666 Dundee Road, Suite 901
Northbrook, IL 60062

CLOVERLEAF

(847) 272-3300
www.cleafgroup.com
info@cleafgroup.com

NEWS

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FOCUS ON THE FUNDAMENTALS:

Why Cloverleaf Is Not Worried About Interest Rates

By Jonathan Basofin, Principal

My eleven-year-old daughter, Georgia, wisely told me that she tries to focus her attention on things she can control more than things she cannot – that when she notices herself worrying about "what ifs," she tries to do something more productive with her mind and time. In addition to feeling proud of Georgia's perceptiveness (and grateful that she is already more grounded than her father), her comment reminded me why Cloverleaf has thrived for over four decades, and how we should proceed from here.

Owning commercial real estate is fraught with theoretical issues to worry about. While Cloverleaf contemplates them, we try to emphasize matters within our control, or for which we can plan. Implicit in managing risks is wagering guesses about a range of future trends and outcomes and creating an accompanying strategy. It is more challenging than ever to predict the timing and trajectory of external influences on real estate. There are more factors at play than ever before, and much like today's rapid news cycles, the facts on the ground change more quickly than they once did.

Consider, for example, interest rates.

Changes in interest rates impact commercial real estate markets substantially, arguably more than any other single influence. Assessing when and how rates will shift over time is complicated guesswork. We of course do our best to project and respond to interest rate fluctuations; but even that undertaking is premised on being able to not only predict how rates will change, but how others will react when they do. For example, if interest rates increase, will more owners be motivated to sell because higher debt service weakens cash flow, or will they wait for a lower rate environment in hopes it will yield higher values? How might that behavior change based on the relative strength of investment alternatives, taxes, global economic indicators, proposed legislative changes, inflation…

So, while we do our best to stay informed and plan, Cloverleaf is best served by following Georgia's advice: Focus the bulk of our attention and strategy on what we can control.

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Other than being judicious with how we use debt, we have no control over interest rates' impact on our portfolio. Therefore, we center our acquisition strategy on factors like location, rents, how we can improve and sustain leasing, and how occupancy changes will alter cash flow, regardless of whether rates go up or down. And importantly, we minimize the effect of rate changes by keeping our debt relatively low, a practice that has been core to Cloverleaf's model since the company's inception. Therefore, rate changes marginally affect our returns and do not limit our ability to continue buying across a range of markets. And importantly, once we own a property, our decision-making is rarely constrained by debt service considerations. For example, as rates increased substantially in mid-2022, our property in Granger, IN required additional funds for leasing opportunities and capital improvements. Because our debt was low to begin with, adding to it was uncomplicated. Cash flow stayed strong and, as discussed elsewhere in this newsletter, the enhancements we made allowed us to sell the asset profitably. Also, like many other armchair prognosticators, we found it tricky to anticipate interest rate trends over the last 10-15 years. In response to a variety of scary economic indicators, the Fed began dramatically lowering rates in late 2007-early 2008, ultimately to 0.00% by the end of 2008. As several years of unprecedently low interest rates followed,-Cloverleaf's response throughout was twofold: We resisted the urge to borrow more, keeping our debt around 50% loan-to-value, and our forward-looking projections assumed rates would increase 2.00% over five years. As noted above, our low debt strategy served us well; but our guesses about rate increases were continuously wrong. The Fed kept rates historically low well into the pandemic, even as capital flooded into the markets and once-in-a- generation inflation took hold. Over the last few years, capitalization rates for sought-after assets dropped very low (i.e., prices surged) as demand was robust. Finally, about a year ago, the Fed began meaningfully increasing rates, including over 4.00% growth in that time. Commercial real estate transactional activity has dropped precipitously since then.

And that's where we are today. What happens next with interest rates (and how others will react) may be impactful, but we cannot control it. As inflation and interest rate changes continue to bounce off one another, buyers and sellers will likely find a way to adjust to a new norm. Then just as they do, the situation will change again. Meanwhile, Cloverleaf will plan as best we can for different eventualities, but will not fret about matters like interest rates. Instead, we will focus on real estate fundamentals as we seek new acquisitions, and work on bettering our properties through concentrated leasing and management.

