ALTERNATIVE INVESTMENTS QUARTERLY

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Beyond the Black Box of Alternatives

The Importance of Continuous Oversight and Monitoring of Alternative Investments

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ADISA

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Executive Director's Letter

By John Harrison, *DBA*

Executive Director, ADISA

Inspire to Not Conspire

We humans are by our nature pattern seekers. As a species, we have made it this long in part by being able to connect dots to learn the skills to thrive. Financial planning is no different; we seek patterns to optimize portfolios, assess real estate, and create new investment products. But assuming some types of patterns, especially for the gullible can be a problem. I speak not only of the miscalculations involving financial patterns, but also of conspiracy theories which can circulate, robbing otherwise rational minds of applying useful patterns instead of unsound ones. Astute financial professionals can be part of this solution to this tendency.

The German social scientist, Michael Butter, in his recent treatise on conspiracy theories (from M. Butter's 2022 work, The Nature of Conspiracy Theories) walks us through the usual "pattern" of the conspiracy theorist's formulation. Three aspects are required to label some idea a conspiracy theory: 1) it must be an intentional "plot", 2) it must involve a secret connection of people, and 3) it must be nefarious. Surely these type of occurrences must be all around us, right? (According to Prof. Butter's research about half of the population of the US believes in at least one conspiracy theory.)

Well, wrong. The theories writ large are rarely real. What is more likely to be real are specific, one-time simple actions (e.g., an assassination, a heist, etc.) not related to anything else. Larger ongoing movements involving lots of folks secretly plotting evil together are almost non-existent—although that doesn't keep folks from looking and theorizing a pattern

Since they are rarely true, why do conspiracy theories persist? Because people seek explanations for patterns they observe. When there's a vacuum of more benign cosmic or divine explanations, conspiracy theories increase. With the Enlightenment began

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the dawn of conspiracy theories (e.g., Illuminati, Freemasons). Modern, secular people are expected to accept a world of chaos and chance with little soothing knowledge alongside; conspiracy theories are sometimes that salve we seek. They represent a chance to get ahead by discovering connections—an unknown edge over regular pedestrians. And, this opposition to the rest of us rational folks. To the conspiracy addict, it is a win in preparing ahead while us normal "unaware" folks only find solace in the evidentiary approach of our friend Father William—of Occam, that is, with his famous razor: the simplest workable explanation is the best. There is no conspiracy, no excess mentality to ascribe, especially not on the part of the Feds or other big governments. Show me a conspiracy theorist, and I'll show you someone who has never worked for the government.

It's hard to convince a conspiracy theorist to not connect the dots in these untestable patterns. Such perceived patterns are often reactions to polarizations of instability vs. authoritarianism. The experts suggest that the best approach in argument to a conspiracy theory is to disprove one or two of the dots themselves, for challenging to overall sinister connections is to cast dispersions on the bearer of the secret answer borne by the heart and ego of the conspiracy theorist him or herself (and, indeed, there's more or less a balance between the sexes in this phenomenon). Another tactic of sane response is to show the scale of the secrecy that would be needed to sustain a conspiracy theory.

Understanding that some investing populations are susceptible to conspiracy theories and how to mitigate that mentality is helpful. Whether it's a coping mechanism of the elderly who've seen perhaps one social change too many, or someone enfeebled by the ever-increasing media onslaught of click-bait bad news (after all, pessimism always sells), the steadiest of us has a responsibility to nurture logical, reasoned approaches that connect facts without assuming excess mentality or a bee-line to cabals of wickedness. We need to inspire them toward neutral explanations and away from wasteful conspirings. ▲

John P. Harrison, *DBA, CAE*

ADISA Executive Director

Q&A with Jade Miller

The Bourne Financial Group
2024 ADISA President

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Q **What do you think is the most important issues currently impacting ADISA members?**

A There are a number of issues that ADISA members may face this year, but I believe the largest issue, and the biggest threat overall to both ADISA members and the alternative marketplace in general, is the cost of doing business. Regulatory concerns or enforcement are coming at large costs to firms. Errors and Omissions (E&O) insurance has continually risen, and with interest rates at all-time highs, profitability and viability for members is becoming difficult.

We've recently seen an uptick in lawsuits in the industry. According to National Economic Research Associates ("NERA"), there were 228 new federal securities class action suits filed in 2023, up from 206 in 2022, with filings in the finance sector more than doubling and the number of resolved cases decreasing to its lowest recorded level in the last ten years. Additionally, FINRA reported that arbitration filings were up 30% in 2023, with many of these filings related to alternative assets. This increase in lawsuits is putting pressure on firms to increase E&O liabilities, which has become quite costly and is putting pressure on firms to either reduce alternative investment exposure or merge with another firm.

This goes hand in hand with the regulatory pressures we face as an industry. The SEC filed 784 total enforcement actions in fiscal year 2023, up 3% over the previous year. We also saw FINRA crack down on marketing, investor communications, and other various infractions last year. This also continues to put pressure on firms and advisors—and not only due to the cost of the fines. Firms must also evaluate the amount of exposure to alternatives they are willing to take on if it comes with this additional risk.

Finally, all members are seeing interest rate and inflation pressure. The cost of leverage and liquidity puts enormous pressure on issuers, sponsors, and the space in general. The cost of hiring and retaining employees has ticked up, while the margins we all run businesses on have continually compressed. Furthermore, lower margins and higher rates have led to a lack of liquidity in the space, which magnifies that the cost of doing alternative business is under pressure and challenging for all members.

Jade Miller
The Bourne Financial Group
2024 ADISA President

Q **Is there anything coming up on the legislative or regulatory front that we should be keeping an eye out for?**

A The SEC has maintained a busy rulemaking agenda under its current administration, and this trend seems poised to continue in the year ahead. A final rule that was adopted in August 2023 requires private fund advisors to provide investors with quarterly statements detailing private fund performance, fees and expenses. Additionally, the rule will in the future prohibit advisors from granting certain preferential treatment to specific clients outright, and others unless such arrangements are fully disclosed.

This rule has sparked potential legal challenges, and the Fifth Circuit Court of Appeals is considering a petition filed by several industry groups. The petition argues that the SEC overstepped its authority by mandating this level of disclosure. I expect that industry participants will be keenly watching the court's decision.

Looking ahead to 2024, the SEC has proposed modifications to the definition of "holder of record" under the Securities Act of 1934. Currently, the definition refers to the registered owner of a security, who enjoys associated rights such as voting and receiving dividends. The proposed changes could potentially impact how ownership and related benefits are determined. Furthermore, the SEC has signaled potential revisions to Regulation D, which governs private placements, including the accredited investor definition. While details remain unclear, these potential adjustments warrant close attention from industry stakeholders

Other areas of interest may be around technology, including crypto assets and artificial intelligence ("AI"). The SEC has largely maintained that most digital assets fall under the purview of securities regulations. Final amendments to a safeguarding rule, which among other things looks to address crypto assets, are expected by April 2024. AI has also captured the SEC's attention, with a projected final rule in 2024 aimed at mitigating conflicts of interest stemming from the use of AI and predictive data analytics. And the SEC continues its focus on cyber security and outsourcing issues, with proposals that may become final this year already on the record.

Q **What do you hope to see from FINRA's Regulation Best Interest enforcement actions as they continue to conduct exams and gather information on firms' practices?**

A First and foremost, I hope that FINRA's enforcement actions will robustly uphold the core principles of Reg BI and prioritize investor protection. It is imperative that retail investors clearly understand the nature of investments, associated risks, and potential conflicts of interest. Our industry's commitment to transparency and accountability is crucial for maintaining investor trust in alternative and direct investments. Similarly, I hope that FINRA will prioritize those cases which have led to tangible investor harm, as opposed to a purely technical approach. This would help to ensure that enforcement actions are both effective and proportionate in addressing the most significant investor protection concerns.

That being said, firms and financial professionals require clarity and consistency from FINRA regarding Reg BI compliance expectations. Our industry is heavily regulated, and the vast majority of industry professionals want to comply with these regulations. It is crucial for FINRA to provide clear guidance and avoid overly complex or contradictory interpretations which could impede any responsible business conduct. Clarity is essential to help these firms operate with confidence when providing suitable investment recommendations for their clients.

I would also like to see FINRA acknowledge the diverse landscape of alternatives and direct investments. This diversity calls for a nuanced approach, and I hope that FINRA will recognize the product-specific characteristics, while still applying the core principles of investor protection.

Finally, I hope that FINRA will place greater emphasis on collaboration and education. While enforcement has its place, I strongly believe that collaborative efforts and robust education initiatives by FINRA will foster a stronger compliance culture among our members and the broader industry. Proactive guidance, best practice sharing, and open communication will support firms in understanding and fulfilling their obligations under Reg BI.

