4Q18 Portfolio Analytics

Our 2CHYP portfolio has always had an above market dividend yield, but recent market events have provided an opportunity to reposition and kick the dividends into high gear. The high yield space is a tricky place in which to invest as it often comes as compensation for high risk, but there is a better source of high yield in the form of mispricing. High quality companies that would normally have only a moderate yield can temporarily become high yield stocks when the market price falls enough. That is how I would characterize a majority of the holdings in the 2CHYP portfolio. Stocks of this nature have 2 potential sources of return:

1) High carrying income
2) Capital gains as the market prices return to normal trading ranges

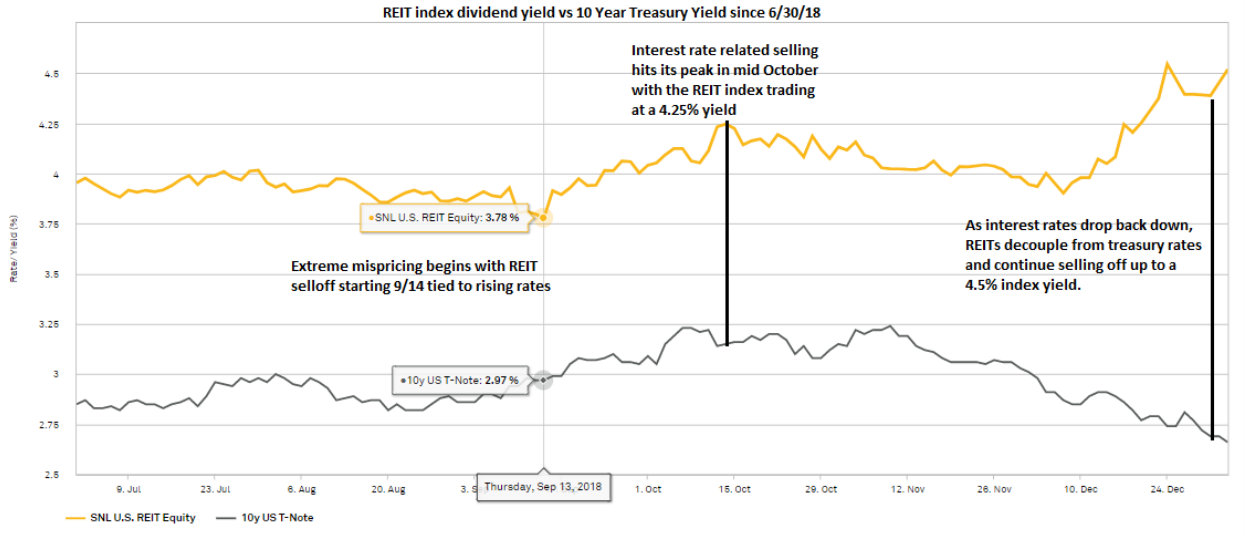
Since mispricing has transcended most of the REIT subsectors, there is opportunity to assemble a well diversified portfolio of mispriced REITs.

Cornucopia of inefficiency

Mispricing is always present. There has never been a market environment in which all individual securities were perfectly priced, but the mispricing that exists today is on a whole other level. It is rampant; wide in scope and deep in magnitude. Mispricing of this degree has manifested from a multitude of simultaneous forces that have amplified each other.

A Perfect Storm

Remember when interest rates were rising? Before the 10 year Treasury yield dropped down to around 2.6% today it had crested above 3.2% in the second half of 2018 and REIT investors were freaking out. Below is the timeline of events.



While REITs are fundamentally quite resilient to interest rates, in recent history their market price has been strongly correlated with the 10 Year Treasury. Specifically, when Treasury yields are up, REITs sell off. This was clearly demonstrated starting in September of 2018 when the 10-Year yield passed 3% and REITs sold off to a 4.25% yield.

As wrong as I believe this correlation between interest rates and REITs to be, it has usually been self-correcting as REITs have often traded back up when rates drop back down. However, late in 2018 there was a decoupling that caused REITs to continue to sell-off despite the 10 year yield falling from about 3.2% to about 2.6%.

