ELMTREE FUNDS
TRACKER
2019 | VOLUME 1

Keynote Interview

A Conversation with Joseph Yiu, Managing Principal, ElmTree Funds

Overall market

Let's briefly review the U.S. net lease market. What were the two key trends in 2018?

First, demand for U.S. net lease real estate continued to increase after coming in at $57.8 billion in 2017, the second highest volume recorded. We saw increasing investor appetite in both the net lease office and industrial spaces. Second, demand rose because of the global search for yield and portfolio diversification, which has driven many foreign investors to increase their holdings of U.S. net lease real estate.

Industrial was all the rage last year. How do you expect the sector to perform in 2019?

Development for industrial product has been healthy over the last few years. The growth of e-commerce retail has spurred the demand for new distribution centers, last mile, and big-box facilities. With this type of product, we have seen more and more facilities being developed in secondary and even tertiary markets along major interstates and outside of larger metropolitan areas. However, we expect to see new construction volume to soften given headwinds such as increasing material costs, a tight labor market, and a general slowdown of economic activity.

What is happening on the demand side? Are you seeing a softening of rents?

On the contrary, net effective rents are going up for class A product. However, there is low demand for obsolete and older assets.

> "We have seen more and more [industrial] facilities being developed in secondary and even tertiary markets along major interstates and outside of larger metropolitan areas."
>
> **Joseph Yiu, ElmTree Funds**

IN THIS ISSUE, INTERVIEWS WITH:

David Bernhaut Executive Vice Chairman of the Metropolitan Area Capital Markets Group **Cushman & Wakefield**	**Lauro Ferroni** Director, Research **JLL**	**Paul Fiorilla** Director of Research **Yardi**	**Jimmy Goodman** Partner **The Boulder Group**
Ryan Severino Chief Economist **JLL**	**Brian Shanfeld** Managing Director – Corporate Finance & Net Lease **JLL**	**Mark West** Senior Managing Director **HFF**	**Joseph Yiu** Managing Principal **ElmTree Funds**

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> “ Over the last two years, tenant improvement packages within gateway markets were up 46% for top-tier properties. ”
> **Joseph Yiu, ElmTree Funds**

There is data that shows older product being orphaned. This is why ElmTree focuses on new development – at the end of the lease term, the asset is still effectively a newer asset within the market.

We continue to see significant increases in net effective rents for industrial and office over the last 12 months in several markets. For industrial, rents are increasing in Nashville, Tennessee (9.4%), East Bay, California (7.9%), and Inland Empire, California (7.7%). For office, rents jumped in San Jose, California (9.5%), Charlotte, North Carolina (7.6%), and Seattle, Washington (5.9%).

In a booming economy, even in this late cycle, where does the balance of power lie, with the tenants or with the landlords?

Due to excess construction, additional space has become available in each sector. As a result, we have seen a slight increase in vacancies and a general “flight-to-quality” sentiment among tenant relocations. As these bigger and better options stabilize within the market, landlords are trying to find creative ways to obtain and/or maintain tenancy. One way landlords look to do this is by providing tenants with attractive tenant improvement (TI) packages. Over the last two years, TI packages within gateway markets were up 46% for top-tier properties. More commonly, we are seeing: (i) tenants negotiating reduced or capped escalations over the course of their lease term; (ii) rent abatements being offered during the first few months of the lease; these savings are often appreciated by the tenant; and (iii) increases in tenant improvement allowances to help fund tenants’ desired build-out programs.

Where do you get most excited about development opportunities in the U.S. today?

We are most excited about development opportunities in markets such as Detroit, Michigan and Charleston, South Carolina.

Detroit is on the brink of a renaissance, which is being driven primarily by the emergence of, ironically, autonomous vehicles. Many have dubbed Detroit the “Silicon Valley” of the Midwest in terms of the market’s growing technology infrastructure being built to power the autonomous vehicle sector.