Q **Overall, alternatives are growing and becoming more widely accepted. Why do you think that is?**

A Today, alternative investments are growing more than perhaps ever before. According to CAIA, alternative investments are currently at $22 trillion in assets under management—15% of global assets under management. Alternative investment fundraising totaled $7.6 billion in January 2024, according to Stanger & Company.

I believe alternative investments are growing for a few reasons. One is democratization. With regulatory changes, such as the revised definition of an accredited investor, alongside the emergence of innovative structures like crowdfunding platforms, alternative investments are now available to a much broader investor base. Similarly, I believe investor preferences are evolving as well. As the investment landscape changes, a growing number of investors are demonstrating a willingness to explore options beyond traditional asset classes like stocks and bonds.

Another reason alternatives may be becoming more widely accepted is due to their potential benefits. Over the past few years, I believe that many investors may have seen the limits of relying solely on traditional assets. Although it's crucial to remember that all investments involve inherent risks, alternative investments often exhibit low correlation with traditional markets, offering valuable diversification benefits. Additionally, they may provide the potential for higher returns, lower overall portfolio volatility, and a hedge against inflation.

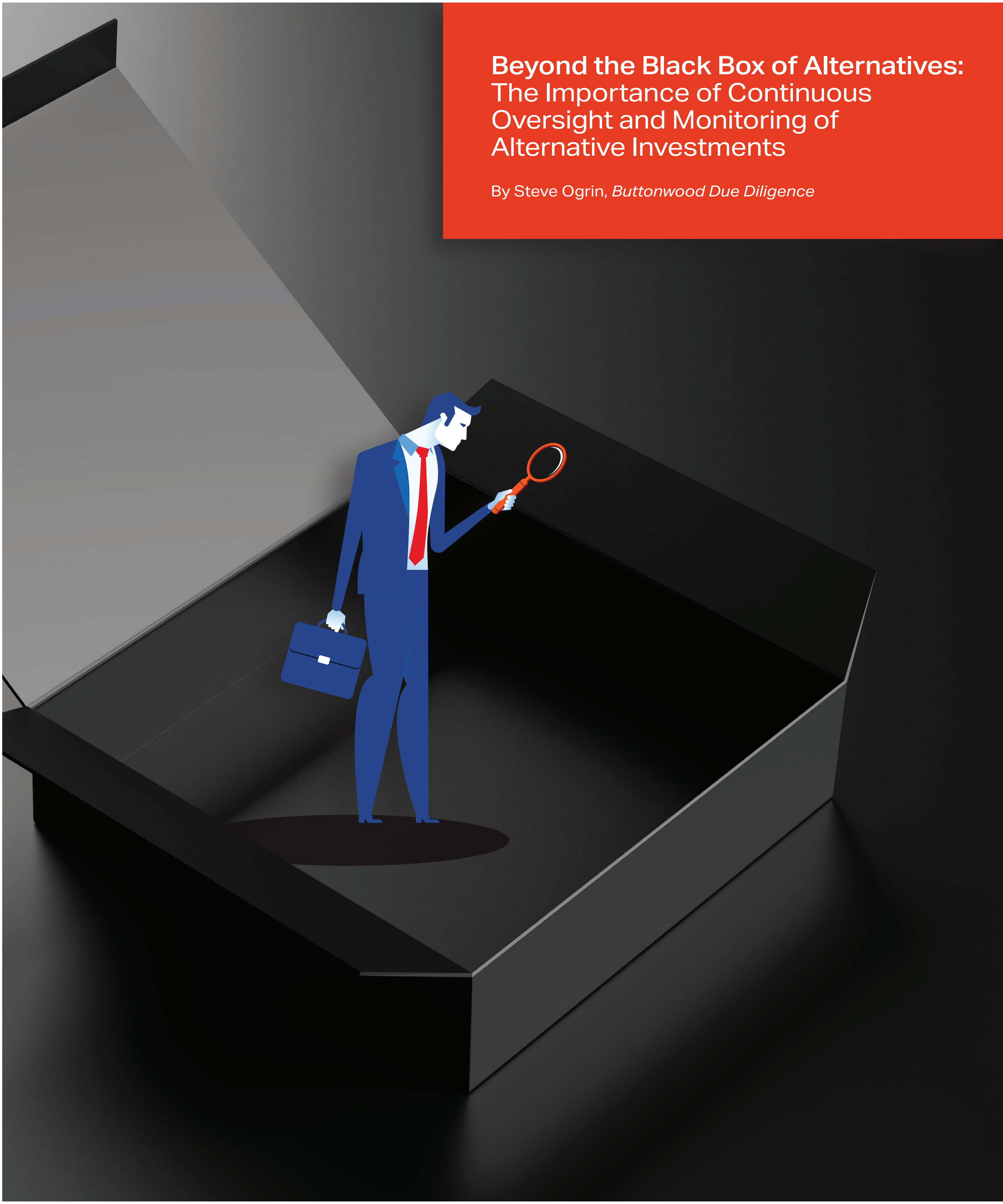
Alternatives also generally offer greater transparency and can be highly or at least somewhat illiquid, which may align well with investors with a lower risk tolerance. In uncertain times, these can be attractive traits for investors.

Non-traded real estate investment trusts reported just $317 million of fundraising in January 2024 compared to $4.6 billion in January 2023. What is causing retail investors to revise their allocation strategy, and should we expect this trend to continue into 2025?

For many years, REITs have been one of the most popular alternative investment options sold by many retail financial advisors, and the recent decline may stem from a variety of factors.

Investors may have moved away from non-traded REITs for several reasons. One such reason may be rising interest rates. The Federal Reserve has raised interest rates 11 times since March 2022. These rising rates can potentially impact property values and decrease cash flow from REITs. Additionally, heightened levels of redemption activity have taken place. According to Stanger, $4.6 billion of requests for net asset value REITs were satisfied in the fourth quarter of 2023. Finally, I think media coverage may have made REITs less attractive to some investors. With the rise of e-commerce, many retail centers and malls are foreclosing, while office space is still affected by remote and hybrid work options. This increased media scrutiny could be generating wariness amongst investors.

Inflation has been steadily falling for 11 months, and the Fed is expected to start lowering interest rates this year, so investors may become more attracted to the space again, especially in certain areas. With an overall housing shortage in the U.S., multifamily may be a compelling choice. Also, with the shift to e-commerce and a trend towards deglobalization, industrial properties may be attractive to some investors as the need for warehouses and distribution grows. Overall, REITs are designed as a longer-term investment tool, so investors who are looking for possible benefits from an illiquid asset may find REITs to be a popular choice. ▲



Beyond the Black Box of Alternatives: The Importance of Continuous Oversight and Monitoring of Alternative Investments

By Steve Ogrin, *Buttonwood Due Diligence*

Now in our 20th year, Buttonwood Due Diligence is a provider of due diligence, education and consulting support to the BD/RIA/VC/Family Office and program Sponsor community. Our knowledge and insight into the alternative investment industry is backed by decades of experience and credentialed analysts including MBAs, CPAs, CAIAs, and JDs.

