

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

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**FORM 10-Q**

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(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended **June 30, 2019**  
OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number **000-54382**

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**KBS STRATEGIC OPPORTUNITY REIT, INC.**  
(Exact Name of Registrant as Specified in Its Charter)

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**Maryland**

(State or Other Jurisdiction of  
Incorporation or Organization)

**800 Newport Center Drive, Suite 700  
Newport Beach, California**

(Address of Principal Executive Offices)

**26-3842535**

(I.R.S. Employer  
Identification No.)

**92660**

(Zip Code)

**(949) 417-6500**

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer

Non-Accelerated Filer

Accelerated Filer

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Securities registered pursuant to Section 12(b) for the Act:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
None	N/A	N/A

As of August 5, 2019, there were 66,321,336 outstanding shares of common stock of KBS Strategic Opportunity REIT, Inc.

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**FORM 10-Q**

**June 30, 2019**

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**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONSOLIDATED BALANCE SHEETS**

(in thousands, except share and per share amounts)

	<b>June 30, 2019</b>	<b>December 31, 2018</b>
	<b>(unaudited)</b>	
<b>Assets</b>		
Real estate held for investment, net	\$ 731,881	\$ 635,567
Real estate held for sale, net	14,081	45,553
Real estate equity securities	65,267	73,876
Real estate debt securities, net	—	10,859
Total real estate and real estate-related investments, net	811,229	765,855
Cash and cash equivalents	110,166	152,385
Restricted cash	10,886	10,342
Investments in unconsolidated joint ventures	51,956	44,869
Rents and other receivables, net	15,874	12,095
Above-market leases, net	3,175	3,377
Prepaid expenses and other assets	13,501	12,736
Assets related to real estate held for sale, net	666	3,330
Total assets	<u>\$ 1,017,453</u>	<u>\$ 1,004,989</u>
<b>Liabilities and equity</b>		
Notes and bonds payable, net		
Notes and bonds payable related to real estate held for investment, net	\$ 655,944	\$ 621,934
Note payable related to real estate held for sale, net	10,589	33,538
Total notes and bonds payable, net	666,533	655,472
Accounts payable and accrued liabilities	20,142	19,506
Due to affiliate	98	36
Below-market leases, net	4,980	4,947
Liabilities related to real estate held for sale, net	42	58
Other liabilities	18,043	21,006
Redeemable common stock payable	5,463	10,000
Total liabilities	715,301	711,025
Commitments and contingencies (Note 14)		
Redeemable common stock	—	—
<b>Equity</b>		
KBS Strategic Opportunity REIT, Inc. stockholders' equity		
Preferred stock, \$.01 par value; 10,000,000 shares authorized, no shares issued and outstanding	—	—
Common stock, \$.01 par value; 1,000,000,000 shares authorized, 66,342,855 and 66,822,861 shares issued and outstanding as of June 30, 2019 and December 31, 2018, respectively	663	668
Additional paid-in capital	547,767	547,770
Cumulative distributions and net income	(247,603)	(256,984)
Total KBS Strategic Opportunity REIT, Inc. stockholders' equity	300,827	291,454
Noncontrolling interests	1,325	2,510
Total equity	302,152	293,964
Total liabilities and equity	<u>\$ 1,017,453</u>	<u>\$ 1,004,989</u>

*See accompanying condensed notes to consolidated financial statements.*

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS**

(unaudited)

