Mick Law - Alts. News Bulletin
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Welcome back from Labor Day! For this edition, we'll provide you with: 1) an update on IRC §1031 product sales, as well as an overview of capital raising developments pertaining to oil/gas programs; 2) our market commentaries from an interview we had with Real Assets Advisor regarding market fundamentals in real estate, oil/gas, and private equity; and 3) information from our one-pager on program blow-ups and how we can better manage risk in these situations. We end with announcements on upcoming events.

Real Assets Interview

We were interviewed by Real Assets Advisor (RAA) regarding market developments affecting private investors of non-traded real estate, energy, and private equity programs. Our interview also covered opportunities that private program investors might consider today within each of these economic segments. Some of our responses to RAA's questions pertaining to real estate and oil/gas are presented below.

Question #1: Multi-Family (MF) assets have historically dominated the retail and institutional sectors of finance in terms of capital raising. Where is MF now and where do you see it a year?

Answer: MF is still a strong play in almost all market conditions. If you look at returns historically, multifamily has generated some of the strongest returns over the past few decades. The asset class has had stable growth, limited downside years, and is the only asset class you can get Fannie Mae/Freddie Mac 10-year fixed rate financing with a 30-year amortization schedule. This has helped boost returns and will continue to benefit current investors during turbulent financing times. Further, the asset class has performed remarkably well over the last two economic cycles, having been the benefactor of strong rent growth and cap rate compression. In the next 12 months, we should see an easing of recent downward pricing trends; however, rent growth will slow from record levels and renter demand will taper off slightly.

Question #2: With interest rates and inflation being where they are today, are there certain sectors of real estate that are performing better than others?

Answer: The short answer is "not really." On the investment sales side, the majority of buyers and sellers are holding off for now. Saddled with more expensive debt, buyers are unhappy with current cap rates and returns. Meanwhile, sellers have been unwilling to accept higher cap rates, so the bid-ask spread is wider than it has been in a decade.

From an existing portfolio perspective, anyone with short-term leases (e.g., student housing, multifamily, self-storage) is in a much better position to take advantage of inflationary rent growth. Also, interest rates will really start to take a toll over the next 12-24 months as existing debt comes

due. Many assets will have trouble meeting the basic lending standards (i.e., debt service coverage ratios and loan-to-value requirements, etc.).

Question #3: So how do prospects look in the oil/gas space and are prospects still favorable?

Answer: Despite the headwinds from left-leaning politicians and environmental groups seeking to displace fossil fuels with renewables (i.e., with Bidenomics favoring solar and wind), the U.S. energy and production (E&P) sector has managed to hold its own in terms of gradual production growth, as demonstrated through an increase in U.S. daily oil/gas production over the past year. However, and as was the case prior to COVID, the fortunes of crude producers will continue on a roller coaster ride into 2024, as oil prices, which reached $130 per barrel (bbl) WTI in May 2022, have stabilized within a range of $65-85 bbl WTI over the past 9-10 months. While opinions can vary, we look for Wall Street's ESG and capital discipline mandates to keep U.S. crude production generally in check and oil prices within the range just discussed through the 2024 election. This creates opportunities for private companies and funds to get into Tier 1 drilling projects in basins where economics are still favorable.

As to the prospects for natural gas, prices in the short term have fallen from the prices observed through much of 2022 due to a pattern of unseasonably warm weather in January. Notwithstanding, the need for U.S. natural gas in Europe and abroad on a long-term scale should help to present opportunities for better pricing into 2024, 2025, and future years.

Question #4: As is the case in real estate today, are there headwinds to think about for those that are looking to invest privately in oil/gas?

Answer: One of the more favorable aspects of retail-oriented oil/gas investment programs is that they don't use a lot of debt to acquire the underlying leaseholds or mineral rights. That said, cost inflation has been a major consideration for drilling programs. For example, a 1.75-mile directional well in the Permian Basin that cost $6 million to drill pre-COVID will cost about $10-11 million today. As such, the need to be incredibly cautious in underwriting these projects is crucial, especially within retail syndications where offering fees and sponsor management fees affect investor level returns.