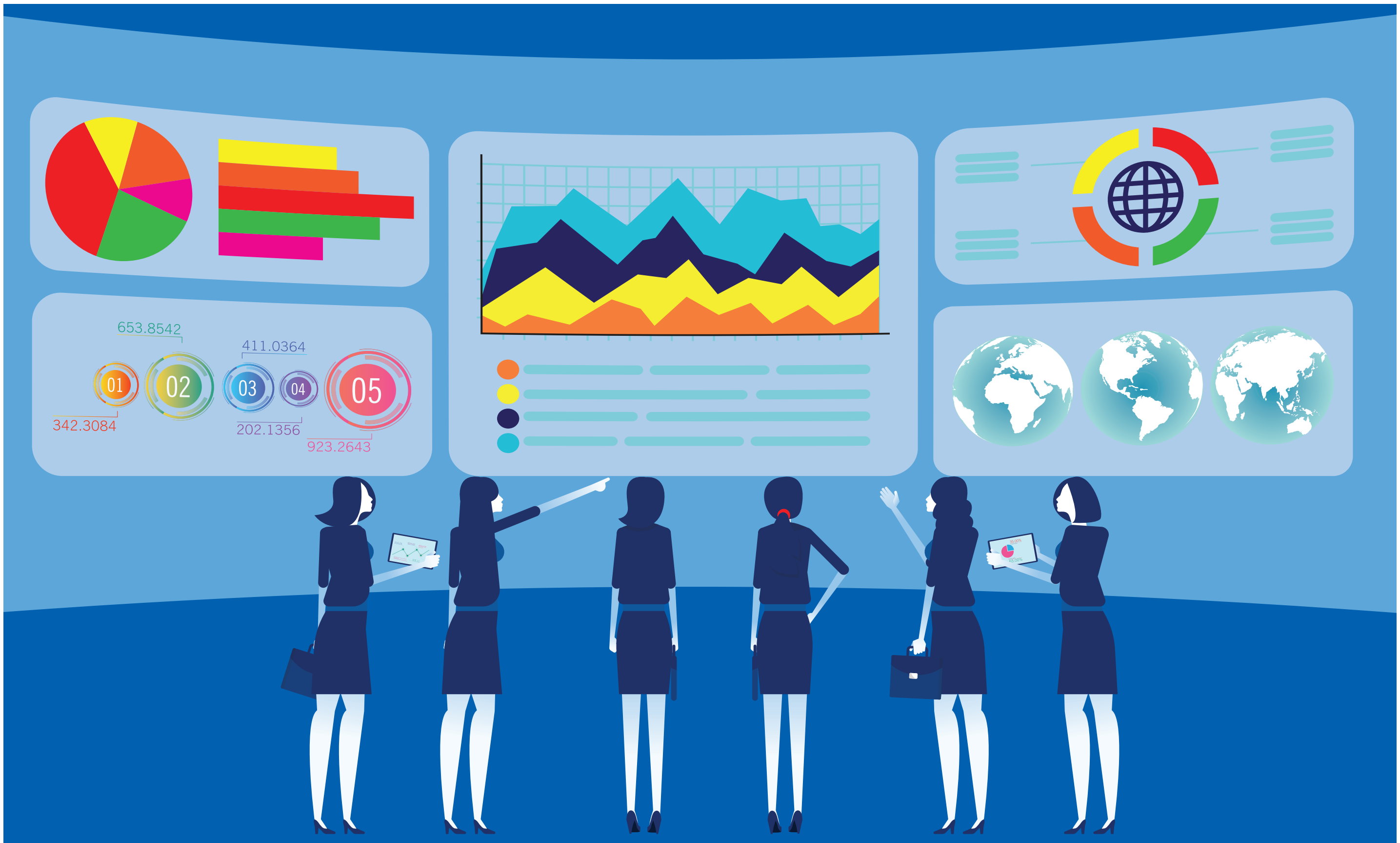
Steve Ogrin earned his MBA from the University of Chicago's Booth School of Business and has been with Buttonwood for 15 years. He acquired the company with Vince Brady in 2021

RIAs, Is Your Continuous Oversight and Monitoring Process Even Remotely Adequate?

Congratulations, you've just completed the process of recommending an alternative investment! You've scrubbed the data room, read through and absorbed the third-party due diligence report, interviewed the program sponsor and even possibly visited the asset, and after weeks, or even months, of checking off the various aspects of your process, the investment has been made. Gold star for you, but what now?

Most RIAs will acknowledge that continuous oversight and monitoring of the investor account and the investments in that account are imperative as a fiduciary. A fastidious RIA will be paying close attention to changes in management personnel and the overall standing of management (i.e., background checks), equity raise and deployment, style drift, distribution and redemption activity, financial performance, status of insurance and tax payments, debt environment…and on and on and on. You get the point… there's a lot to be informed on.

For those of you squirming a bit right now as you realize that your oversight and monitoring process is, at best, touching on a fraction of the topics listed above, fear not, you're not alone. The reality is that one of the more perplexing aspects of the alternative investment process, especially for private offerings, is that once the investment has been made the due diligence and oversight process metaphorically packs up and goes home. Despite many of these investments having a 3, 5, even 10-year hold, for most of the hold period the RIA is often left on their own, scrounging for scraps of information. These



The RIA often doesn't have the margins to hire a full-time alts analyst or the internal capacity to conduct thorough ongoing due diligence on all their alts investments, and the program sponsors traditionally have not faced RIA pressure to provide for ongoing support through a third party (like they do with pre-investment due diligence reports) on an ongoing basis.

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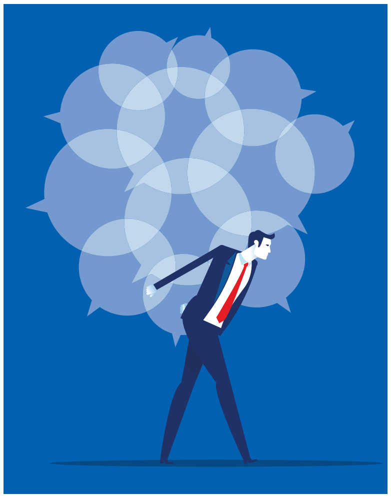
scraps may take the form of a smattering of pedestrian data points from a fintech platform or possibly a semi-annual one-pager released by the sponsor. I suppose if the RIA takes 147 steps in the opposite direction, squints hard enough and tilts their head to the left, the consumption of these scraps may constitute adequate continuous oversight and monitoring (*cough* *cough*...it doesn't).

For public programs we have the opposite problem. The need to thoroughly read and understand every 10-K, 10-Q and 8-K filed—for each investment—presents such an overwhelming task for most RIAs that they either hire an analyst dedicated solely to the consumption of these amazing page-turners, or they simply shut down the advisory practice for the week so they can huddle in a dark corner of their basement reading filings and wondering where they went wrong in life. Neither option is very palatable for most and the net effect is that many end up with an oversight and monitoring process that is inadequate, or worse, they simply avoid alternative investments altogether.

So if the RIA is caught between eating scraps (private program) or drinking from a fire hose (public program), what are they to do? First off, for the avoidance of doubt, in many situations an inadequate oversight and monitoring program is not the fault of the RIA…it's a systemic problem! For decades the process of investing in alternatives has been to do a bang-up job evaluating and conducting due diligence pre-investment, but then post-investment the RIA often spends the next 5-10 years clutching the proverbial pearls and relying on the sponsor alone to tell them that everything was going to be ok. The process was simply not built for post investment oversight and monitoring. And when I say "not built" I am of course referring to a problem of dollars. The RIA often doesn't have the margins to hire a full-time alts analyst or the internal capacity to conduct thorough ongoing due diligence on all their alts investments, and the program sponsors traditionally have not faced RIA pressure to provide for ongoing support through a third party (like they do with pre-investment due diligence reports) on an ongoing basis. Prior to the 2023 launch of Buttonwood Due Diligence's Alternative Investment Monitoring (AIM) program, there simply weren't realistic options for the RIA to efficiently conduct oversight and monitoring of their investments.



So if the RIA is caught between eating scraps (private program) or drinking from a fire hose (public program), what are they to do?

So how should the RIA address this problem without throwing a bunch of money at it, or resigning themselves to a life of conducting ongoing due diligence? One solution is to utilize third party support such as the aforementioned BW AIM program, while another option being utilized by some RIAs is to realize efficiencies through a collective due diligence review process. These collective due diligence efforts are designed to provide the RIA with thorough initial and ongoing due diligence on alternative investments—a must have for RIA oversight and monitoring—while spreading the effort across a consortium of RIAs. While each RIA needs to have their own due diligence process that meets the needs of their firm, there is no need for each element of that process to be unique, opening the door to collective consumption of centrally-prepared due diligence and monitoring. One such example of a collective effort is Buttonwood Due Diligence's Centurion, a consortium of RIAs currently being built for the purpose of providing education, due diligence and investment monitoring support to member RIAs that relies on the concept of centrally-prepared due diligence.

The solution here will be an individual decision for RIAs; throw money at the problem, develop a vitamin D deficiency sitting in the basement conducting due diligence and monitoring, or utilize a third party effort like Buttonwood's AIM or Centurion program. What's most important is that you have a robust continuous oversight and monitoring process in place. ▲

Expanding the Scope: IRC Section 721 Partnership Contributions

By Kyle Kadish, *IBN Financial Services*

Since entering the financial services industry in 2004, Kyle has worked with investors to take advantage of the breadth of investment opportunities across all markets. He introduces investors to strategies, securities, and investment structures to enhance their portfolios. Kyle has found that knowledge and a focus on individual relationships are key drivers to his success. By establishing a personal relationship and consultative approach, he can identify prime opportunities to maximize wealth while factoring in deferred tax strategies. As Due Diligence Officer, Kyle uses this mindset to source and review investment opportunities for IBN's registered representatives, advisors, and clients.

In the intricate world of taxation, partnerships play a pivotal role, offering a flexible structure for businesses to operate and grow. Within this framework, IRC Section 721 governs partnership contributions, delineating the rules and implications of transferring property to a partnership in exchange for an ownership interest. This article aims to provide a thorough understanding of IRC Section 721 partnership contributions, exploring its nuances, implications, and practical applications.

IRC Section 721 serves as the cornerstone for tax-deferred treatment of contributions to partnerships. Under this provision, a partner can transfer property to a partnership in exchange for an ownership interest without triggering immediate tax consequences. Instead, the transfer is deemed a non-taxable event, allowing partners to maintain their tax basis in the contributed property, thereby deferring recognition of gain or loss until a subsequent taxable event occurs.

A partnership contribution encompasses any property transfer in exchange for a partnership interest, including cash, tangible assets, intangible assets, or services. The contributed property becomes an integral part of the partnership's capital structure, contributing to its overall value and operations. It is essential to distinguish between contributions and purchases of partnership interests, as IRC Section 721 explicitly addresses contributions, while purchases entail different tax implications.