(in thousands, except share and per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
<b>Revenues:</b>				
Rental income	\$ 19,837	\$ 22,091	\$ 38,210	\$ 39,439
Other operating income	1,509	1,479	2,902	2,214
Interest income from real estate debt securities	—	511	369	1,012
Dividend income from real estate equity securities	343	1,209	2,119	2,260
<b>Total revenues</b>	<b>21,689</b>	<b>25,290</b>	<b>43,600</b>	<b>44,925</b>
<b>Expenses:</b>				
Operating, maintenance, and management	6,826	7,571	13,098	13,058
Real estate taxes and insurance	3,301	3,435	6,279	5,773
Asset management fees to affiliate	1,971	2,217	3,861	4,043
General and administrative expenses	2,015	2,250	3,548	4,302
Foreign currency transaction loss (gain), net	2,474	(10,111)	5,290	(9,114)
Depreciation and amortization	8,357	9,042	16,037	16,307
Interest expense	7,249	7,819	14,417	14,410
<b>Total expenses</b>	<b>32,193</b>	<b>22,223</b>	<b>62,530</b>	<b>48,779</b>
<b>Other income (loss):</b>				
Income from unconsolidated joint venture	—	131	—	185
Equity in (loss) income of unconsolidated joint ventures, net	(215)	(2,373)	7,096	(4,751)
Casualty-related loss	(506)	—	(506)	—
Other interest income	636	419	1,327	1,349
Gain (loss) on real estate equity securities	4,294	8,724	15,459	(7,287)
(Loss) gain on sale of real estate	(6)	25	7,569	649
Loss on extinguishment of debt	—	—	(856)	—
<b>Total other income (loss), net</b>	<b>4,203</b>	<b>6,926</b>	<b>30,089</b>	<b>(9,855)</b>
<b>Net (loss) income</b>	<b>(6,301)</b>	<b>9,993</b>	<b>11,159</b>	<b>(13,709)</b>
Net loss (income) attributable to noncontrolling interests	52	43	(627)	64
<b>Net (loss) income attributable to common stockholders</b>	<b>\$ (6,249)</b>	<b>\$ 10,036</b>	<b>\$ 10,532</b>	<b>\$ (13,645)</b>
<b>Net (loss) income per common share, basic and diluted</b>	<b>\$ (0.09)</b>	<b>\$ 0.16</b>	<b>\$ 0.16</b>	<b>\$ (0.22)</b>
<b>Weighted-average number of common shares outstanding, basic and diluted</b>	<b>66,559,771</b>	<b>61,910,602</b>	<b>66,685,447</b>	<b>62,216,998</b>

*See accompanying condensed notes to consolidated financial statements.*

**PART I. FINANCIAL INFORMATION (CONTINUED)**
**Item 1. Financial Statements (continued)**
**KBS STRATEGIC OPPORTUNITY REIT, INC.**
**CONSOLIDATED STATEMENTS OF EQUITY**

For the Three Months Ended June 30, 2019 and 2018

(unaudited)

(dollars in thousands)

	Common Stock		Additional Paid-in Capital	Cumulative Distributions and Net Income	Accumulated Other Comprehensive Income	Total Stockholders' Equity	Noncontrolling Interests	Total Equity
	Shares	Amounts						
Balance, March 31, 2019	66,584,729	\$ 666	\$ 547,775	\$ (240,781)	\$ —	\$ 307,660	\$ 1,462	\$ 309,122
Net loss	—	—	—	(6,249)	—	(6,249)	(52)	(6,301)
Issuance of common stock	28,030	—	278	—	—	278	—	278
Transfers from redeemable common stock	—	—	2,279	—	—	2,279	—	2,279
Redemptions of common stock	(269,904)	(3)	(2,565)	—	—	(2,568)	—	(2,568)
Distributions declared	—	—	—	(573)	—	(573)	—	(573)
Distributions to noncontrolling interests	—	—	—	—	—	—	(85)	(85)
Balance, June 30, 2019	66,342,855	\$ 663	\$ 547,767	\$ (247,603)	\$ —	\$ 300,827	\$ 1,325	\$ 302,152

  