Charleston continues to grow at record levels. The Port of Charleston in particular has been one of the nation’s fastest growing container ports since the early 2000s. It grew at more than double the U.S. average in recent years. Traffic is up 14% since 2015, compared to Port of Savannah’s 6.5%. The South Carolina Ports Authority announced the highest monthly container volume in its history, with 206,541 twenty-foot equivalent container units (TEUs) handled in August 2018. Companies such as Google, Mercedes-Benz, and Kuehne + Nagel have recently announced plans to either invest or grow existing operations in the Charleston area.

The outlook seems rosy, but do you have concerns?

As we are 11 years out from the last financial crisis and the political outlook is uncertain,

Some Economic Factors That Impact Cap Rate Movement

Factor	Effect	Importance	Correlation	Impact on Cap Rates in 2019
10-year Treasury yield	Risk-free rate	High	▲ Positive (Treasury up, cap rates up)	Upward pressure
AAA/Bond spread	Economy-wide risk measure	Medium	▲ Positive (spread up, cap rates up)	Mild upward pressure
Inflation	Pushes up rent	Low	▼ Negative (inflation up, cap rates down)	Neutral
U.S. dollar	Affects price paid by foreign capital	Low	▲ Positive (dollar up, cap rates up)	Mild upward pressure
Quantitative easing	Affects demand for risky assets and sentiment	Low	▼ Negative (QE up, cap rates down)	Mild upward pressure
Change in unemployment rate	Indicates economic strength and confidence	High	▲ Positive (unemployment down, cap rates down)	Downward pressure
Debt growth	Increases liquidity	High	▼ Negative (debt up, cap rates down)	Downward pressure
Real rents	Pushes up asset values	Medium	▲ Negative (rent up, cap rates down)	Downward pressure

Source: CBRE Research, November 2018

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> “ If investors continue to have a risk-off mentality, spreads in triple net lease real estate may remain healthy over the next 24 months, hovering at around 350 bps to 450 bps over the 10-year Treasury. ”
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> **Joseph Yiu, ElmTree Funds**

many investors have exited the stock market and are sitting in cash and Treasuries in expectation of an oncoming recession. Economists expect interest rates to increase further, but the 10-year Treasury may stay artificially low as investors seek safety in uncertain times, especially with the potential breakdown of tariff negotiations between the U.S. and China. If investors continue to have a risk-off mentality, spreads in triple net lease real estate may remain healthy over the next 24 months, hovering at around 350 bps to 450 bps over the 10-year Treasury.

What is your outlook for 2019?

Overall, we see U.S. commercial real estate fundamentals remaining positive over the course of 2019. Even if the Federal Reserve Bank further increases interest rates, we don't believe there will be a market overcorrection and cap rates will remain relatively unchanged. As a result, we believe returns should hold steady. With that in mind, asset appreciation could slow down in the industrial sector. Conversely, as suburban office and retail have been trending downward, there could be a minimal change in overall returns.

On ElmTree

How was 2018 for ElmTree?

It was an exciting year for ElmTree. We have been active in the market, acquiring assets including eight single-tenant industrial, healthcare, and office properties in Alabama, Michigan, Missouri, South Carolina, Texas, and Virginia. Four are industrial, three office, and one healthcare. Collectively, they represent more than 2.8 million square feet. Each property is fully leased, and seven of the eight buildings acquired are build-to-suit (BTS) properties.

We also formed a joint venture partnership with Trammell Crow Company that was awarded a 259,947 square foot BTS office building leased to General Services Administration for 20 years in Dallas, Texas.

Internally, we brought on Annie Hsieh as executive vice president of investor relations, promoted Kerry Gawrych to chief financial officer, and hired Richard Eisemen, formerly with Gramercy Property Trust, as senior vice president of operations.

In light of economic and market trends, how are you shaping your acquisition and disposition strategy?

We are focusing on class A product – and specifically BTS industrial and office products – because that's where our 25-plus years of real estate expertise lies. Specifically, we have been targeting BTS or newly constructed assets, leased to investment-grade tenants for ten to 20 years in or near the top 50 metropolitan areas. Corporations need newer facilities to consolidate their logistics operations and new office buildings to attract and retain the millennial labor force. The submarkets we focus on demonstrate secular growth and are less correlated to market volatility. They give us comfort especially if we enter a downturn. We believe that these mission-critical assets, leased to investment-grade tenants for long lease terms, will reduce our probability of default.