One of the primary advantages of IRC Section 721 is the tax-deferred treatment afforded to partnership contributions. The contributing partner does not recognize any immediate gain or loss upon transferring property to a partnership. Instead, the partner's tax basis in the contributed property carries over to the partnership interest received. This basis continuity ensures that the partner's initial investment remains intact, facilitating tax deferral until a later disposition event.

While IRC Section 721 provides broad tax deferral benefits for partnership contributions, certain exceptions and limitations apply. For instance, if a partner contributes property subject to a liability exceeding its adjusted tax basis, a taxable gain may arise to the extent of the excess liability assumption.

Additionally, contributions of appreciated property to a controlled partnership may trigger gain recognition under the anti-abuse rules outlined in IRC Section 707.

Accurately determining the value of a partnership interest is crucial for complying with IRC Section 721 requirements. The fair market value (FMV) of the contributed property is the basis for calculating the partner's ownership interest in the partnership. Valuation methodologies vary depending on the nature of the contributed assets, with tangible assets often appraised based on market comparables, while intangible assets may require specialized valuation techniques.

A consistent tax basis is essential for partners to accurately compute their share of partnership income, deductions, and distributions. IRC Section 721 ensures that partners retain their tax basis in the contributed property, which subsequently adjusts to reflect the partnership's operations and allocations. Any subsequent distributions, allocations of income or loss, and partnership liabilities affect the partner's tax basis accordingly, shaping their overall tax position.

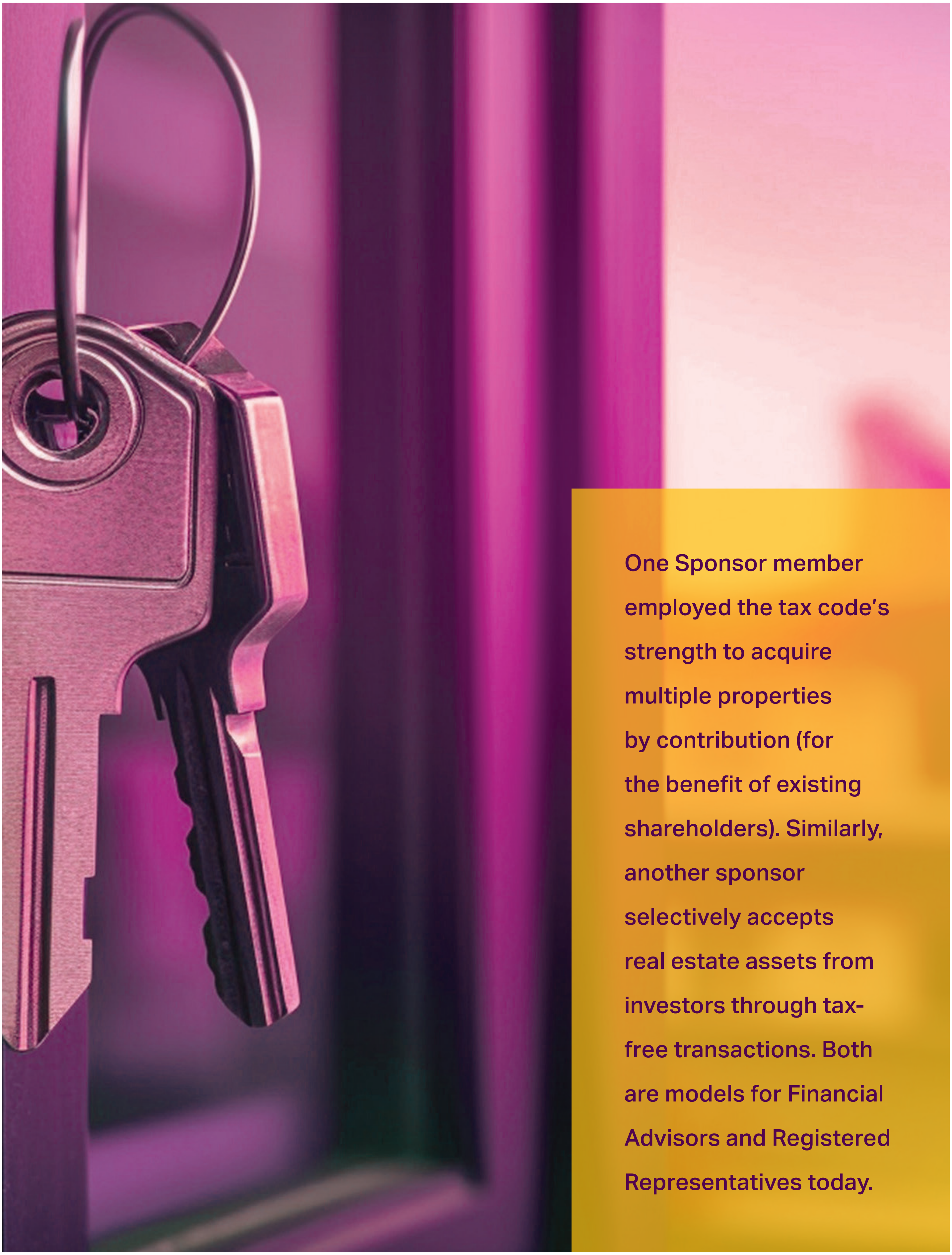
Partners contemplating contributions to a partnership must navigate various practical considerations and compliance requirements. Adequate documentation of the contribution transaction, including partnership agreements, valuation reports, and IRS Form 8308, is essential for substantiating the tax treatment and maintaining compliance with IRC Section 721. Moreover, partners should consult with tax advisors to assess the tax implications and structuring options tailored to their circumstances.

We should commend ADISA Sponsor and Affiliate Members for introducing non-taxable contributions over the past few years. Sponsors began discussing the 721 UPREIT transaction when Congress threatened to end 1031 exchanges. Since then, many Delaware Statutory Trust (DST) sponsors have incorporated contribution language to a REIT's Operating Partnership in offering documents and marketing collateral. These transactions instantaneously diversify investors' exposure to the asset class, often transitioning from a property (or handful of properties) to hundreds. Now that fractional units are owned, investors can easily incorporate exit scenarios into estate planning or optimize tax liabilities.

One Sponsor member employed the tax code's strength to acquire multiple properties by contribution (for the benefit of existing shareholders). Similarly, another sponsor selectively accepts real estate assets from investors through tax-free transactions. Both are models for Financial Advisors and Registered Representatives today. Is a 1031 exchange the best option for an investor? The investment landscape might grow dramatically depending on a client's asset(s).

Finally, partnership law does not restrict the asset class. As referenced above, contributions can consist of cash, real or personal property, and tangible & intangible assets. Currently, a couple of asset managers market exchange funds that utilize IRC 721 rules. The concept revolves around immediately diversifying an investor's portfolio without tax liability—primarily targeting concentrated securities holdings. This broader application of tax strategy might allow wealth managers to grow their client base, moving beyond the four walls of real estate.

IRC Section 721 is critical in facilitating tax-efficient transactions within the partnership framework, offering partners a mechanism for contributing property without immediate tax consequences. By deferring gain recognition and preserving tax basis continuity, this provision promotes investment and business growth while ensuring compliance with relevant tax laws. Understanding the nuances of partnership contributions under IRC Section 721 empowers partners to make informed decisions and optimize their tax positions within the partnership structure. ▲