	Common Stock		Additional Paid-in Capital	Cumulative Distributions and Net Income	Accumulated Other Comprehensive Income	Total Stockholders' Equity	Noncontrolling Interests	Total Equity
	Shares	Amounts						
Balance, March 31, 2018	64,745,413	\$ 647	\$ 538,972	\$ (152,551)	\$ —	\$ 387,068	\$ 1,957	\$ 389,025
Net income (loss)	—	—	—	10,036	—	10,036	(43)	9,993
Issuance of common stock	42,174	—	485	—	—	485	—	485
Transfers from redeemable common stock	—	—	5,839	—	—	5,839	—	5,839
Redemptions of common stock	(10,104,927)	(100)	(110,361)	—	—	(110,461)	—	(110,461)
Distributions declared	—	—	—	(882)	—	(882)	—	(882)
Noncontrolling interests contributions	—	—	—	—	—	—	734	734
Balance, June 30, 2018	54,682,660	\$ 547	\$ 434,935	\$ (143,397)	\$ —	\$ 292,085	\$ 2,648	\$ 294,733

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONSOLIDATED STATEMENTS OF EQUITY**

For the Six Months Ended June 30, 2019 and 2018

(unaudited)

(dollars in thousands)

	Common Stock		Additional Paid-in Capital	Cumulative Distributions and Net Income	Accumulated Other Comprehensive Income	Total Stockholders' Equity	Noncontrolling Interests	Total Equity
	Shares	Amounts						
Balance, December 31, 2018	66,822,861	\$ 668	\$ 547,770	\$ (256,984)	\$ —	\$ 291,454	\$ 2,510	\$ 293,964
Net income	—	—	—	10,532	—	10,532	627	11,159
Issuance of common stock	56,814	1	563	—	—	564	—	564
Transfers from redeemable common stock	—	—	4,537	—	—	4,537	—	4,537
Redemptions of common stock	(536,820)	(6)	(5,101)	—	—	(5,107)	—	(5,107)
Distributions declared	—	—	—	(1,151)	—	(1,151)	—	(1,151)
Other offering costs	—	—	(2)	—	—	(2)	—	(2)
Noncontrolling interests contributions	—	—	—	—	—	—	12	12
Distributions to noncontrolling interests	—	—	—	—	—	—	(1,824)	(1,824)
Balance, June 30, 2019	<u>66,342,855</u>	<u>\$ 663</u>	<u>\$ 547,767</u>	<u>\$ (247,603)</u>	<u>\$ —</u>	<u>\$ 300,827</u>	<u>\$ 1,325</u>	<u>\$ 302,152</u>

	Common Stock		Additional Paid-in Capital	Cumulative Distributions and Net Income	Accumulated Other Comprehensive Income	Total Stockholders' Equity	Noncontrolling Interests	Total Equity
	Shares	Amounts						
Balance, December 31, 2017	52,053,817	\$ 521	\$ 388,800	\$ (155,454)	\$ 25,146	\$ 259,013	\$ 1,970	\$ 260,983
Cumulative effect adjustments to retained earnings	—	—	—	27,618	(25,146)	2,472	—	2,472
Net loss	—	—	—	(13,645)	—	(13,645)	(64)	(13,709)
Issuance of common stock	83,855	1	963	—	—	964	—	964
Stock distribution issued	13,069,487	130	150,169	—	—	150,299	—	150,299
Transfers from redeemable common stock	—	—	9,969	—	—	9,969	—	9,969
Redemptions of common stock	(10,524,499)	(105)	(114,966)	—	—	(115,071)	—	(115,071)
Distributions declared	—	—	—	(1,916)	—	(1,916)	—	(1,916)
Noncontrolling interests contributions	—	—	—	—	—	—	742	742
Balance, June 30, 2018	<u>54,682,660</u>	<u>\$ 547</u>	<u>\$ 434,935</u>	<u>\$ (143,397)</u>	<u>\$ —</u>	<u>\$ 292,085</u>	<u>\$ 2,648</u>	<u>\$ 294,733</u>

*See accompanying condensed notes to consolidated financial statements.*

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited)  
(in thousands)