In 2018, ElmTree Funds acquired a number of properties, including:

375,466 square foot build-to-suit industrial development in Valley, Alabama, leased to WestRock Co.
1.5 million square foot build-to-suit industrial property located in the Southwest, leased to an investment-grade tenant
210,126 square foot office property in Greenville, South Carolina, leased to Jacobs Engineering Group
259,947 square foot build-to-suit office property in Dallas, Texas, leased to USCIS
100,000 square foot build-to-suit office property in Detroit, Michigan, leased to Tenneco
15,720 square foot build-to-suit healthcare property in Kansas City, Missouri, leased to Baxalta
142,000 square foot built-to-suit industrial property in Charleston, South Carolina, leased to Curtiss-Wright
220,825 square foot built-to-suit industrial property in Richmond, Virginia, leased to Pepsi

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Market Commentary

Clear Skies, With Clouds on the Horizon

In a year where most asset classes have struggled, 2018 was strong for commercial real estate, highlighting its usefulness as a diversification strategy.

Despite four interest rate hikes, activity in U.S. property markets remained robust throughout the year. In the office and industrial sectors, CBRE reported historic low vacancies at 12.6% and 4.3%, respectively; positive net absorption; and the second-highest annual totals of construction completions since 2009.

Single-tenant net lease industrial, office, and retail transaction volume rose to an aggregate record high of $55.3 billion in 2018, an increase of 21.5% over the previous year, according to data provider Real Capital Analytics.

While expansion in 2019 is expected to slower than previous year, economists and market veterans foresee factors on the horizon that could dampen growth such as political instability and trade wars.

Weakness on the Horizon?

Going into 2019, the state of the economy – and not interest rates – is at the top of investors' minds.

"We're seeing the shift from investors, from the question of interest rates and the attack on pricing, to a discussion about the impact of the macroeconomy, volatility, and equity markets," says Lauro Ferroni, director, Research at JLL. "These are front and center now in terms of how real estate investors are underwriting transactions they're looking at currently."

Although the Federal Reserve Bank increased its target benchmark rate 100 bps to 2.5% by the end of 2018, the 10-year Treasury rate – the benchmark for most real estate debt – has not responded by the same velocity, starting the year at 2.46% and ending a hair higher at 2.69%.

Tight labor markets and the rising cost of employment are issues already facing real estate investors and investment managers, with market players carefully watching policy makers as they react to rising inflation and the steady climb of wage growth following the 2008 financial crisis.

It's an issue that will continue to rise in prominence as unemployment rates remain low. The unemployment rate reached 3.9% in December 2018, well below the 80-year average of 5.77%. In addition to inflationary pressures stemming from the record-long period of economic expansion, there are concerns that trade frictions could put a brake on economic growth.

According to the Turner Building Cost Index, the cost of non-residential building construction in the U.S. in the fourth quarter of 2018 increased 1.36% over the third quarter and 5.86% over the fourth quarter of 2017. Over the course of 2018, the national average construction cost for non-residential projects rose by 3.4%, reports JLL.