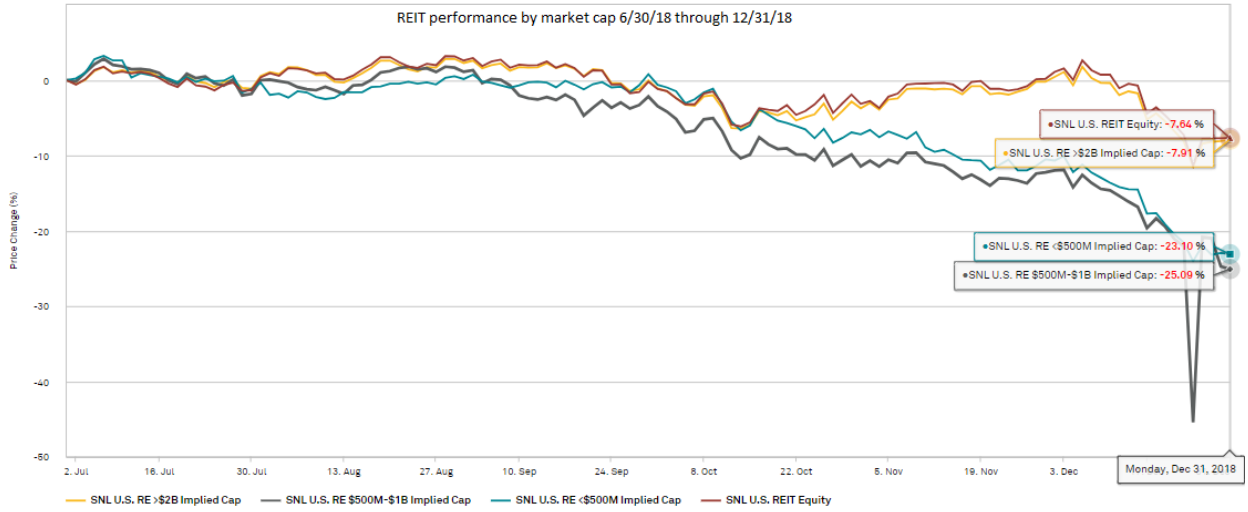
In my opinion, this decoupling was caused by a slew of forces that usurped the market's collective mindspace causing it to forget about the interest rate based trading behavior. The following forces were working in tandem.

- General market sell-off
- Algos and ETFs
- Small cap decimation
- Tax loss selling

Passive share has gotten quite large and the combination of algorithms, robo advisors, ETFs, and closet indexers now likely makes up more than half of the trading volume. The 4th quarter saw a massive sell-off in the broader markets with most major indexes approaching bear market territory. With the passive share being higher now than in any previous bear market, new things are happening; chaotic things.

Selling pressure is no longer isolated to the securities of companies that are troubled or those that are exposed to a particular headwind. Trade war fears, slowing global growth and whatever other fears happened to pop up scared the market and people began exiting passive funds in droves. It didn't matter that REITs are almost entirely isolated from a trade war or that their predominantly domestic properties have impunity from slowing global growth because the big REITs are in the broader market ETFs. When people sell SPY, they are selling REITs along with everything else.

One may think the small cap REITs could have evaded the selloff due to not being present in the major ETFs, but bear markets breed fear and fear impacts small caps the most. In the second half of 2018, small cap REITs under $1B in market cap fell over 23%.



Source: SNL Financial

The weakness fed upon itself heading into the closing months of 2018 as the stocks that were already down became targets of tax loss selling. When the added supply of tax loss selling was piled on to a group of stocks that were already falling, it created a liquidity crisis in which shares were being sold into a void. Many REITs had to drop absurd amounts to find a bid to catch the market sell orders. Preferred REIT securities and small caps were the most impacted by the liquidity crisis as their already low trading volumes were not equipped to handle the tax loss sellers.

Market sell-offs happen frequently, but do not always represent opportunity. This selloff is unique in that it is entirely disconnected from fundamentals. As we get to discussing our reasons for owning each of the securities in 2CHYP I intend to demonstrate that the fundamentals remain healthy and in many cases are stronger than they were before the sell-off. The intrinsic value of these companies has gone up slightly over the past 6 months, but now we can buy them at a much cheaper price. Taking advantage of the mispricing, we have substantially repositioned the portfolio and following are its holdings heading into the new year.

2CHYP Portfolio 12/31/18								
Stock	Weight	Shares	Price	Market Value	FFO/share*	P/FFO	Indicated Dividend $	Yield %
CBL-E	4.33%	500	$ 9.56	$ 4,780.00	n/a	n/a	$ 828.13	17.32%
CXW	4.84%	300	$ 17.83	$ 5,349.00	$ 2.43	7.34	$ 516.00	9.65%
FPI***	4.52%	1100	$ 4.54	$ 4,994.00	$ 0.26	17.46	$ 220.00	4.41%
GMRE	8.05%	1000	$ 8.89	$ 8,890.00	$ 0.89	9.99	$ 800.00	9.00%
GNL	5.42%	340	$ 17.62	$ 5,990.80	$ 2.15	8.20	$ 724.20	12.09%
IRM***	9.54%	325	$ 32.41	$ 10,533.25	$ 3.16	10.26	$ 794.30	7.54%
GOOD	8.60%	530	$ 17.92	$ 9,497.60	$ 1.64	10.93	$ 742.00	7.81%
KIM	5.64%	425	$ 14.65	$ 6,226.25	$ 1.46	10.03	$ 476.00	7.65%
MPW	5.82%	400	$ 16.08	$ 6,432.00	$ 1.43	11.24	$ 400.00	6.22%
PLYM	7.99%	700	$ 12.61	$ 8,827.00	$ 1.62	7.78	$ 1,050.00	11.90%
RLJ	8.91%	600	$ 16.40	$ 9,840.00	$ 2.32	7.07	$ 792.00	8.05%
UMH	9.11%	850	$ 11.84	$ 10,064.00	$ 0.84	14.10	$ 612.00	6.08%
UNIT***	9.87%	700	$ 15.57	$ 10,899.00	$ 2.62	5.94	$ 1,680.00	15.41%
WPG	5.50%	1250	$ 4.86	$ 6,075.00	$ 1.30	3.74	$ 1,250.00	20.58%
CASH	0.26%			$ 282.15	$ -		$ -	
Dividends receivable	1.61%			$ 1,782.07				
Portfolio Total**	100.00%	n/a	n/a	$ 110,462.12	$ 12,423.70	8.34	$ 10,884.63	10.04%
*FFO/share is the 2019 consensus estimate provided by SNL Financial.								
**Totals include cash and dividends receivable. P/FFO is calculated as portfolio common stock value over portfolio FFO.								
*** FPI IRM and UNIT earnings figures are consensus 2019 AFFO								
Deep Value								
Quality Value								

