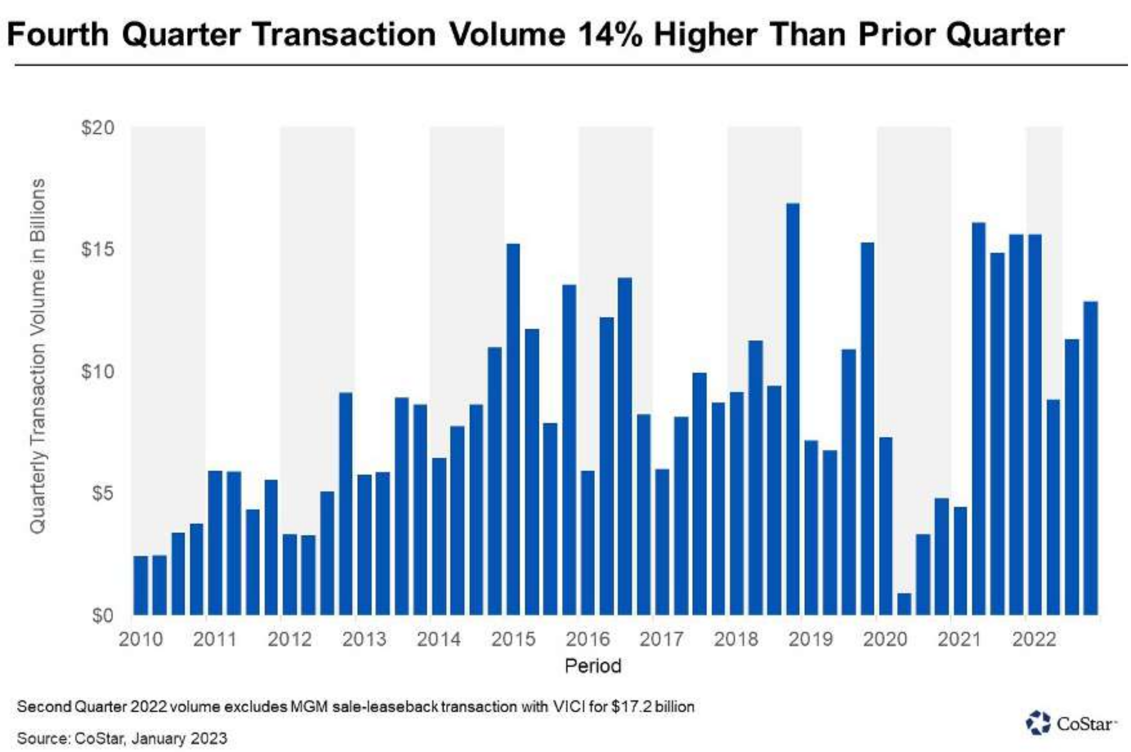
Industrial is in a similar position to Multifamily, and it might even be oversupplied, but it is certainly on trend and a solid long-term play. The same caution applies to waiting until we see interest rates and CAP rates declining. I would caution that industrial is the easiest asset class to oversupply as it is relatively simple to build and easier to entitle than other types.

Office is a red 'X' except for a few outlier opportunities until the dust settles and we get some direction on where return to office (WFH) will stabilize. I agree with the 'flight to quality' theory, where high-quality tenants are moving to and will pay for newer properties with exceptional amenities. I believe utilization rates will stabilize well below 2019 levels. While the residential conversion theory sounds good, it will not save the owners (or the cities) except on a limited basis. At best, 20% will make good conversion candidates, and prices will need to fall dramatically to make that work. As someone who has owned and developed Office, I have never been more pessimistic about an asset class. I usually try to find lemonade from lemons, but this challenge will take time to work through the oversupply.

While there is certainly some opportunity in the Retail class, it is fraught with risk and will take an adept operator. It will also be capital intensive as there will continue to be turnover from the losing to the winning tenants. CAP rates are better reflecting risk, but debt will remain expensive and difficult in this environment for all but the best operators.

Hospitality is by far the best opportunity for 2023. It is also the one that Sortis has developed the most capability to act on. That is no accident, as Sortis started positioning itself at the beginning of the Pandemic to take advantage of Hospitality opportunities. We identified this trend in the Spring of 2020 and have been building capability in that area ever since, culminating with the acquisition of the Ace Hotel brand. Figure 12 below shows that Hospitality investment is ramping up as the rest of CRE is ramping down due to distress forcing pricing to meet the buyers, clearly showing investors are on board with our analysis.

Figure 12: Costar graph showing Hospitality transaction volume ramping up



Even without counting our capability or the amount of competition, the Hospitality market is the best distress opportunity in this cycle. The Pandemic crushed balance sheets for all but the absolute best-capitalized owners with a year or longer of shutdowns without revenue. While operations have roared back with 'revenge travel,' the interest deferrals and the rise in interest/CAP rates made refinancing require large amounts of capital to right-size the balance sheet. Many hotels had too much leverage, including mezzanine loans when money was cheaper, making an excellent Entry Point for the distressed investor.