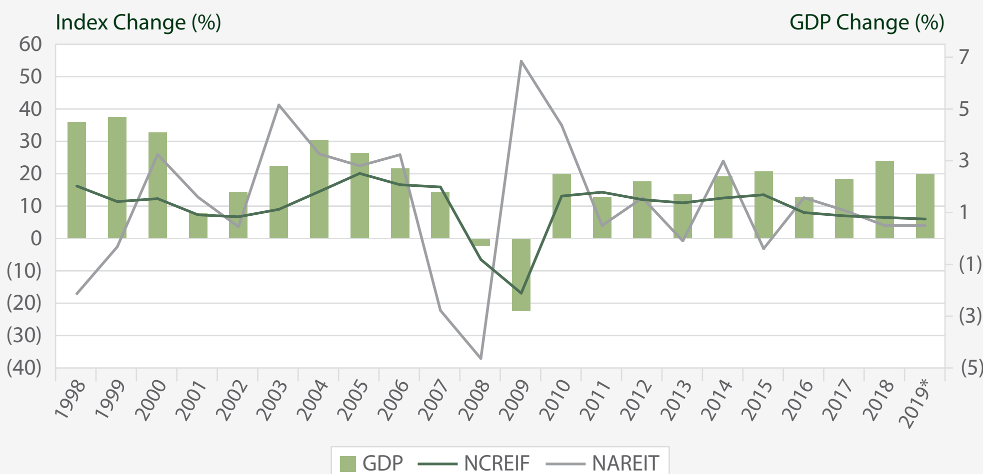
Anecdotally, construction costs in some booming markets such as Arizona and Florida have risen 30% to 35%, and in some cases 40%. About three-quarters of these costs are due to higher wages. Depending on the project, these rising costs could have a significant impact on the bottom-line.

Debt financing is another factor on the watch-list for investors and managers, as they look to underwriting standards in today's late-cycle markets – and the fallout that could come from weakness in the secondary and tertiary markets in the U.S.

Although banks have demonstrated great discipline when underwriting loans since the financial crisis, credit quality tends to deteriorate over time.

"We're 11 years into the cycle and, the odds are pretty strong that we're going to have a recession sometime in the next few years," says Paul Fiorilla, director of research at technology company Yardi. "Anybody who's writing a loan that's more than short-term has to make sure that it's underwritten

U.S. Real Estate Returns and Economic Growth



Sources: NCREIF, NAREIT, Bureau of Economic Analysis/U.S. Department of Commerce, *ULI Real Estate Economic Forecast*.
* NCREIF, NAREIT and GDP data for 2018 and 2019 are based on forecasts for these indicators in the *ULI Real Estate Economic Forecast*, October 2018

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>
> **Ryan Severino, JLL**

Financing

Sale-Leaseback Activity Primed to Increase

Recent weakness in the high-yield debt market could pose an opportunity for increased sale-leaseback as a source of both investment-grade and non-investment-grade deal financing in 2019.

“Sale-leaseback capital could become an even more attractive option to help capitalize net lease transactions,” says Brian Shanfeld, managing director – Corporate Finance & Net Lease at JLL. “It would stand to reason that if capital is drying up in one place it may create a push towards sale-leaseback.”

The clarification of new sale-leaseback accounting standards in conjunction with the new revenue recognition standard, of whether a sale-leaseback transaction is a bona-fide sale or a financing and in certain cases recognizing the gain or less on a qualified sale-leaseback, should further clear the path for these transactions.

in a way that withstands some kind of stress during the course of the loan.”

Being this late in the cycle brings up the perennial question of when will the next crash occur. Economic fundamentals may be strong, but underneath a magnifying glass, cracks in the walls begin to appear.

Chasing yield in secondary and tertiary markets, which could be 150 bps to 200 bps higher than in primary markets, at this stage of the cycle may also portend trouble.

“We haven’t seen as much [signs of weakening] in the primary markets just yet, but we’re starting to see signs of weakening in the secondary and tertiary markets,” says Ryan Severino, chief economist at JLL. “Investors typically start to get concerned about their exit in a rising interest rate environment. The secondary and tertiary markets are where you start to see the disruption first.”

For Severino, signs of disruption could occur in the second half of 2019.

“We have passed the peak [occupancy] in the four major food groups. Apartment and office vacancies bottomed out a few years ago. We’re finally starting to see signs of a bottom in retail. Over the last few quarters, industrial has flat-lined a bit. It doesn’t seem like vacancies got the downward momentum that it had just a few years ago.”

“That leads me to think that, at least on aggregate, we’re starting to see fundamentals weakening a bit on a fairly widespread basis. I feel like we’re nearing an inflection point.”

Demographics Drive Office Strategies

The movement back to the primary markets is showing up in the office sector, where competition for class A properties have led to high prices and razor thin margins.