Each stock is selected for its individual potential to generate return as well as how it fits into the portfolio's diversification and overall characteristics. Below is how 2CHYP stacks up as compared to the REIT index.

	2CHYP	SNL US REIT index
P/FFO*	8.34	17.62
Dividend yield	10.04%	4.42%
Payout ratio**	80.9%	77.9%
*2CHYP P/FFO is portfolio's common stock market value over aggregate FFO of holdings		
As aggregate FFO is not readily available for the SNL REIT index P/FFO is the forward estimate provided by SNL Financial.		
**Payout ratio calculated as indicated portfolio common stock dividends		
over indicated FFO of aggregated holdings in the portfolio		
Data as of 12/31/18 for 2CHYP and SNL index		

While the dividend yield of the REIT index beats that of the S&P, 4.42% is simply not enough income for many people. The US is in the midst of a retirement crisis in which the majority of Americans do not have enough savings to meet their retirement goals. After adjusting for inflation, a 4.42% dividend yield requires a massive nest egg to generate enough income from which to live.

In my opinion, the only solution to America's retirement crisis is higher returns and a great starting point for higher returns is higher yield. A 10.04% yield can make ends meet with a much smaller sum of money.

One must be cautious, however, in pursuing high yield as most high yield REIT portfolios are stuffed full of mortgage REITs that pay out dividends far in excess of earnings. The key to sustainable high yield is high cash flows to support that yield.

2CHYP has a dividend payout ratio of 80.9% of FFO which means the underlying companies preserve some cashflow to grow their earnings. Mathematically, there is only one means of obtaining high dividend yield that is fully supported by cashflows and that is through value.

The REIT index has gotten cheaper due to the recent market crash, but it still trades at 17.6X FFO at the close of 2018.

Source: SNL Financial

Such valuation simply cannot support a 10% dividend yield. The REIT index consists primarily of overpriced large cap and mega cap REITs that disguise the extreme value that exists within the REIT universe.

2CHYP's FFO multiple comes in at 8.34X (as of 12/31/18) which is less then half that of the index. 2CHYP's roughly 12% FFO yield is what supports the 10% dividend yield and it comes from a basket of hand-selected mispriced securities from a variety of economic sectors.

Fundamental exposure	Positions (12/31/18)	Weight
Industrial	PLYM, GOOD	16.59%
Retail	WPG, KIM, CBL-E	15.46%
Healthcare	MPW, GMRE	13.87%
Fiber Infrastructure	UNIT	9.87%
Data security	IRM	9.54%
Manufactured housing	UMH	9.11%
Hotel	RLJ	8.91%
Office	GNL	5.42%
Corrections	CXW	4.84%
Farmland	FPI	4.52%
Dividends receivable		1.61%
Cash		0.26%
Total		100.00%

Industrial

Industrial is widely regarded as the growth sector for REITs with simultaneous booms in e-commerce and domestic manufacturing. Unfortunately, most of the sector is priced for growth with high trading

multiples. Plymouth (PLYM) and Gladstone Commercial (GOOD) are the exceptions to the rule with FFO multiples under 8X and 11X, respectively. This provides us with similar exposure to the growth, but at a far better price than the other industrial REITs which trade closer to 18X.