Distress/opportunistic and Hospitality investing are not suited for every investor, and we certainly understand that. It is operationally intensive and historically more volatile than other asset classes. Sortis is uniquely positioned with operational capability and distress expertise, while these factors limit competition and provide a generational opportunity in 2023.

WRAP UP

A couple of thoughts to wrap up and tie this all together. There has been and will continue to be a commercial real estate valuation correction over the next 12 to 18 months of 5% to 10% on non-office real estate classes, and we could see up to 30% to 40% on office. These are nationwide averages, which are misleading as every piece of real estate is unique. There has been such a unique bifurcation in the markets related to the Pandemic, both by asset class, geography, and urban versus suburban.

The non-office losses are directly attributable to the Fed rate hikes, while office as explained above, was a combination of rates and the Pandemic. CAP rates will peak in the very near term when we see a pause in Fed rate hikes. Suppose operating fundamentals continue to hold up as we expect they generally will. In that case, we should see values head up later in 2024 with good potential in 2025 across all non-office classes.

Without much excess supply (except for office) and with development pipelines impacted by the Pandemic coupled with a slowdown in construction lending, this combination bodes well for future appreciation. This real estate cycle is one of the most unusual in recent memory because of the Pandemic related factors. If anything, it is similar to the short 2001 recession that was triggered by 9/11 and was followed by unprecedented growth. As typical with real estate cycles, a little pain will always give way to gain, and this current one is no different.

Is it 2009 all over again?

The most common question triggered by the headlines is 'Is this 2009?'. A resounding NO is my answer. The short version is that we do not have an oversupply of any residential or commercial real estate asset class other than Office. A supply glut of homes caused the GFC due to lax mortgage underwriting. People losing homes to foreclosure, the resulting slowdown in the housing industry, which historically has led us out of recessions, and bank balance sheet challenges all made for a unique set of circumstances different from what we have today.

Let's start by breaking down the for-sale housing market. Yes, prices will fall in some areas, especially the markets that had the highest increases in 2021-2022, but those will likely be single-digit to low double-digit decreases as we have already seen the market stabilizing in early 2023. Figure 8 (Page 15) shows home equity at above $31 trillion and current debt at around $13 trillion or 42% LTV. This compares to $15 trillion of equity to $10 trillion of debt or 66% LTV at its peak just before the GFC. We have a much larger equity cushion than in 2008/2009, one of the key factors that make this market different.

Coupling that with the housing inventory levels, which peaked at over 4 million in 2007 and are currently around 500,000 or approximately a 2.6-month supply. Historically, this would still be a seller's market and an undersupply of housing. Figure 13 on the next page shows that inventory has slightly decreased going into the Spring 2023 selling season. Even with the rise in interest rates, it looks as if the housing market has and will hold together, which not many people predicted a year ago when rates started to rise.

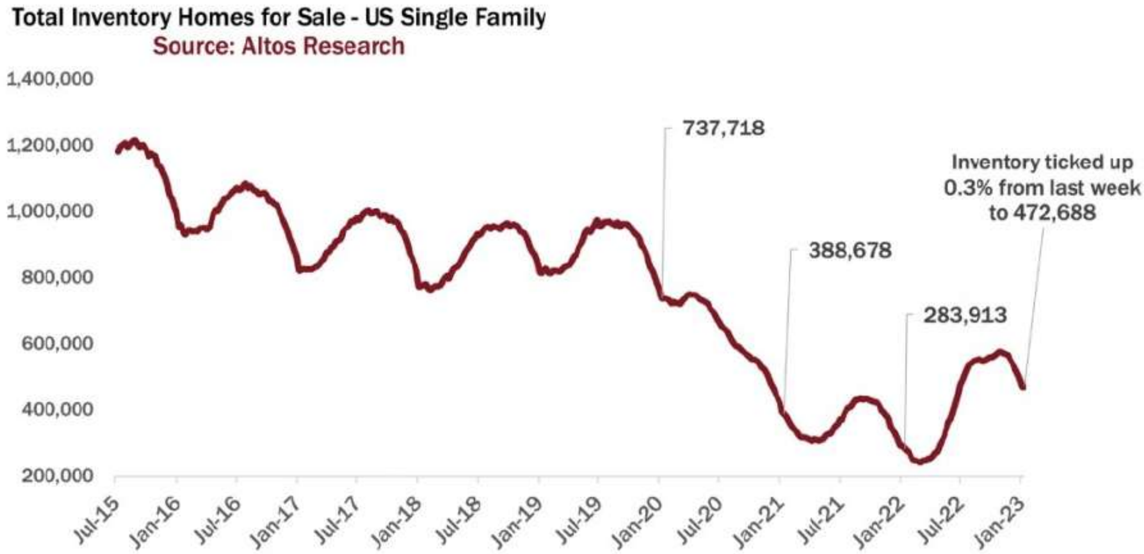


Figure 13: Inventory in 2023 continues to go back down after a 2022 peak

The GFC in 2008/2009 was a housing-led recession, which has been the case for most recessions, coupled with oversupply in almost all commercial real estate asset classes. The 'Easy Money' policies of 2002-2006 were key to the oversupply problem. If we had to categorize this latest correction, it would be the 'Cheap Money' that made us vulnerable, as banks and other lenders were generally more diligent in underwriting and lending in this cycle. So, it is only the office market and some pockets of retail that have supply issues as we move through 2023.