“We’re seeing a flight to quality again,” says Ferroni. “Investors are wanting longer-term hold assets that can weather cyclical changes in the core markets. In the office sector that’s coming at the cost of activity and also increasingly at the cost of pricing in secondary markets.”

Labor and demographic trends are also continuing to reshape the office and healthcare markets in the U.S.

Employers – focused increasingly on employee engagement, retention, and recruitment – may be utilizing a third less space per employee today versus 2000, but it doesn’t mean they don’t want best-in-class, with all the latest amenities.

U.S. Office Vacancy Rates and Rent Growth

Source: CBRE Econometric Advisors, Q4 2018

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> “ If macroeconomic growth slows, how will these business models [such as co-working and new retail concepts] for which we don’t have a lot of track record of performance fare in a year or two? ”
>
> **Lauro Ferroni, JLL**

Fiorilla pointed to rising density within office spaces, as well as co-working and flexible working solutions, as contributing to a flattening in demand for the property type.

However, while net effective rents on existing office properties and renewals may be “stagnant”, according to David Bernhaut, executive vice chairman of the Metropolitan Area Capital Markets Group at Cushman & Wakefield, build-to-suit and renovation-to-suit office rents are “significantly higher. Larger office tenants are looking for top of the market, class A buildings that are fully amenitized,” he said.

It’s a key strategy for tenants in terms of employee recruitment, retention, and engagement. To attract workers of all ages, not just millennials, office buildings today need to include common areas for eating, gyms, green spaces, and areas to collaborate, as well as smart technology that monitors air quality, light, and movement.

However, newer business models such as co-working, as well as the supply chain related to e-commerce delivery and other new retail concepts, could be tested in a downturn.

“If macroeconomic growth slows, how will these business models for which we don’t have a lot of track record of performance fare in a year or two?”, says Ferroni. “I think we have less historic precedent there to look at and to help guide us as to what to expect.”

Medical Offices are Sought After

Demographics are also rewriting demand for healthcare properties.

“With an aging population, there is increased demand from investors for medical assets. This is especially true for properties with the backing of an investment-grade tenant or a large hospital system as these tenants typically have history of long tenancy,” says Jimmy Goodman, partner at The Boulder Group. “Medical assets are most sought after in the net lease sector.”

Demand is high for both larger medical assets (above $10 million) and smaller assets (between $1 million and $10 million), the latter of which are a big target for 1031 Exchange buyers.

Indeed, demand is so strong that “even non-credit medical is often trading at lower cap rates than credit office deals,” said Bernhaut. “Residual value seems to be less of a focus on medical [office] than single-tenant office [properties].

In the New York tristate area, Bernhaut notes investor interest in large healthcare properties adjacent to hospitals. “The capital markets prefer single-tenant hospital credits on campus,” he said – essentially an

Returns

A Tale of Interest Rates and Cap Rates

With four interest rate hikes in 2018 and two possible further interest rate increases in 2019, the relationship between interest rates and cap rates is again under the spotlight.

“As a general rule, there tends to not be a very good relationship between interest rates and cap rates in the sense that it’s only one of the factors that really influences cap rates,” says Ryan Severino, chief economist at JLL.

Although net lease is often considered a fixed income alternative and therefore should be more sensitive to interest rates, the long-term nature of net lease investment buffers it from short-term changes in interest rates and can offer attractive risk-adjusted premiums versus Treasury yields in markets with strong economic fundamentals.

In this late cycle, institutional investors like the predictability of cash flows, which comprise the majority of net lease investment returns. And the effects of interest rate hikes can be mitigated through clauses in long-term leases to offset inflation and potential interest rate increases.

Paul Fiorilla, director of research at Yardi, attributes this to commercial real estate’s higher yields than alternatives; investors’ optimism about the performance of the sector, particularly strong anticipated demand for industrial and multifamily; and vast amounts of undeployed capital looking for a place to park.

“As long as those three elements remain in place and the economy is healthy, prices will remain firm,” says Fiorilla.