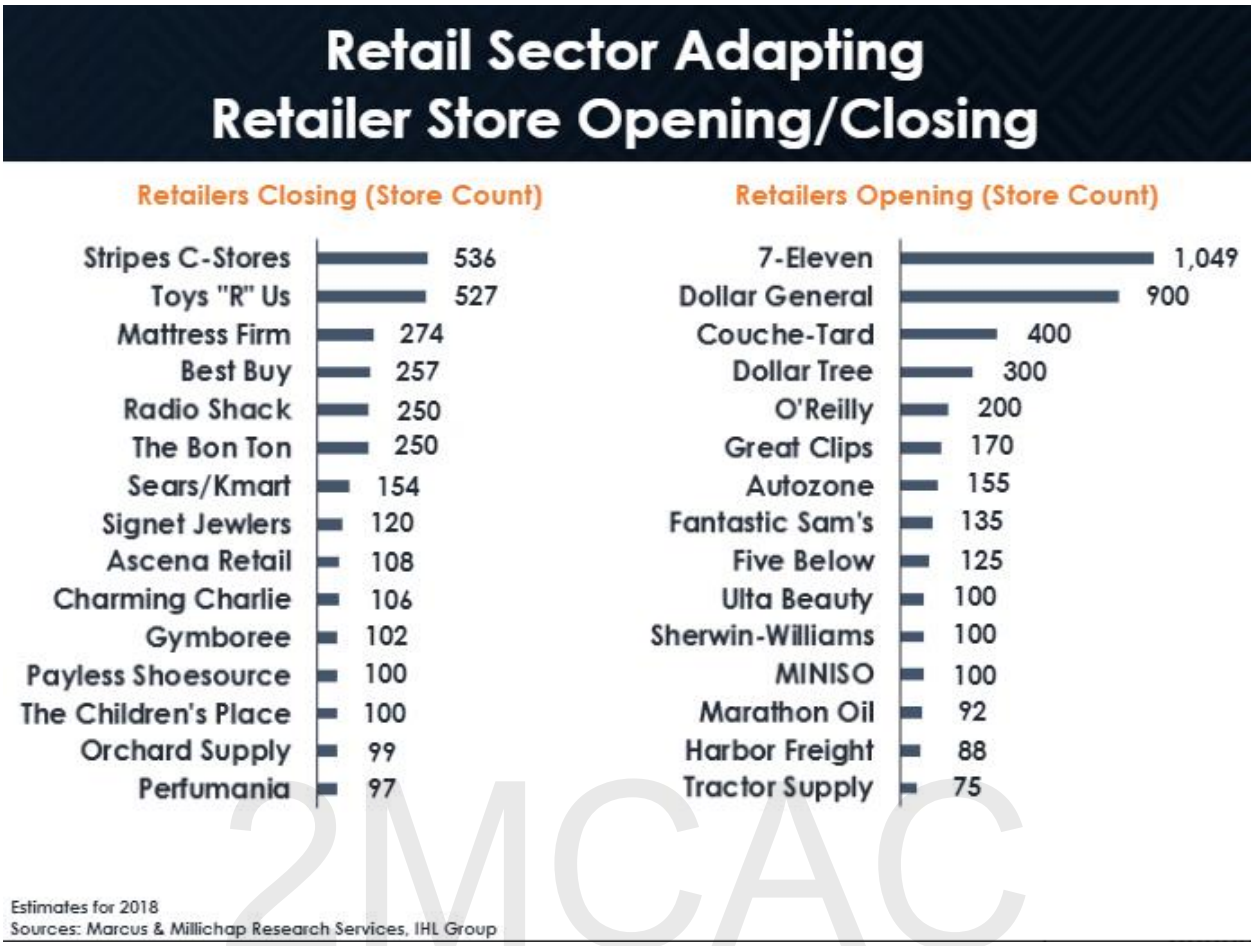
Plymouth is arguably one of the riskiest stocks in the portfolio due to its micro cap size and high leverage. Both small size and high leverage are two sided in that while they increase risk they also amplify returns. If industrial macro fundamentals remain strong, PLYM has potential for sizable growth as it marks its currently below market rent to market. PLYM is also having success in leasing up some vacant space which produces incremental NOI. Each rental rate increase, new lease or acquisition adds meaningfully to the bottom line. With a market cap of about $70mm, everything moves the needle.

Gladstone Commercial is the more defensive industrial play as its cashflows come from long duration NNN contracts. While we are anticipating some growth from its approximately 8% cap rate acquisition pipeline, the main appeal of this stock is its steady cashflows. GOOD was one of few stocks to maintain its dividend through the entirety of the financial crisis and given the strength of industrial fundamentals, the dividend has gotten even more stable.

Retail

I fundamentally believe that there is a place for both e-commerce and brick and mortar retail. Amazon itself is proving this concept with plans to open large numbers of physical retail locations. They believe omnichannel is the way of the future and I tend to agree. Physical stores have been shown to increase online sales due to their presence improving customer awareness of the brand.

While market prices of retail REITs remain exceedingly low, the fundamental bottom already happened. Store openings now exceed store closures.