Why Cloverleaf Does Not Buy More Assets

By: Michael Basofin, Principal

We are often asked by investors and others why we do not buy more properties. How we regard risk is fundamental to the answer. When reviewing potential acquisitions, there are several variables we consider in assessing the risk/reward balance. Here are some of the most important:

- **LOCATION:** Will this location get better, worse, or stay the same? We make an educated guess based on trends, neighboring alternatives, construction costs, demographics, and other factors.
- **TENANT ROSTER:** Are the current tenants impacted by internet sales? Do they have a history of financial stability? Where are their competitors?
- **RENTS AND LEASE EXPIRATIONS**: Are the rental rates paid by each tenant likely to go up, down, or stay the same? Are there many near term expirations and is that lease rollover an opportunity or a negative?

- **REAL ESTATE TAXES**: How is the property assessed today and how might it change based on our purchase price and/or changes in the net operating income?
- **VACANCIES**: What is the vacancy rate in the immediate area? How long have the vacancies in the subject property been unoccupied and why? Have they been vacant because the location is undesirable, because there are too many “category killers” in the center/area, or is it a reflection of current ownership not deploying the necessary funds for buildouts and commissions?
- **CAPITAL IMPROVEMENTS:** How old and in what condition are the roof, HVAC units, parking lot, etc.? Does the property need a facelift? In what condition are the vacant units? How much will it cost to get them presentable and finish them for occupants?
- **INTEREST RATES**: As Jonathan Basofin noted in another article in this newsletter, Cloverleaf emphasizes interest rates less than many others, but trying to assess rate trends is always a consideration. Will we have an opportunity to refinance based on leasing success and/or projected interest rates? How will rates affect cash flow and, ultimately, sale?

No one ever accused the Basofins of being overly aggressive about risks. That mentality has a lot to do with why we have been in business for over 40 years and why the company is the size that it is. In evaluating risk, we take comfort in some basic personal and business values. Maybe that is why Cloverleaf is generational: shared values, shared risk/reward assessments, and not trying to be the biggest or best-known player in the real estate world.

Cloverleaf Sells Three Stabilized Assets

Following lease-up and stabilization, Cloverleaf completed the following sales over the last nine months:

GREENWOOD SPRINGS (GREENWOOD, IN) (CLOVERLEAF FUND VI) SOLD

In July 2022, we completed the sale of Greenwood Springs, a 28,028 square foot center in south suburban Indianapolis, for $10,112,497. The property, which consists of two multitenant buildings on the corner of a Walmart Supercenter anchored development, was purchased by Cloverleaf Fund VI in November 2014 for $4,725,000. At the time of our acquisition, the center included a handful of vacancies, under-market rents, and unstable tenants. We believed the location was ripe for substantial growth and were gratified that the area matured considerably during our ownership, becoming more sought after by tenants and investors. Over time, we filled the vacancies and upgraded the majority of the property’s leased spaces to higher-rent paying tenants. While this asset was part of Fund VI, when viewed on its own, the investment yielded an 19.30% IRR and 3.31 equity multiple.

GRANGER STATION (GRANGER, IN) (CLOVERLEAF FUND VII) SOLD

In February 2023, we completed the sale of Granger Station, a 17,539 square foot center in the South Bend area, for $2,900,000. The property, which is adjacent to a separately owned Martin’s grocery store, was purchased by Cloverleaf Fund VII in June 2016 for $1,600,000. At the time of our acquisition, the property had significant vacancy and tenant transiency. We stabilized the rent roll, including recently adding a new ten-year Dunkin Donuts lease, and made considerable capital improvements. While this asset was part of Fund VII, when viewed on its own, the investment yielded a 10.68% IRR and 1.69 equity multiple.