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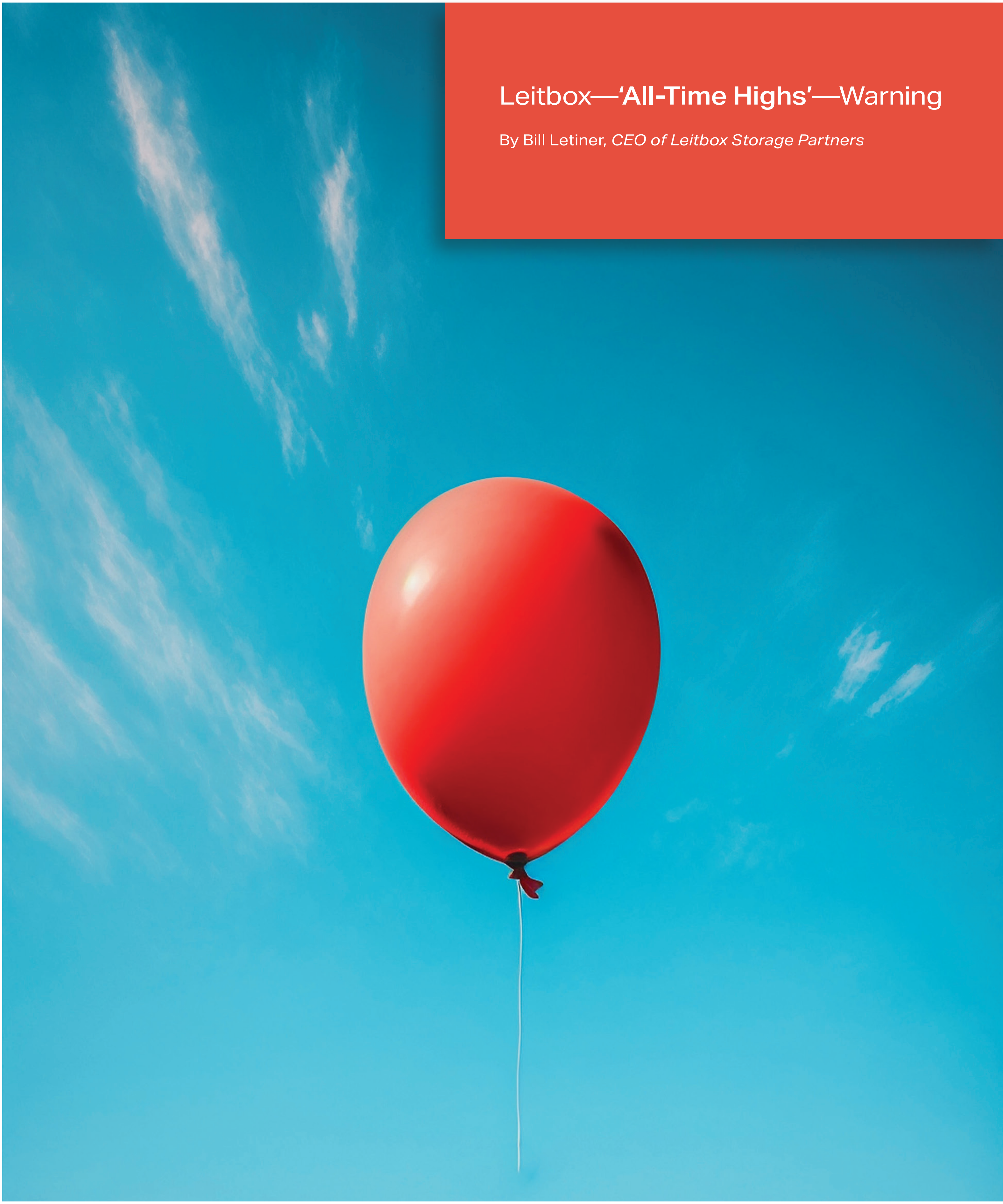
Leitbox—**'All-Time Highs'**—Warning

By Bill Letiner, *CEO of Leitbox Storage Partners*

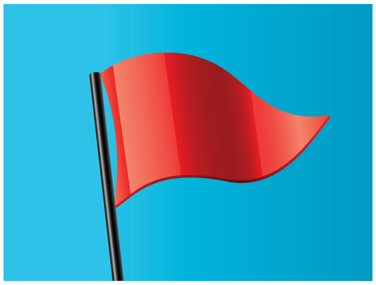


Leitbox Storage Partners ("Leitbox") is a real estate investment company that develops and acquires self-storage (often with mixed use & retail integration) in primary and secondary markets throughout the United States. In addition to programmatic, greenfield development of vertical self-storage, Leitbox utilizes its 30+ year history in the retail and mixed-use sectors to identify and acquire retail, big-box conversion opportunities and income-producing, storage facilities presenting value-add upside potential.

The phrase 'all-time high' often evokes a sense of achievement and success, particularly in the realms of economics and finance. However, this seemingly positive indicator can sometimes be a harbinger of less favorable outcomes. Currently, key economic indicators, such as Treasury bill issuance in the 3rd and 4th quarters of 2023 and 1Q 2024, the number of apartments under construction and the volume of loan maturities over the next 24 months, have reached all-time highs. While at first glance, these may appear as signs of robust economic health, a deeper analysis suggests caution may be warranted.

The Paradox of Treasury Bill Issuance Peaks.

Overview: The recent surge in Treasury bill issuance is a double-edged sword. On the one hand, it reflects strong demand for government debt, often seen as a safe havendured uncertain times. On the other, it raises red flags about the underlying economic conditions necessitating such high levels of government borrowing, especially with Japan and China taking a back seat.



The Boom in Apartment Construction: A Bubble in Disguise?

Current Trends: The construction industry is witnessing a boom in apartment building, with a record number of units under construction set to be delivered soon—almost twice the historical average. This boom is driven by various factors, including urbanization trends, demographic shifts, and investment influxes into the real estate market.

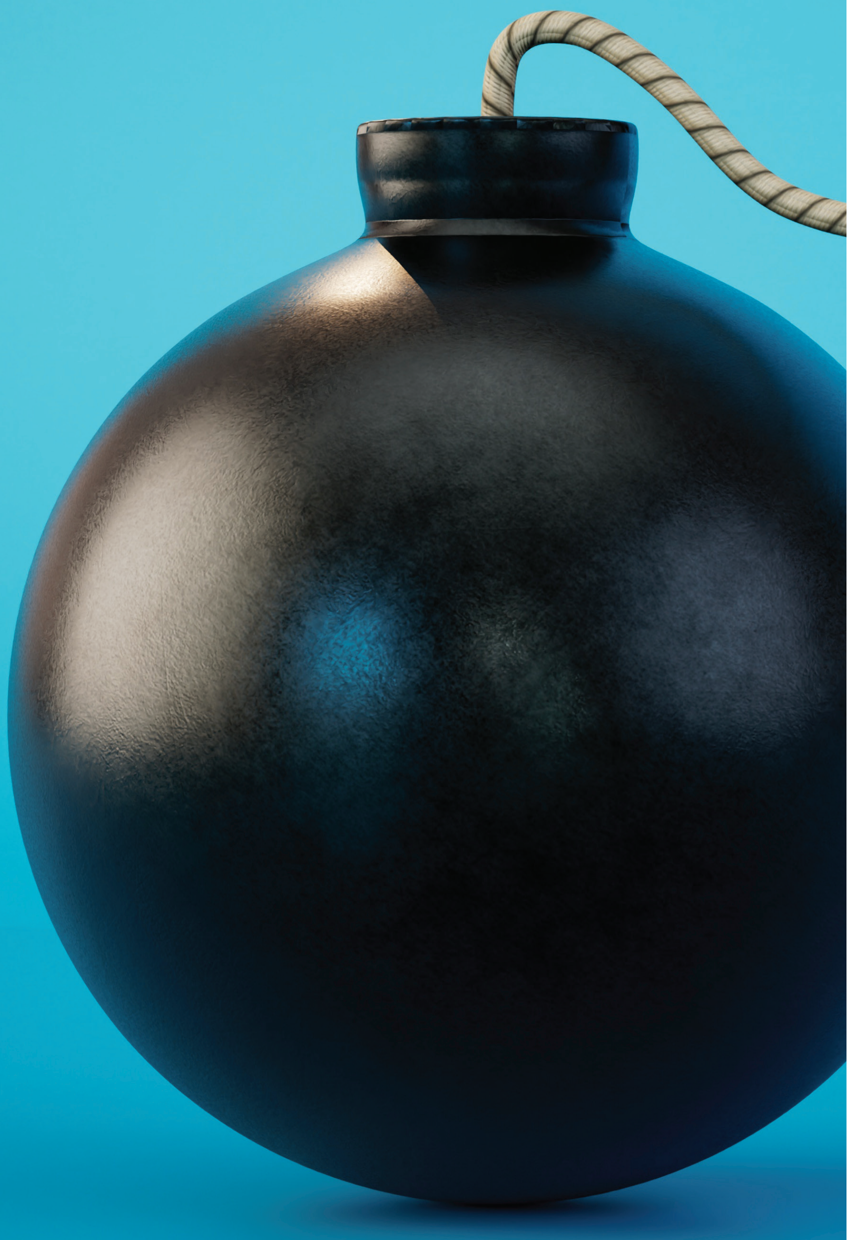
> ...it raises red flags about the underlying economic conditions necessitating such high levels of government borrowing, especially with Japan and China taking a back seat.

Loan Maturities: The Ticking Time Bomb.

The Situation: An unprecedented volume of loans is set to mature over the next 24 months. This situation is partly due to the favorable lending environment of the past few years, where low-interest rates encouraged borrowing. JLL says it's over $1 trillion of loans maturing.

Potential Fallout: As these loans mature, borrowers may face challenges in refinancing, especially if interest rates rise or if lenders tighten their credit standards. This could lead to increased defaults, putting pressure on the financial system.

A wave of defaults could impact not just the borrowers but also the lenders, potentially leading to a credit crunch.



Risks and Consequences: While this boom may seem like a response to housing demands, it could lead to an oversupply in the market, especially if economic conditions change or if the actual demand for these new apartments fails to meet projections. Historical examples, such as the housing market bubble of 2008, demonstrate how oversupply can lead to significant economic downturns.