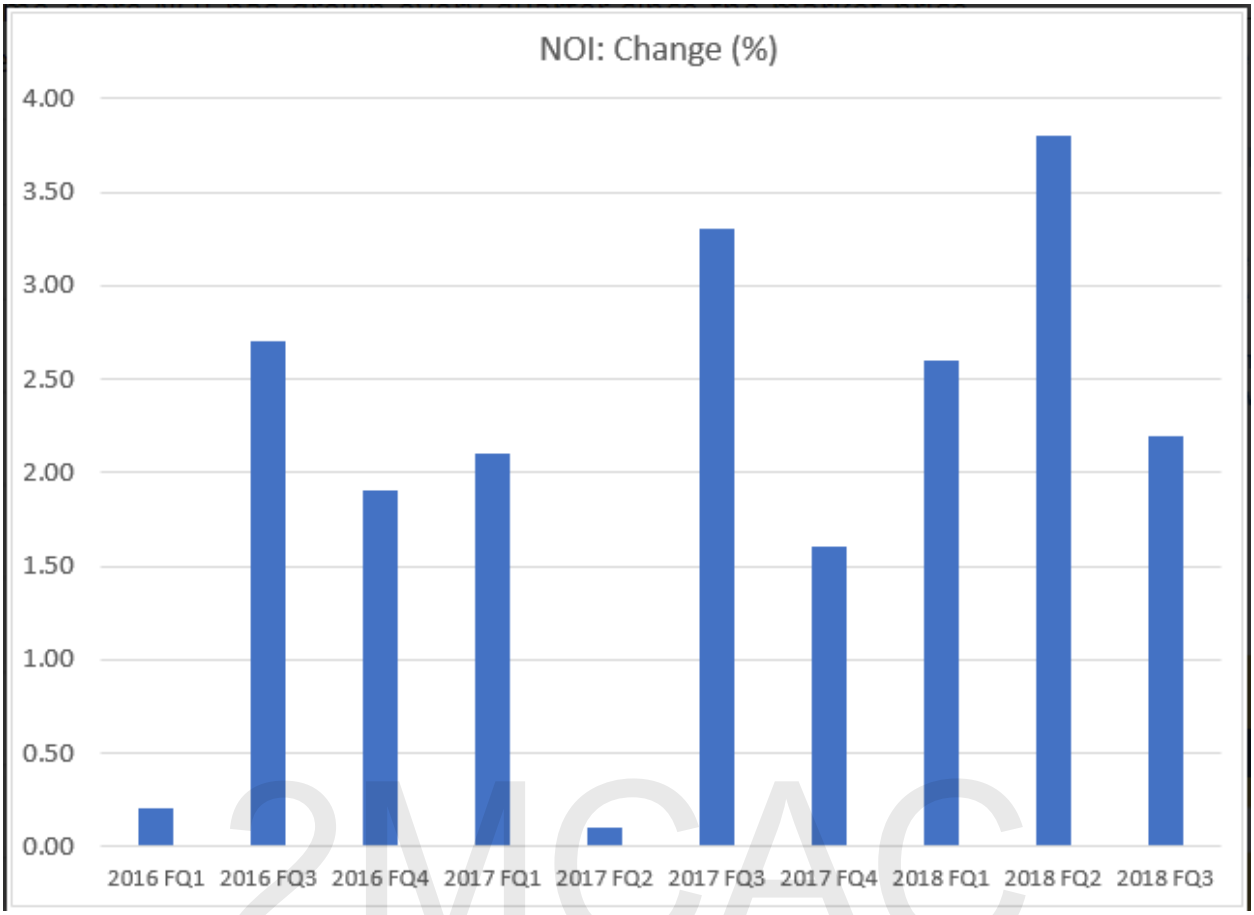


There is no doubt that retail is changing and there will be both winners and losers. Thus, we approach investment in the retail REITs by buying across the spectrum. We are confident that retail real estate as a whole is undervalued and this total spectrum approach maximizes our chance of realizing the disconnect between market prices and intrinsic value.

At the low end of the sales per foot spectrum we invest in Washington Prime (WPG) as it is the most proactive in adapting its portfolio to meet consumer demands. It began the shift to experiential retail before its peers and accelerated the shift by incenting its leasing agents to sign favorable types of tenants such as gyms, entertainment, beauty and dining rather than departments stores or basic apparel. With a more lifestyle tenancy, WPG is better prepared than its B-mall peers to succeed through the challenging environment.

WPG is priced for disaster with a P/FFO of 3.74X 2019 consensus FFO, but 3.68X EBITDA coverage of interest expense and stable sales per square foot suggest it is significantly stronger.

Kimco (KIM) serves as the higher quality retail and is regarded by many as a blue chip REIT. However, its market price has fallen substantially due to declining FFO. I believe the market has mistaken the FFO decline as KIM struggling fundamentally, but it actually is the result of over $1B of asset sales. KIM's remaining portfolio is leaner and higher growth and we expect FFO/share to rapidly recover. Organic growth has consistently been strong at Kimco as shown below.



Source: SNL Financial – data graphed in Excel.

Going forward, this should translate to bottom line growth now that KIM's disposition program has largely completed.

CBL Properties (CBL) is a high risk, high reward proposition as it has the lowest FFO multiple of any REIT, but also has near term cashflow constraints due to major capex required in re-tenanting its properties. A careful study of CBL's capital stack reveals a way to take a good portion of this risk off the table while still holding massive upside potential.

CBL's preferreds have fallen so far that a mere return to par would result in an investor getting more than 2.5X their money back. Even if their market prices remain depressed, the investor is getting paid a whopping 17% yield to wait. Our analysis shows that even in a fairly rough fundamental outcomes CBL's preferreds are positioned to recover most or all of their fundamental value. The key is in the value of the properties being far larger than the amount of debt senior to the preferreds. Property values can change, but we find the magnitude of change required to hurt the preferreds to be rather unlikely.