On the morning of publication of the Blog this WSJ article Stop Equating the Latest Bank Failures to the 2008 Crisis came out that does an excellent job of quantifying the current bank issues. For those of you without a subscription the headline is the impacted institutions in 2008 including Freddie, Fannie, AIG, Citigroup, Lehman, Bear Sterns were an inflation adjusted $8.7 trillion versus the $506 billion impacted in 2023. That is only 6% of the impact of 2008. The following Figure 13 details the impacts.

Figure 13: Impact of Failures 2008

<u>Is the FED done with rate increases?</u>

A resounding YES…they better be. I think they've done plenty and possibly too much. The latest failure of First Republic and other signs of slowing should be enough to get them to pause as they telegraphed at the last meeting.

HOW DOES THIS MARKET IMPACT THE SORTIS FAMILY OF FUNDS?

Sortis Income Fund (SIF)

We have certainly felt the impacts of the rate increases both positive and a little negative. Since 35% of our portfolio is floating rate (with a floor of 12% and in some cases with rate caps), we did get benefit of the rate increases. At the same time, the lack of liquidity in the market in general has slowed velocity of payoffs resulting in less new loan production. This impacts yields as our loans are typically more front end loaded with points so the shorter durations will maximize yields to the fund. We turned down over $30M of new loans in Q1 of 2023 as demand for loans is at an all-time high reflecting the illiquidity in the overall market.

As far as positioning, let's start with the fact that we have 0% Office exposure in the portfolio. Our Retail is concentrated in the close in neighborhoods and suburbs that have been thriving at the expense of the urban centers. We have land exposure, but we are very comfortable in the quality and equity cushion. We recently provided this deck outlining our two largest land loans, which we believe are exceptional quality. I started my development career in 1991 as a land developer and have developed thousands of lots in addition to other product types. This expertise coupled with a stabilized residential market gives us great comfort in this space.

The residential market seems to have stabilized as you read above in our residential market analysis in the FAQ 'Is it 2008 all over again?'. We are bullish on residential going forward due to lack of supply and a continued demand even with interest rate headwinds. Our Hospitality loans were all made during the pandemic at a low basis, and we believe current market is well above initial valuations. We have great capability in the Hospitality space and believe we are well positioned in these going forward. As more new capital comes in and is put to work, we believe we can get into the higher end of our 8% to 10% target range.

Sortis REIT (SREIT)

We are taking our own advice and holding tight on fundraising and new acquisitions until we see a window where rates will come back down. On new acquisitions interest rates will make it tough to hit the target distributions and returns even if we make a great buy. We believe this window will open later in 2023/early 2024 and we expect to start to push fundraising and acquisitions at that time.

Sortis Rescue Fund (Closed for Investment)

Virtually all the investments made to date were hospitality related and as you have read here, we believe strongly in the hospitality market. Rates have clearly delayed our ability to take Sortis Holdings, our roll up entity, to the public market. We believe as the Fed moves rates down in late 2023/early 2024 that the public market window will re-open as there is plenty of capital on the sidelines waiting to participate. We continue to see strong performance across the brands and have yet to see any recessionary headwinds. The employment scenario continues to gradually improve as does supply chain and cost. We remain optimistic for the balance of 2023 that we are well positioned.

Sortis Opportunity Fund I (SOF I)

We plan on launching a real estate focused opportunity fund to take advantage of the distress opportunities in Q2 of 2023. It will be focused on hospitality real estate assets drafting behind Sortis Holdings, our operating platform, using it for both deal flow and operational expertise. As mentioned above we have been tracking dozens of opportunities that we believe will ripen this year. Our unique skill set dealing with complex acquisitions as demonstrated with our Rescue Fund execution, gives us a unique advantage to our competitors. Deal flow is always a question on distress investment funds, and we are seeing inbound opportunities almost daily. We are well positioned at every aspect of the deal including sourcing, underwriting, acquisition execution, capital access, and operational execution.

Years of planning starting with our last blog in spring of 2020 has us as poised for what we believe is a generational buying opportunity. A quote from the latest Warren Buffet investor letter, "Our satisfactory results have been the products of about a dozen truly good decisions. That would be about one every five years." I'd rate our work to be prepared for this great opportunity one of those five year decisions.