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Conclusion:

In 2024, watch the 'all-time highs' and use a cautious approach to investing in commercial real estate. With Leitbox Self Storage, on a comparative asset class basis, our capital appetite is small, overhead costs are low, margins are improving via technological advances, and the tenant base is diversified. We "Do Storage Differently."

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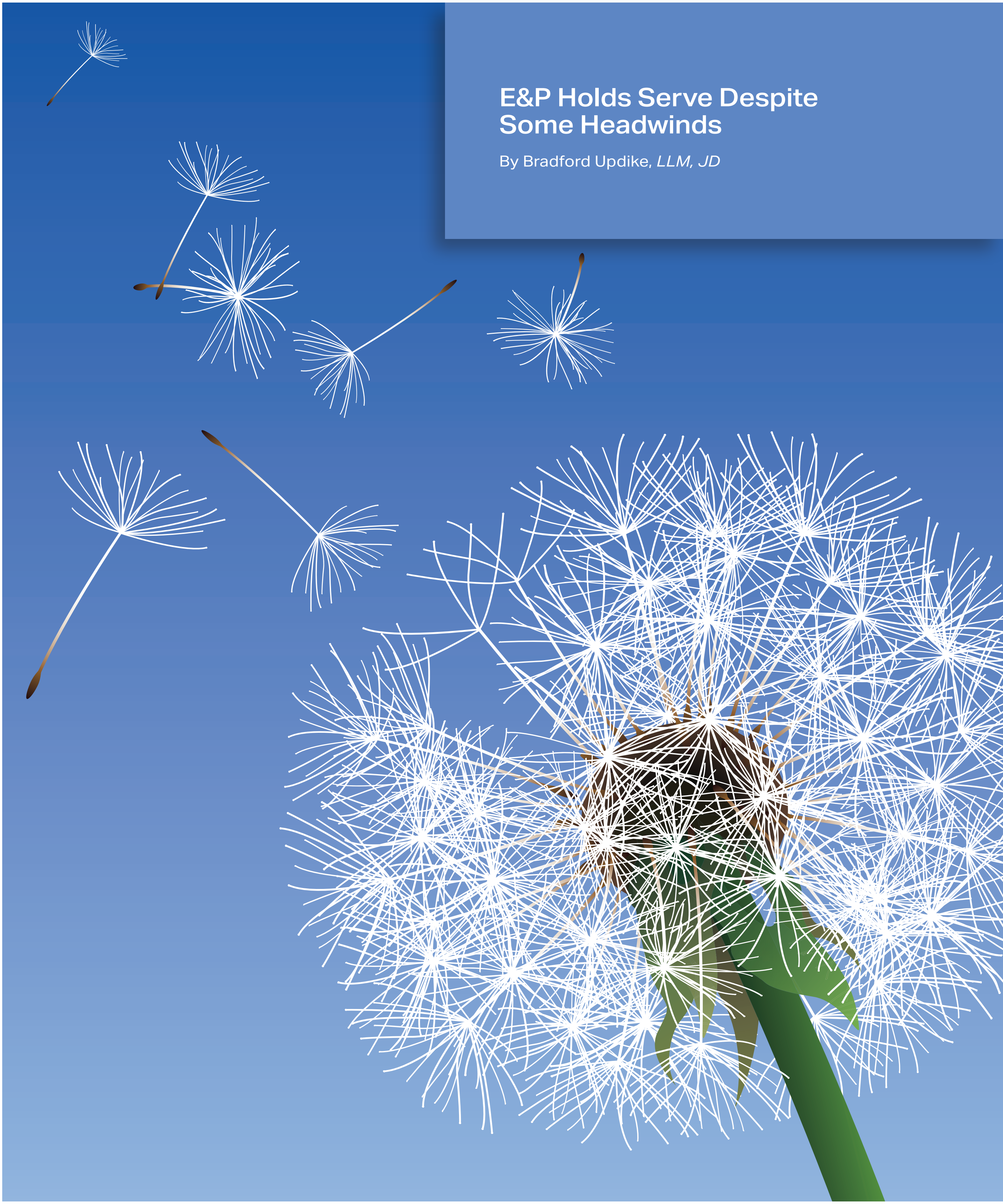
While this boom may seem like a response to housing demands, it could lead to an oversupply in the market, especially if economic conditions change or if the actual demand for these new apartments fails to meet projections. Historical examples, such as the housing market bubble of 2008, demonstrate how oversupply can lead to significant economic downturns.

E&P Holds Serve Despite Some Headwinds

By Bradford Updike, *LLM, JD*



Mick Law P.C. is a specialty firm comprised of full-time and of-counsel attorneys who each possess a concentrated area of expertise and in-depth knowledge. In addition to their law school credentials, the attorneys also have professional and educational credentials, including MBAs, LLMs, and securities industry licenses. While providing a broad range of legal services to our valued clients, the firm focuses on two principal areas of practice: broker-dealer and register investment advisor representation and real estate finance.

As the world's subeconomies and commercial markets escaped from the clutches of COVID from 2021-2023, world oil supply and demand reached equilibrium, which enabled crude prices last year to land at a level in which earnings can be achieved for projects inside and outside of the retail investment channel. That said, political and economic developments remain in 2024 that will work to keep oil/gas prices volatile through the U.S. election year and possibly beyond it.

From a political perspective, and despite the continuing headwinds from the "left" side of our Federal Government seeking to impose their "Green Deal" to displace fossil fuels with solar and wind, the U.S. E&P sector arguably held its own in 2023 in terms of up-stream related business activity, which was demonstrated through a year over year increase in U.S. onshore drilling activities (i.e., rig counts), as well as a significant increase in daily oil and natural gas production. Drilling momentum in the U.S. and particularly the Delaware Basin of the greater Permian has persisted despite political pressures from the left and the economic pressure in the U.S. that surfaced in mid-2022 and Q1 2023 due to the interest rate hikes implemented by the Federal Reserve to reduce inflation. Add in the geopolitical pressures occasioned by the conflicts in Ukraine and the Red Sea, and we can begin to appreciate the volatile price ride we're in for this year and into 2025.

As our firm reported in January 2023, the prospects for economic success in E&P continues with *"incredibly cautious optimism"* going into this year. For oil, a relatively stable price range persisted in 2023 in comparison to what we saw during the Pandemic through much of 2022, as world oil supply and demand slowly yet gradually achieved a balance point due to the economic recoveries of most countries and their subeconomies throughout the world. As the result of this recovery, oil managed to land at $80 bbl for much of 2023. While we achieved equilibrium from a supply/demand perspective, some moments of uncertainty persisted in 2023 as the result of the geopolitical pressures within Ukraine and the Middle East that caused short-lived oil pricing spikes to $90-95 bbl in parts of 2023.

As has been the case for the past 20 years, expect natural gas to continue its wild ride through 2024 and 2025 as we deal with changing winter climates and liquefied natural gas ("LNG") exporting infrastructure. In terms of the gas prices in 2023, they were tempered considerably because of the unseasonably warm weather we had in early 2023 and December 2023. *While a series of arctic blasts in late December 2023 and early January 2024 worked to cool our national winter climate momentarily, natural gas storage levels come March 31, 2024 will again test U.S. gas prices through most of this year, which hinges upon whether a more normal pattern of cold weather comes into play from now through late March.* Against this backdrop, and as mentioned by EQT's Chief Executive Toby Rice during his press appearances last year, the need for U.S. natural gas abroad on a long-term scale should eventually present better opportunities for favorable natural gas pricing in 2025, 2026, and future years.

Energy Sector Capital Summary

In 2023, we covered fourteen (14) sponsor companies which operate within the upstream ("E&P") oil/gas sector and raise money from retail investors. This group of sponsors collectively funded 24 private oil/gas programs that raised $1.226 billion to support drilling and E&P infrastructure, mineral interest acquisitions, and related projects. This represented a 12.17% year-over-year increase in capital funding from what was reported by these sponsors in 2022 (i.e., $1.093 billion). This also resulted in the highest capital raise year from the E&P sponsor group that we cover (i.e., since 2005).

For a second year in a row, leading the way in terms of fundraising was U.S. Energy Development Corp. ("U.S. Energy"), at $483.0 million, which was followed by MDS Energy ("MDS"), at $196.0 million, and Mewbourne Development Corporation ("Mewbourne"), at $180.0 million. Collectively, and as was the case in 2023, these three sponsors accounted for approximately 70% of the capital raised by the E&P sponsor group we cover.

In terms of funding growth, about half of the sponsors from the E&P group reported year-over-year gains in fundraising, which helped to continue the capital raising momentum that was established in 2021-2022 after the headwinds of COVID subsided (i.e., with $273 million being the capital raise from the E&P group in 2020 during the Pandemic year). A chart of the fundraising totals of the E&P sponsors we cover is provided to the right.