In 2018, industrial cap rates largely have not been negatively impacted due to the high demand for assets and large pools of capital searching for yield.

David Bernhaut, executive vice chairman of the Metropolitan Area Capital Markets Group at Cushman & Wakefield, observes that the interest rate increases have had more impact on office than industrial.

“Industrial has been very attractive to the institutional all-cash buyer and cap rates are often lower than the cost of long-term conventional financing,” says Bernhaut. Smaller net lease transactions with private buyers and 1031 Exchange deals in that market are also less sensitive to interest rates.

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> “ Industrial is certainly the favorite asset class in the commercial real estate business right now, because there’s not enough of it. ”
>
> **Mark West, HFF**

expansion of hospital and medical facilities compared to previous preferences for expansion via multiple private practitioners.

Goodman observes that the non-investment grade market, which comprise three-quarters of the single-tenant net lease medical market priced between $1 million and $10 million, as becoming “extremely competitive among all buyer types.”

“Single-tenant dialysis centers, plasma centers, and emergency care medical centers are sought after and e-commerce resistant,” says Goodman, noting that the cap rates for these smaller medical assets rose by 22 bps to 6.47% in the third quarter of 2018.

Don’t Forget the Rise of Industrial

While almost all commercial real estate investors and managers are anticipating and preparing for a downturn in the coming years, there is one sector that continues to hold strong: industrial.

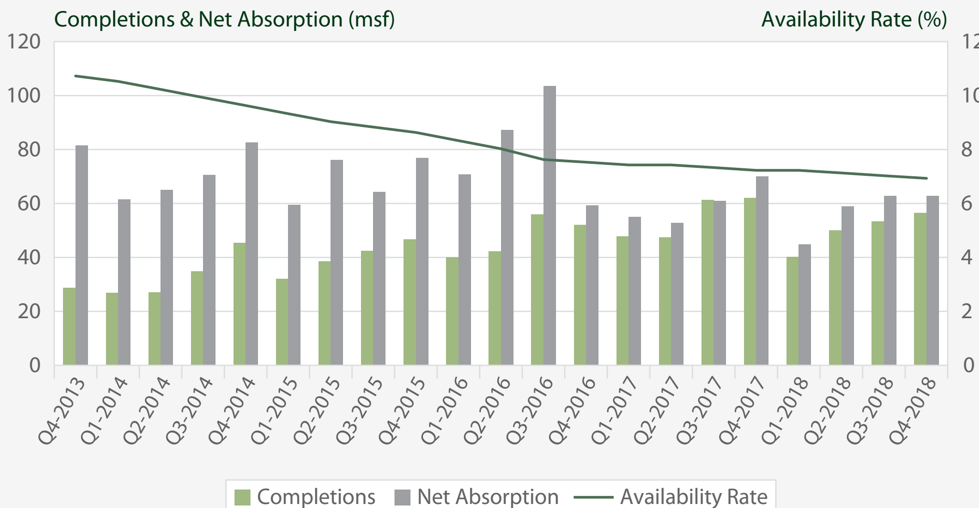
E-commerce has fundamentally transformed and cannibalized retail, not least big-box retail. But it has been a boon for the industrial sector.

The race for last-mile distribution centers to deliver products ever faster to end users has led to a huge demand for all industrial assets, from logistics and warehousing to manufacturing and flex space.

According to Yardi, more than 128 million square feet (msf) of space was absorbed nationally in the first half of 2018. Meanwhile, another 238 msf is under construction nationally. JLL reports that vacancy rates reached a historic low of 4.3% in the third quarter of 2018, while the average industrial transaction size increased 9.1% during the same period.

“Industrial is certainly the favorite asset class in the commercial real estate business right now, because there’s not enough of it and everybody is looking for more industrial product,” said Mark West, senior managing director and head of the net lease/CTL group at HFF. “Everybody’s under-allocated in industrial.”

U.S. Industrial Supply and Demand



Source: CBRE Econometric Advisors, Q4 2018

Development is occurring in all locations and across types of industrial assets. In addition to the core traditional industrial markets of Chicago, New Jersey, Dallas-Fort Worth, and Inland Empire, developers are looking into new markets and providing new solutions.