Healthcare

Healthcare fundamentals differ greatly by property type. Senior housing is suffering from oversupply and labor costs. Skilled nursing facilities or SNFs are losing occupancy from declining length of stay outweighing the favorable demographic wave.

Hospitals and Medical offices or MOBs are far better positioned. Due to higher acuity, length of stay cannot be reduced at hospitals in the same way insurers have forced its reduction at SNFs. The shift to outpatient visits enhances the demand for medical offices.

Most of the MOB REITs trade at premium multiples reflective of the strong fundamentals. While strong fundamentals may be comforting to invest in, there isn't much opportunity when paying full price. Global Medical REIT is the exception as it has full exposure to MOB fundamentals, but at a much lower multiple of just 10X.

In my opinion, the primary reason for GMRE's discount is its size. Small cap REITs often fly under the radar which causes a disconnect between market price and intrinsic value. Analysts see the value in GMRE with consensus predictions for FFO/share growth.

Funds From Operations

YEAR	FFO ($)
2017 A	0.72
2018 E	0.81
2019 E	0.89
2020 E	0.99

Source: SNL Financial

That much growth is not consistent with a 10X multiple and if the analysts are anywhere near correct GMRE is too cheap right now.

Medical Properties (MPW) is the only pure-play hospital REIT and they are the dominant player in the space with connections to the best operators in the US and Europe. MPW has been a long term investment for us and we have continually been impressed by the execution of management in capturing positive opportunities and evading problems. While MPW's market price has grown, its FFO/share has grown with it, thereby keeping its multiple at a reasonable 11.2X.

Recent dispositions have demonstrated MPW's process with truly impressive IRRs.

- In September, MPW sold North Cypress Medical Center for $148mm, realizing a gain of $100mm
- In June, MPW sold a 50% interest in a 71 Hospital German Portfolio for 1.14B Euros recognizing a gain of 500mm Euros.

Fiber Infrastructure

Most of you have heard my pitch on Uniti Group (UNIT) plenty of times, so instead I want to discuss the barriers to entry in long distance fiber.

Most technology related costs are getting cheaper. The microchip stocks are getting killed because the marginal cost of processing power is declining relentlessly. This is because chips are now a commodity.

Fiber is the opposite. The marginal cost of laying fiber has increased significantly over time and that is because only a tiny portion of the cost is the fiberoptic cable itself. A majority of the cost is digging up the earth and obtaining the permits to do so. Construction labor prices are rising and regulations have gotten far costlier in terms of both monetary cost and delays.

Fiber that was laid a decade or so ago is more expensive to replace now and that is a large barrier to entry which inhibits competition, benefitting incumbents.

Uniti is an incumbent as one of the largest fiber owners in the US and the largest fiber owner in secondary and tertiary markets of the southeastern US. As the cost of replacement rises, the value of Uniti's fiber rises.

Data security

Data center demand is growing rapidly, but so is supply. The structure is highly repeatable and there are minimal barriers to entry. As such, the pipeline is vast with a nearly unlimited potential to put capital to work, but the cap rates are low in the mid-single digits. The constant supply keeps rental rates fairly low relative to cost of building.

Iron Mountain (IRM) has a path of entry into the data center business that comes at a higher cap rate. IRM is the global leader in physical data storage and is on its way to becoming the global leader in physical to digital data transmission and storage. It is the synergy between its legacy business and its data center business that paves the way for growth.

As IRM's data center portfolio expands, it gains the ability to transfer existing customer's physical papers to digital form, thereby retaining customers who no longer need the physical storage and doing so at a higher margin. I consider this business line as synergy because it does not require all that much investment. The existing physical storage business is still producing its normal revenues and the data centers are producing their normal revenues, but IRM can generate addition revenues from the intersection of the two.

This synergy is unique to IRM and gives them an advantage over data center peers, yet IRM trades at a discount to the data center REITs. In my opinion this discount represents mispricing and therefore opportunity.

Manufactured Housing

UMH Properties' market price has been held back by its securities portfolio which produced sizable losses in Q3 and likely again in Q4. These losses are arguably one time in nature as they are based on fluctuating market prices and since the capital is invested in US equities which tend to go up over time it should be long-run profitable. However, market prices are often dictated by myopic interests and the losses made UMH's FFO look incredibly weak.

If one looks past the securities portfolio it is clear that UMH's primary business in manufactured housing is firing on all cylinders. UMH consistently produces high single digit same store NOI growth and has an accretive development pipeline due to its ownership of land surrounding existing communities.

Once the temporary weakness of the securities portfolio blows over or even reverses itself, the market may begin to see that this is a growth stock and price it accordingly.

Hotels

RLJ Lodging Trust (RLJ) is correctly taking advantage of the public/private arbitrage in the hotel industry by selling its hotels into the higher price private market and using the proceeds to buy back its underpriced stock.

This is a rather simple investment thesis: High quality properties run by a strong management team and it is trading at a discounted FFO multiple and discount to NAV.

Office

Global Net Lease (GNL) has extremely transparent cashflows with a weighted average lease term of roughly 10 years. These cashflows are further secured by a high portion of its tenants being investment grade indicating that the chance of realizing these cashflows is fairly high.