Ten Internal Revenue Code ("IRC") Section 1031 ("§1031") eligible

2023 E&P Capital by Strategy

Total Capital:	$1,226,666,905
Contributing Sponsors:	14
Drilling:	$909,400,600 (74%)
E&P Opportunity Funds:	$174,482,305 (14%) (includes a QOZ fund)
Minerals /Royalties:	$142,792,000 (12%) (84% were structured as direct interest)

Table 1 - Capital Raised					
Company	Strategy	2023 Raise	2022 Raise	2021 Raise	2020 Raise
Mewbourne	*Drilling*–Horizontal Wells in the Permian Basin, Texas Panhandle and Anadarko Basin	$180.00 MM	$250.00 MM	$119.80 MM	$55.31 MM
MDS	*Drilling*–Horizontal Wells in the Marcellus Shale Play	$196.00 MM	$225.00 MM	$146.919 MM	$60.0 MM
STL	*Drilling*–Marcellus Shale of Eastern Pennsylvania	$31.00 MM	$42.50 MM	$29.5 MM	$17.3 MM
U.S. Energy	*Drilling*–Permian Basin, Powder River Basin and Eagle Ford Shale Play; the QOF is an OZ Fund Seeking Working Interests and Other Upstream Assets	$388.0 MM drilling; $80.0 MM QOF program; $15.0 MM 1031 program	$267.93 MM drilling; $56.65 MM QOF program; $8.10 MM 1031 program	$145.0 MM drilling; and $45.0 MM QOF program	$64.0 MM drilling; and $20.0 MM QOF program
Waveland	*Opportunity Fund* Targeting Minerals and Non-Operated Working Interests in the Bakken Shale	$94.482 MM	$42.64 MM	$13.255 MM	$22.0 MM
Resource Royalty	*1031 Program* Acquiring Minerals and Royalties in STACK Play of Oklahoma	$29.592 MM	$32.9 MM	$11.067 MM	$5.373 MM
Montego Minerals	1031 Programs Acquiring Minerals and Royalties in the Permian Basin and East Texas	$77.0 MM	$62.20 MM	$19.730 MM	$12.5 MM
JHO	*Drilling*–Oil Producing Zones in Tennessee	$3.782 MM	$5.00 MM	$6.704 MM	$4.35 MM
White Hawk Energy	*Royalty Fund* Acquiring Mineral Rights, Royalties, and Overriding Royalties	$21.20 MM	$65.70 MM	NA	NA
Barrow Shaver Resources	*Drilling*–E. Texas Bossier and Cotton Valley; Horizontal Drilling for Oil/Nat. Gas	$36.50 MM	$4.95 MM	NA	NA
Texakoma Resources , LLC	*Drilling*–Granite Wash Play in Tex. Panhandle; Horizontal Drilling for Oil/Nat. Gas	$32.0 MM	$30.00 MM	$20.00 MM	$15.00 MM
Texas Standard Energy	*Drilling*–Barnett Shale Combo Play in N. Tex.; Horizontal Drilling for Oil/Nat. Gas	$40.0 MM (first full year)	$4.0 MM	NA	NA
Unspecified	Two additional Reg. D sponsors also collectively raised equity for Mid Con. Based E&P projects	$2.0 MM	NA	NA	NA
Totals		$1.226 billion	$1.093 billion	$556 million	$273 million

programs were wholly or partially funded in 2023 by Resource Royalty, Montego Minerals, and U.S. Energy. Overall, the §1031 energy capital raised last year ($121.592 million) increased from what was reported in 2022 ($103.20 million) and 2021 ($31.0 million). Based upon relatively stable oil pricing, as well as longer-term natural gas market developments, we think this segment will hold serve in 2024.

We note that the size of the E&P sponsor group that we cover has been moderately stable over the past few years (e.g., generally 10 to 14 E&P sponsors from 2017-2023), with drilling programs outpacing royalties and opportunistic funds in terms of fundraising (and with the 75/25 allocation of retail funded E&P capital among drilling and other deployment strategies generally also holding true as to the years leading up to 2023). The fundraising of this sponsor group has been incredibly choppy since 2017 ($330 MM 2017, $401 MM 2018, $369 MM 2019, $273 MM 2020, $556 MM 2021, $1.093 billion 2022, $1.226 billion 2023). The choppiness has been caused by incredible market volatility, coupled with the fact that the oil/gas sector continues to seek the reestablishment of investor trust that was lost because of performance failures by several companies that no longer raise capital in the retail channel. Based upon current oil market fundamentals and longer-term natural gas pricing developments due to anticipated LNG export growth, the E&P sponsor group appears to be fairly positioned to achieve a respectable volume of capital raising in 2024/2025.

Basin	Primary Products	1/19/2024 Big Count	Year Ago Rig Count
Arkoma/Woodford Region	Gas	25	32
Barnett Shale	Gas	1	2
DJ-Niobrara	Gas	12	16
Eagle Ford Shale	Oil	55	72
Granite Wash	Gas	2	10
East Texas & Haynesville Shale	Gas	42	69
Marcellus Shale	Gas	29	37
Mississippian Play	Gas	2	4
Permian Basin	Oil	307	354
Utica Shale	Gas	13	15
Williston Basin/Bakken	Oil	34	42

Source: Baker Hughes, 1/19/24

What's Going on in the Field?

Presently, U.S. oil production is at about 13.25 million bbls per day, which is about one million bbls per day less than what was reported a year ago. As such, oil production has rebounded from the COVID affected levels reported throughout 2020 (i.e., 10.78 million bbls per day average April through December 2020) and all of 2021 (i.e., 11.17 million bbls per day average). This increase resulted from the headwinds of the economic recovery coming out of COVID in 2021 and 2022, which resulted in completions of many wells that had been drilled but were not completed (i.e., DUC wells) at the time the Pandemic surfaced.[1]

While oil production is at a high level, note that the U.S. rig count, which stood at 620 onshore rigs as of January 19, 2024, has come down from the 771 rigs reported just a year prior. On this point, rig counts within ALL major U.S. Basins are down from the levels reported a year prior, with the counts in the natural gas plays experiencing perhaps the greatest levels of reduction due to lower prices. As there are still over 3,500 DUCs remaining to be completed across all U.S. Basins (821 in the Permian Basin), we may continue to see a modicum of disconnect between the U.S. oil produced daily and the general direction of rig counts across the on-shore U.S.

Motivation to Drill—What are the Break-Evens?

Despite recent pricing headwinds facing natural gas drilling projects, oil prices have arguably held serve over the past year, with the 2023 average WTI of $78 bbl being generally consistent with WTI's trailing three-year average ($80/bbl). This stabilization in oil pricing presents opportunities for U.S. E&P companies to continue their earnings patterns by reallocating rigs and resources from natural gas plays to areas where crude is more abundant.

Despite oil's decent ride over the past couple years, we CAUTION that cost inflation has reduced, to some extent, the profit margins that were realized by the E&P industry post-COVID (i.e., 2021/2022). An illustration of how inflation has affected E&P profit margins is shown within the table to the right (with break-evens reported on a "per bbl" basis):

Table 2 - Drilling Break Even Points

Play	Avg. Break Even for Drilling (Jan. 2022)	Avg. Break Even for Drilling (Jan. 2024)	2Yr. Cost Increase
Permian-Midland	$46	$58	+26%
Permian-Delaware	$49	$61	+24%
Permian-Other	$53	$66	+25%
Eagle Ford	$46	$56	+17%
Other U.S. Shale	$58	$61	+5%
Other U.S. Non-Shale	$53	$63	+17%

Federal Reserve Bank of Dallas Survey

Based upon the findings of an oil/gas industry survey published by the Federal Reserve Bank of Dallas (January 11, 2024), many E&P companies are, in fact, gearing up to increase their drilling and production over the next 12 months. Within a survey of several executives from 144 oil/gas drilling and field service companies, the average forecasted oil price for year-end 2024 was $78 per bbl, with the group of executives predicting natural gas to end the year at $3.09 per mcf. In response to the question of whether the surveyed firms were likely to increase or decrease their E&P expenditures in 2024, 69% stated that they intended to either increase or maintain their expenditures year over year from 2023. Coincidentally, and in response to a question about their primary goals for 2024, 70% of the surveyed firms stated that their companies intend to either grow or maintain their oil/gas

Table 3 - Operating Break Even Points			
Play	Avg. Price to Recover Op. Costs (Q1 2022)	Avg. Price to Recover Op. Costs (Q1 2024)	Trailing 2Yr. Cost Increase
Permian-Midland	$27	$29	+7%
Permian-Delaware	$26	$29	+10%
Permian-Other	$33	$40	+25%
Eagle Ford	$17	$31	+80%
Other U.S. Shale	$33	$33	0%
Other U.S. Non-Shale	$34	$45	+35%

Federal Reserve Bank of Dallas Survey

production over the next 12 months.