Bernhaut observes that he is seeing development in port-related and brownfield sites, and “also selectively seeing developers reposition office and retail properties, especially in infill locations” to be repurposed for industrial and logistics use.

In comparison with typical industrial warehouses of over 1 msf, redevelopments in urban infill locations are occurring at a much smaller scale, of about 150,000 to 250,000 square feet each.

And yet there is a shortage of such sites. Although the average land price for single-story warehouses has doubled in the past five years to $30 per buildable square foot, the availability of small bay infill warehousing facilities is down 27%, while demand is up 20 percent since 2014, reports CBRE.

To solve the proverbial last-mile problem in densely populated urban areas, developers are looking to go multistory, both upwards and subterranean. CBRE reports that seven of such projects are in the works or planned as of the end of 2018, including in New York City, Seattle, and San Francisco.

“It’s clearly a reflection of a structural change in the economy,” says Severino. “I think investors are excited about the prospect of building multistory now, even though the costs would obviously be higher, relative to something that’s single story, because you can offer delivery times that are shorter.”

Industrial demand is so strong that Fiorilla believes the sector will remain healthy for a “very long time” to come.

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Net Lease Trends

Industrial Pushes Volume to Record High

Industrial transaction volume rose 48.7 percent over the previous year to nearly $30 billion, helping make 2018 the most active year for single-tenant net lease activity in history. However, cap rates were largely flat while spreads over the U.S. Treasury narrowed.

Net Lease Transaction Volume

Source: Real Capital Analytics. Based on independent reports of properties and portfolios $2.5m and greater

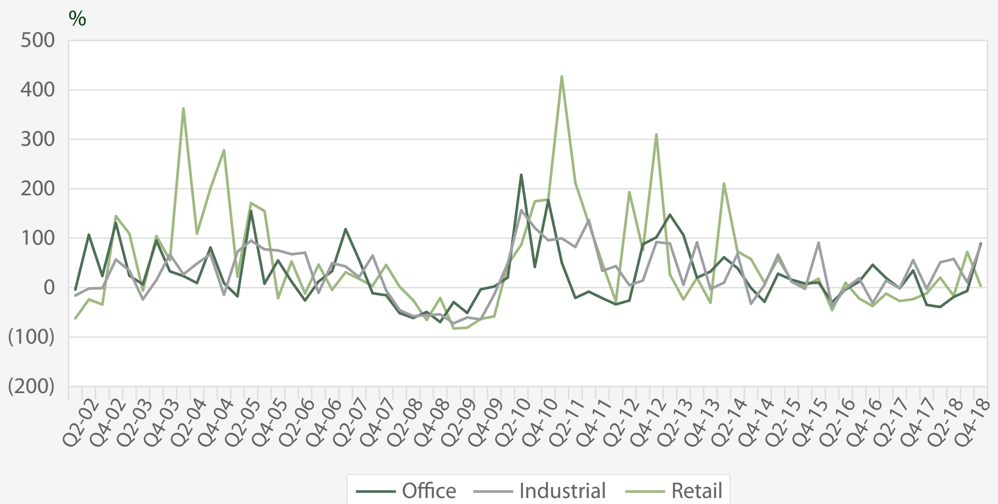
Record high net lease transaction volume in 2018

Single-tenant transactions rose 21.5 percent to a record high of $55.3 billion in 2018 and almost 10 percent higher than 2010. Industrial accounted for more than half of activity, at 54.1 percent, while the proportion of office and retail fell to 32.9 percent and 12.9 percent, respectively, over the past year.

Industrial and office YoY activity spiked in Q4 2018

After four quarters of negative growth over the previous year, office transaction volume recovered strongly in the fourth quarter of 2018, rising 88 percent over the previous year. Industrial activity also ended strongly at 85 percent over the previous year and especially after the third quarter's increase of only 9 percent.