Simple bond math on these cashflows would indicate a far higher price than where GNL trades today, but the company is stigmatized due to its origins from the American Realty family which immediately causes it to be associated with the scandal at ARCP (now VEREIT).

I would agree with the market that there may be some alignment risk with management, but cashflow is still cashflow and I don't know of any other stock that generates a 12% yield from investment grade tenants. In my opinion, the risks are overly priced in here.

Corrections

As always, I will keep the discussion on this topic as non-political as possible. Core Civic (CXW) has the leading market share in the private prison industry and is awarded the most contracts with ICE and the US Marshalls, both of which are expanding under the current administration.

CXW has some vacancy which is being filled as new contracts with ICE, the US Marshalls and individual states roll in. Incremental cashflows filter through quite cleanly to the bottom line and we believe CXW's FFO/share will rebound to its former higher levels.

At a trough multiple on trough earnings, CXW presents a better than usual investment proposition relative to its history.

Farmland

Farmland Partners (FPI) represents one of the greatest deltas between market perception and economic reality.

- FPI is considered a volatile, high risk stock, but farmland as an asset class is among the most steady.
- Management is feared by many potential FPI investors due to rampant accusations, but its actions are well aligned with shareholders. Stock buybacks, personal investment in FPI by the CEO and voluntary pay cuts all suggest strong alignment with shareholders.
- Rumors have been spread suggesting FPI vastly overpayed for its assets, but the USDA's farmland valuation suggests it has appreciated slightly since purchase. This was further supported by FPI's recent sale of farmland at prices significantly above purchase price.

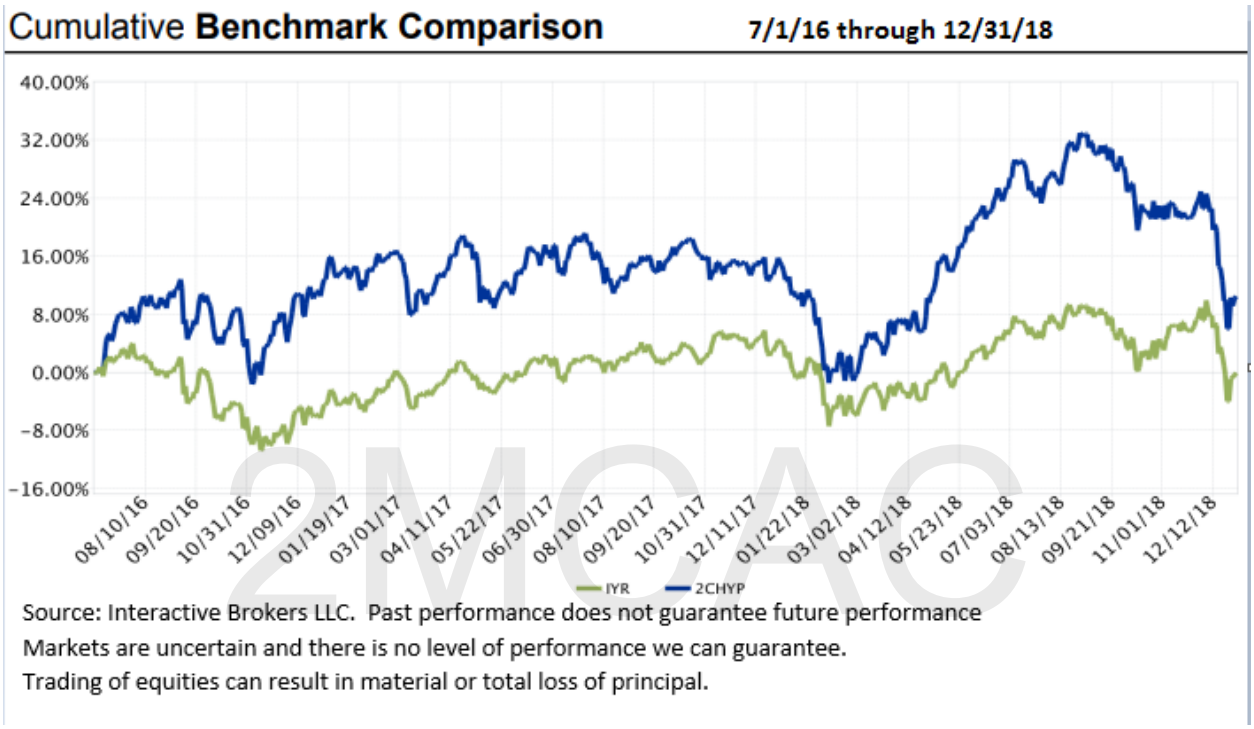
This disconnect between perception and reality affords purchase of a fundamentally steady and well run company at the price of a risky and unpredictable company.

We like farmland as an asset class due to its low capex nature and long term value appreciation. FPI is a means of investing in farmland deeply below NAV.