Continuing to drive the motivation to drill/produce oil/gas is the fact that both can be produced at profitable levels in many regions despite gradual reductions in prices since 2022, with the operating costs in the major portions of the Permian remaining stable over such period. Even in areas where production costs have increased, the break-even prices continue to provide opportunities for companies to operate at profitable levels. A table illustrating the movements within U.S. E&P operating costs is presented in the table above.

Conclusion

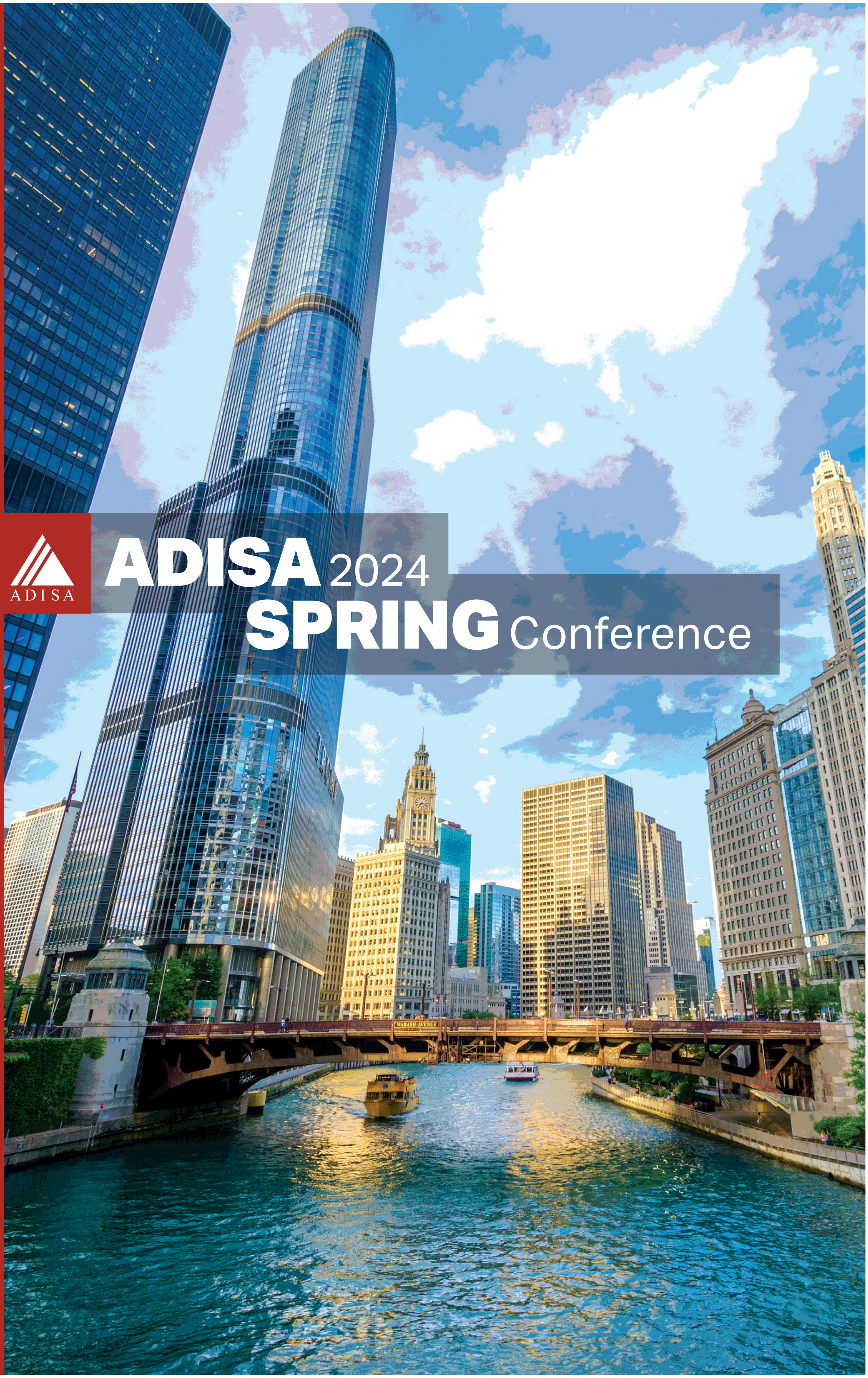
Despite past optimism about the prospects of oil today and natural gas long-term, we must remain steadfast in our underwriting of oil/gas companies, because no one is immune to the next cycle. For this reason, we must pay attention to break even prices and the break points in which an E&P sponsor's pro forma becomes unprofitable.

At a sponsor due diligence level, we must also pay attention to a sponsor's patterns of success in good times and bad, as well as their short-term liquidity, leverage use, and overall dependence upon the retail channel's funding for survival (i.e., with all of these being major reasons for E&P sponsor blow-ups over the past several years). As cap. ex. and lease operating costs have increased because of improved pricing fundamentals, we must stay the course in the quest for sponsors and products that have prospects for success under less fortunate market circumstances than what we've seen from 2021-2023. As we have written in our past year-end reports, stay committed to cautious due diligence. As history has taught us, the next cycle will come—we just don't know when. ▲

1—"Federal Reserve Bank of Dallas, Energy Slideshow (Jan. 11, 2024) (reporting a draw down in DUCs in the Permian from about 3,000 uncompleted wells during 2020 to 821 uncompleted wells remaining as of January 2024).

ADISA NEWS

NEXT WEEK



ADISA 2024 SPRING Conference

APRIL 8-10

The Fairmont Chicago Millennium Park

AGENDA *As of 4/2/2024*

MONDAY April 8

11:45 am-1:45 pm

Women's & Next Generation Luncheon
➤ Crystal Room

1:45-2:30 pm

ECLIPSE VIEWING

2:30-3:20 pm

(1) Fundamentals of Alts
➤ Gold Room

(2) The Reg BI Duty of Care: FINRA's Exam Expectations and Enforcement Cases
➤ International Ballroom

(3) 721 Exchanges—Full Cycle Considerations ➤ State Room

3:30-4:20 pm

(4) Real Assets, Real Estate, Still Real Returns: What Today's Real Estate Market Looks Like and How to Capitalize on it
➤ International Ballroom

(5) Tech Solutions to Lessen the Pain of Alternative Investing ➤ Gold Room
(6) Key Deal Terms ➤ State Room

4:30-4:45 pm

Welcome Session
➤ International Ballroom

4:45-6:00 pm

General Session I: Industry Updates
➤ International Ballroom

6:00-7:00 pm

Welcome Cocktail Reception & Exhibition
➤ Exhibit Hall

TUESDAY April 9

8:00-9:00 am

Breakfast & Exhibition
➤ Exhibit Hall

9:00-9:55 am

General Session II: Legislative & Regulatory Update
➤ International Ballroom

10:00-10:50 am

(7) Real Estate Outlook: Challenges and Opportunities in a Changing Environment
➤ International Ballroom

(8) Cyber Breaches, Regulation and You: What's at Stake? ➤ Gold Room

(9) Navigating Leverage and the Cost of Capital in Today's Market
➤ State Room

11:00-11:50 am

(10) New Products
➤ International Ballroom

(11) Restructuring DSTs
➤ Gold Room

(12) AI—What's Coming
➤ State Room

12:00-1:15 pm

Lunch & Exhibition
➤ Exhibit Hall

1:15-2:05 pm

(13) Navigating the Bridge: A Comprehensive Review from Multiple Perspectives ➤ State Room

(14) The 4 Ws of the Corporate Transparency Act: What You Need to Know
➤ Gold Room

(15) Oil & Gas: Is it Really Different This Time? ➤ International Ballroom

2:10-3:00 pm

(16) Challenges for RIAs When Using Alts
➤ State Room

(17) The Fundamentals of Non-Listed Preferred Stock ➤ Gold Room

(18) The New Age of Real Estate: Does Renting Make More Sense?
➤ International Ballroom

3:00-4:00 pm

Networking Break
➤ Exhibit Hall

4:10-5:15 pm

General Session III: Reg D Issues/506(b) vs. 506(c)
➤ International Ballroom

5:15-6:30 pm

Cocktail Reception & Exhibition
➤ Exhibit Hall

WEDNESDAY April 10

7:30-9:00 am

Breakfast & Exhibition
➤ Exhibit Hall

9:00-10:00 am

General Session IV: The M&A Wave —Insights into Realities and How to Capitalize on Them
➤ International Ballroom

10:10-11:00 am

(19) Credit Market Outlook and Opportunities in an Evolving Market
➤ State Room

(20) Personal Technology: Using the Latest IT Tools and Features to Save Time and Effort ➤ Gold Room

(21) RIA Peer-to-Peer
➤ International Ballroom

11:15 am-12:00 pm

(22) RIA Council
➤ International Ballroom

(23) Broker-Dealer Advisory Council
➤ Gold Room

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