Net Lease YoY Transaction Growth



Source: Real Capital Analytics. Based on independent reports of properties and portfolios $2.5m and greater

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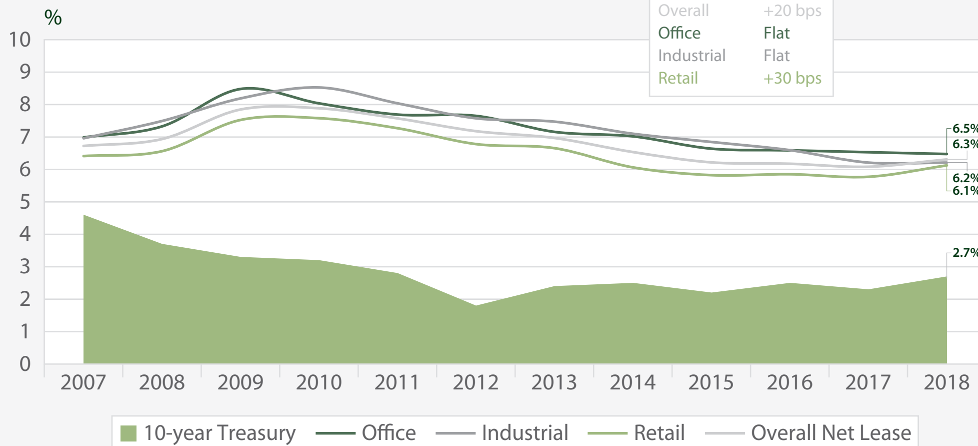
Average Net Lease Cap Rate



Source: **JLL Research, Real Capital Analytics.** Includes transactions larger than $5m and entity-level transactions

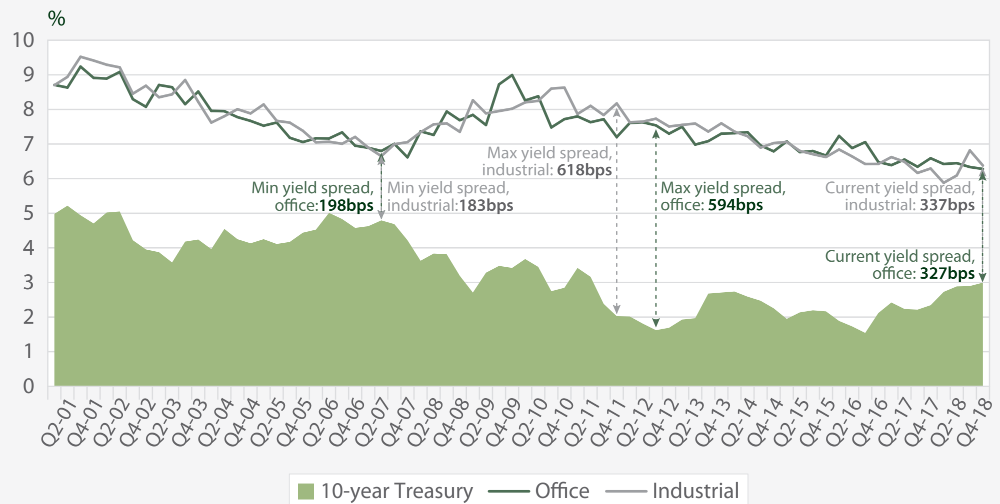
Cap rates are trending up, mainly due to retail

Cap rates for completed net lease office and industrial asset transactions are holding steady at near historic lows. Retail accounted for most of the increase in average net lease cap rates, increasing 30 bps since 2017 due to the cannibalization by e-commerce.

Spreads over Treasuries continue to compress

At the end of 2018, spreads between net lease office and industrial cap rates and 10-year Treasuries compressed to 3.27 percent and 3.37 percent, respectively, which are lower than the pre-recession average of 3.5 percent. Spreads were larger a year ago, at 4.24 percent and 3.94 percent, respectively.

Net Lease Cap Rate Spreads: Office and Industrial



Source: **Real Capital Analytics, Federal Reserve Bank.** Data as of December 31, 2018

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