Performance

We began trading the 2CHYP portfolio on 7/1/16 with the IYR as our stated benchmark. Our goal is to maximize total returns and beat the benchmark by as much as possible. So far, we are beating the benchmark by a decent margin, but the absolute returns are a bit disappointing due to REIT weakness in terms of market price.

Over the 2 and a half year period (7/1/16 through 12/31/18) REITs, as measured by the iShares US Real Estate ETF (IYR) are down 0.06%. 2CHYP returned 10.46% over the same period.



The 4th quarter of 2018 was rough for REITs and even rougher for us as we held many of the undervalued names that were most susceptible to tax loss selling.

While the paper losses were uncomfortable to watch, it also created an opportunity to fuel 2CHYP's dividend engine.

Dividend engine

Each market downturn some stocks are beaten up more than others. By strategically shifting to the ones that have become the most undervalued, we can increase our dividend income.

The market price of the stocks in 2CHYP may be down in the 4th quarter of 2018, but the indicated dividend stream produced by the portfolio is up to $10,884. This is a 10.88% yield on cost against the $100,000 initially invested in 2CHYP. We view this as an engine that is more reliable than the volatile market. The prices will bounce around, but the growing dividends reflect the growing fundamentals.

Risks and concerns

The 2CHYP portfolio is not for everyone. At a minimum, it requires a moderate degree of risk tolerance and a long investment horizon. REIT market prices are volatile and those in 2CHYP are slightly more volatile due to the increased small cap exposure.

Many of the issues held within 2CHYP have low trading volumes which can make execution difficult. We use limit orders to take advantage of the oversized bid/ask spreads, but this comes with the potential of not getting executed.

The Bottom Line

We believe this portfolio of stocks is undervalued and positioned to outperform the market and we actively trade by continuously repositioning into the most opportunistic securities. I have publicly staked my reputation on this portfolio for 2 and a half years and will continue to do so.

Important Notes and Disclaimer

2nd Market Capital and its affiliated accounts are long CBL-E, CBL-D, CBL, CXW, FPI, FPI-B, GMRE GNL, IRM, GOOD, KIM, MPW, PLYM, RLJ, UMH, UNIT and WPG. I am personally long CBL, CBL-D, CBL-E, CXW. FPI, GMRE, GNL, IRM, GOOD, KIM, MPW, PLYM, RLJ, UMH, UNIT and WPG. This article is provided for informational purposes only. It is not a recommendation to buy or sell any security and is strictly the opinion of the writer. Dane Bowler is an investment advisor representative of 2MCAC, a Wisconsin registered investment advisor. Commentary may contain forward looking statements which are by definition uncertain. Actual results may differ materially from our forecasts or estimations, and 2MCAC and its affiliates cannot be held liable for the use of and reliance upon the opinions, estimates, forecasts and findings in this article. Positive comments made by others should not be construed as an endorsement of the writer's abilities as an investment advisor representative.

The holdings presented were the entire holdings of 2CHYP as of 12/31/18, but may not represent the holdings for other time periods. We do not intend presentation of 2CHYP's holdings as a recommendation, but rather as a statement of historical fact.

We cannot determine whether the portfolio holdings presented are suitable for any given reader. Readers are encouraged to contact their financial professional to discuss the suitability of any strategies or holdings prior to implementation in their portfolio.

The specific securities identified and described herein do not represent all of the securities purchased or sold for advisory clients of 2 nd Market Capital Advisory Corporation (2MCAC). It should not be assumed that investments in the securities identified and described were or will be profitable.

A list of all prior purchases and sales made by the investment advisor representative (Dane Bowler) in the 2CHYP portfolio is available upon request. It should not be assumed that purchases and sales made in the future will be profitable or will equal the performance of the securities in this list.

Benchmark Comparison: 2CHYP portfolio is compared to the iShares REIT ETF (IYR) because this is a common methods for investing in a portfolio of REITs and we view it as a competitor or alternatives to 2CHYP. IYR has fees that are factored into performance, while 2CHYP does not have a fee aside from trading commissions which are factored into performance. 2CHYP's dividends are reinvested, while IYR's dividends are paid but not reinvested.

Strategy and market conditions: 2CHYP uses a bottom up stock selection process which may fare better in certain market conditions than in others. It may perform better when value is in favor or worse when value is out of favor.

Expenses: Returns reflect the deduction of any transaction expenses. There are no costs or management fees charged nor deducted.

Past performance does not guarantee future results. Investing in publicly held securities is speculative and involves risk, including the possible loss of principal. Historical returns should not be used as the primary basis for investment decisions. Although the statements of fact and data in this article have been obtained from sources believed to be reliable, 2MCAC does not guarantee their accuracy, and assumes no liability or responsibility for any omissions/errors.

Calculation Methodology: Partial year return for the period 7/1/16 through 12/31/18, unaudited. Dividends in 2CHYP are reinvested.

Conflicts of Interest. We routinely own and trade the same securities purchased or sold for advisory clients of 2MCAC. This circumstance is communicated to clients on an ongoing basis. As fiduciaries, we prioritize our clients' interests above those of our corporate and personal accounts to avoid conflict and adverse selection in trading these commonly held interests.