Despite cost inflation, the appetite in the retail sector for oil/gas drilling opportunities was good in 2022 based upon the capital raised, and we expect that trend to continue into 2023 as inflationary forces begin to wane within the E&P equipment and service sectors. Despite capital raising being down in conventional real estate/DSTs, we'd mention that sponsors of royalty interest programs with a 1031 exchange option are doing good and are funding deals at about the same pace as last year (e.g., Montego Minerals, LLC, Resource Royalty, LLC, U.S. Energy Development Corp.).

Please note that a full version of our interview, which also covers private equity and renewable energy developments, will be presented in the next edition of RAA magazine.

DST Market Overview

Despite the economic headwinds occasioned by inflation and rising interest, forty-eight (48) DST sponsors managed to raise $2.537 billion in equity across 95 programs through Q2 2023. Through

Q2, 2023, the top DST sponsor in terms of capital raised was Ares Real Estate Exchange ($442 million, 17% of the DST market), followed by Inland Private Capital ($287 million, 11%), JLL Exchange ($224 million, 9%), ExchangeRight Real Estate ($202 million, 8%), Capital Square Realty Advisors ($152 million, 6%), Passco Companies ($114 million, 5%), and Net Lease Capital Advisors ($110 million, 4%). These seven companies accounted for 60% of the DST capital raised through Q2 2023.

In terms of sector coverage, multi-family assets continue to account for the highest percentage of the DST equity (40%), which was followed by Industrial (24%), Office (16%), and Self-Storage and Retail (each 5%). A breakout of equity sought, loan-to-values, days on market, and year-one cash-on-cash returns among the various real estate sectors in terms of open programs is provided in the following table:

Sector	Available Equity	Median Loan to Value	Days on Market	Cash on Cash
Oil & Gas	$103 million Three open deals	No Leverage	NA	NA
Hospitality	$53 million Two open deals	0%	179	5.11%
Industrial	$751 million 15 open deals	28%	186	4.13%
Multi-Family	$1.259 billion 36 open deals	36%	264	3.90%
Multi-Manufactured	$28 million One open deal	20%	256	4.00%
Multi-Student Housing	$62 million Three open deals	45%	305	3.86%
Office	$508 million Seven open deals	32%	196	4.20%
Office/Medical	$36 million Three open deals	0%	157	4.28%
Retail	$161 million 15 open deals	37%	235	4.13%
Self-Storage	$170 million Eight open deals	23%	116	5.03%
Senior Housing	$76 million Five open deals	23%	141	5.44%
Other	$16 million Three open deals	0%	113	4.18%

*Oil & Gas 1031s are structured as fractional interest programs

Of the 95 1031 deals that were open at the end of Q2 2023, the average days on the market was 214 and the average year-one cash on cash return was 4.33%. Also, of the open 1031 products on the market, about a third are reporting that they are all cash with no leverage used. Of the deals that are using leverage, a substantial majority are using it at loan-to-values of 30% to 50%.

Oil & Gas Fundraising – 2023

Coming off its best capital raising year since 2014, the E&P sector of our practice is continuing it momentum in 2023, with nine sponsors having raised approximately $650 million. In terms of

capital raised thus far in 2023, $450 million has been raised by five sponsors for drilling (70% of the raised capital), with the other $200 million raised by five sponsors for royalties, QOZ/QOF programs and strategic income/growth-oriented acquisitions (with 30% of the capital deployed in such programs).

Presently, 11 sponsors have opened E&P focused programs with approximately $1.0 billion in additional capital raising capacity. Again, drilling accounts for most of the program capacity, but with five sponsors continuing to raise capital for royalty and mineral rights acquisitions and for developing E&P assets within QOZ/QOF structured programs.