849 ELMHURST ROAD (DES PLAINES, IL) (CLOVERLEAF FUND VI) SOLD

In August 2022, we completed the sale of 849 Elmhurst Road, an 8,400 square foot multitenant building in northwest suburban Chicago, for $1,550,000. The property, which sits next to a Jewel grocery store, was purchased vacant by Cloverleaf Fund VI in April 2015 for $710,000. Though we brought it to 100% occupancy, the asset experienced challenges because its largest tenant, a fitness user, struggled (particularly during the pandemic), while real estate taxes increased dramatically. Cloverleaf typically avoids Cook County because of its high, volatile taxes. Here, we incorrectly calculated that the upside would overcome that issue. After assessing all alternatives, we determined a sale was preferable to continued ownership. While this asset was part of Fund VI, when viewed on its own, the investment yielded a 2.64% IRR and 1.19 equity multiple.

Cloverleaf Fund IX Acquires Geographically Diverse, Midwestern, Value-Add Properties

Cloverleaf Fund IX has purchased three well-located value-add properties, each in different Midwestern markets. As reported in a previous newsletter, in July 2021, we acquired Pyramid Place, a 52,184 square foot center on the north side of Indianapolis. Since then, we bought the following properties:

HALES CORNERS, WI CENTER (HALES CORNERS, WI)

In July 2022, Cloverleaf Fund IX acquired a 35,690 square foot value-add property in south suburban Milwaukee in an off-market transaction. The multitenant building, which was 29% vacant upon our purchase, sits between two established, busy grocery-anchored centers and shares access lanes with both properties. The asset is located in a particularly dense, infill portion of Hales Corners and enjoys excellent visibility, good signage, and easy ingress/egress. We acquired the property with a mix of capital from Fund IX investors and a loan equal to 40% of the purchase price, but with the ability to add more debt as needed. We believe that with enhanced attention to leasing and management needs, and a willingness to put additional funds into the project, we can stabilize and improve it, while receiving reliable cash flow, even at current occupancy.

HOUSTON COMMONS (FLORENCE, KY)

In February 2023, Cloverleaf Fund IX acquired a 44,252 square foot value-add property in south suburban Cincinnati. The multitenant building, which was 15% vacant upon our purchase, includes a long-term leased, well-performing PetSmart and is part of a development anchored by a separately-owned Target. It is located along the primary retail corridor in Florence, KY, a strong market in the Cincinnati MSA. The property is approximately a half mile from I-71/I-75, five miles from Cincinnati/Northern Kentucky International Airport, and 10 miles from downtown Cincinnati. We acquired the center with a mix of capital from Fund IX investors and a loan equal to 47.5% of the purchase price, but with the ability to add more debt as needed. Additionally, the asset sits across the street from St. Elizabeth Florence Hospital. We believe the property presents a compelling combination of stability and value-add.

Welcome to New Cloverleaf Team Member, Patricia Flynn

We are pleased to have recently welcomed Patricia Flynn to our team as Cloverleaf's Accounting Assistant. Patricia's primary responsibilities include accounts payable, bank reconciliations, month-end work, and other accounting activities in support of the company's Controller, Ruth Moschel. An Irish ex-pat and graduate of Oakton Community College, Patricia brings over 20 years of related experience.

Cloverleaf Staff

Jonathan Basofin
Principal

Michael Basofin
Principal

Liz Vanden Heuvel
Manager of Administrative Services

Joy Parker
Property Manager

Ruth Moschel
Controller

Ross Cosyns
Vice President

Dylan Mahon
Analyst

Patricia Flynn
Accounting Assistant

Advisory Committee

Michael Basofin
Principal Cloverleaf

Jonathan Basofin
Principal Cloverleaf

Donald DeGroff
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Attorney

Frank Mariani
Chief Executive Officer, Mariani Landscape

Elliott Robinson
Chairman, Robinson Financial Group, Inc.

Steven Roth
Executive Vice President, CBRE

Sean Sharko
Senior Managing Director Investments,
Marcus & Millichap