Company	Max. Offering	Strategy
U.S. Energy	$300 million ($90 million raised)	Drilling – operated and non-operated projects in the Permian Basin and Powder River
	$150 million ($60 million raised)	QOF/QOZ – operated and non-operated projects
	$100 million ($20 million raised)	1031/Royalties
MDS Energy Dev.	$400 million ($150 million raised or allocated to selling group)	Drilling – Snyder Bros. operated projects in the Marcellus Shale Play
Resource Royalty 20	$9.109 million	1031/Royalties
Montego Permian Plains	$15.71 million	1031/Royalties
WhiteHawk Income Corp.	$100 million	Royalties/Minerals
John Henry Oil – Trenton Black River Six (2023)	$10 million	Drilling – sponsor-operated projects in Tenn. Trenton Play
Texakoma Resources	$50 million	Drilling – non-operated projects in the Anadarko Basin
Bakken 2023-2 LP Donovan Ventures	$30 million	Working Interests in Producing Wells (Income Strategy)
Texas Standard	$50 million ($16.70 million raised)	Drilling – sponsor-operated projects in Barnett Shale Play
APX Energy, LLC	$50 million	Drilling – Kansas oil projects
STL Energy Fund D	$100 million ($2 million raised)	Drilling – sponsor-operated projects in Marcellus Play

In addition to the above sponsors that have open deals, several additional sponsors are expected to launch programs and complete their due diligence in relation to their 2023 capital efforts. The companies that we expect to review over the next 30-60 days include the following:

Company	Strategy	Engagement Status
R.G. Partners	Drilling/Production	Engagement Signed – Awaiting PPM and Terms of Offering
Waveland Resource Partners VII	Non-Op WI	Engagement Signed – *Due Diligence Almost Completed*
Rising Phoenix	Royalties & Minerals	Engagement Signed – Due Diligence Ongoing
Wyoming Reserve Fund	Silver/Gold Commodities	Engagement Signed – Due Diligence Ongoing
Citizen Energy III	Drilling	Engagement Signed – Due Diligence Started Late Aug. 2023

On a final note, we mention that Mewbourne Development Corp of Tyler Texas closed its 2023 drilling program in July. The program raised $180 million from retail investors to fund drilling projects in the Permian Basin in New Mexico and west Texas and the Anadarko Basin in central Oklahoma.

Finally …. THE ANATOMY OF A BLOW UP

As a final resource, we have included information from our one-pager on various blow-ups that have occurred within our sector of alternative investments over the past 10-15 years. Much of the shared sentiment from this comes from our many discussions that were undertaken as a member of ADISA's AI Betterment Committee. *While we acknowledge profound improvements in due diligence practices over the past decade*, we must continue to be mindful of the events and circumstances that can lead to disastrous program results and consequences.

The blow-ups

Provident, Sun West, DBSI, Alaska Trust, Medical Capital, GPB, Payson, Breitling, UDF, Others

Reasons for the same (the cycle)

The sponsors marketed their programs on payments of regular distributions

The sponsor's operations were undisciplined

1. Lack of formal accounting practices

2. Lack of periodic financial reporting
3. Affiliate transactions – no restrictions nor limits
4. Depth of operations is weak (especially in accounting)

The sponsors were marketing machines that raised money too quickly

The sponsors did not follow their stated investment theses or engaged in "style drift"

The sponsors paid the distributions regardless of program earnings

Black Swan events challenged the program's cash resources (e.g., Great Recession and COVID)

The sponsors made bad decisions after one or more programs ran out of cash

1. Program A sold Assets to Program B (i.e., de facto Ponzi transaction); or
2. The sponsor took cash from one program to pay out another program

And <u>most notably</u> sales firms did not update their due diligence on a periodic basis

Process – prevention

1. Require due diligence <u>with economic underwriting</u> on every deal (i.e., Series 1 through 32, not just Series 1 and 2)
2. Look at the marketing materials – are they fair/balanced?
3. Perform sponsor level analysis periodically – look at the sponsor's financials
   a. How's the sponsor's net capital and cash flow?
   b. Does the sponsor HAVE to raise money to stay afloat?
4. Look at the quality of the sponsor's accounting systems
5. Performance reviews – are prior programs paying distributions with EARNINGS
6. Affiliate transactions –just don't do it!
7. Require audits or reviewed financials during years the program raises capital

AI Industry Announcements

ADISA's 2023 Year End Conference
October 9-11
Cosmopolitain Hotel
Las Vegas, Nevada

2023 Mick Law Real Estate Symposium
October 22-24, 2023
The Westin
Tempe, Arizona

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