	Six Months Ended June 30,	
	2019	2018
<b>Cash Flows from Operating Activities:</b>		
Net income (loss)	\$ 11,159	\$ (13,709)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Loss due to property damages	—	600
Casualty-related loss	506	—
Equity in (income) loss of unconsolidated joint ventures, net	(7,096)	4,751
Depreciation and amortization	16,037	16,307
(Gain) loss on real estate equity securities	(15,459)	7,287
Gain on sale of real estate	(7,569)	(649)
Loss on extinguishment of debt	856	—
Unrealized loss on interest rate caps	37	31
Deferred rent	(2,230)	(1,670)
Bad debt recovery	—	(218)
Amortization of above- and below-market leases, net	(536)	(500)
Amortization of deferred financing costs	1,709	1,699
Accretion of interest income on real estate debt securities	(13)	(128)
Net amortization of discount and (premium) on bond and notes payable	(46)	29
Foreign currency transaction gain (loss), net	5,290	(9,114)
Changes in assets and liabilities:		
Rents and other receivables	(1,517)	(1,854)
Prepaid expenses and other assets	(2,716)	(3,606)
Accounts payable and accrued liabilities	(1,462)	911
Due to affiliates	19	13
Other liabilities	(383)	388
Net cash (used in) provided by operating activities	<u>(3,414)</u>	<u>568</u>
<b>Cash Flows from Investing Activities:</b>		
Acquisitions of real estate	(90,266)	(312,348)
Improvements to real estate	(18,207)	(14,108)
Proceeds from sales of real estate, net	17,894	2,567
Reimbursement of construction costs	—	1,636
Insurance proceeds received for property damages	438	—
Purchase of interest rate cap	(28)	(163)
Contributions to unconsolidated joint venture	(5,000)	(1,320)
Distributions of capital from unconsolidated joint venture	8,051	1,160
Investment in real estate equity securities	(15)	(15,851)
Proceeds from the sale of real estate equity securities	24,076	—
Proceeds from principal repayment on real estate debt securities	7,750	—
Funding of development obligations	(134)	(892)
Net cash used in investing activities	<u>(55,441)</u>	<u>(339,319)</u>
<b>Cash Flows from Financing Activities:</b>		
Proceeds from notes and bonds payable	84,268	184,351
Principal payments on notes and bonds payable	(62,508)	(5,711)
Payments of deferred financing costs	(1,097)	(2,702)
Payments to redeem common stock	(5,107)	(115,071)
Payment of prepaid other offering costs	(2)	(295)
Distributions paid	(587)	(38,567)
Noncontrolling interests contributions	12	742
Distributions to noncontrolling interests	(1,824)	—
Other financing proceeds, net	1,822	—
Net cash provided by financing activities	<u>14,977</u>	<u>22,747</u>
Effect of exchange rate changes on cash, cash equivalents and restricted cash	2,203	(303)
Net decrease in cash, cash equivalents and restricted cash	(41,675)	(316,307)
Cash, cash equivalents and restricted cash, beginning of period	162,727	377,182
Cash, cash equivalents and restricted cash, end of period	<u>\$ 121,052</u>	<u>\$ 60,875</u>

*See accompanying condensed notes to consolidated financial statements.*

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

June 30, 2019

(unaudited)

**1. ORGANIZATION**

KBS Strategic Opportunity REIT, Inc. (the “Company”) was formed on October 8, 2008 as a Maryland corporation and elected to be taxed as a real estate investment trust (“REIT”) beginning with the taxable year ended December 31, 2010. The Company conducts its business primarily through KBS Strategic Opportunity (BVI) Holdings, Ltd. (“KBS Strategic Opportunity BVI”), a private company limited by shares according to the British Virgin Islands Business Companies Act, 2004, which was incorporated on December 18, 2015 and is authorized to issue a maximum of 50,000 common shares with no par value. Upon incorporation, KBS Strategic Opportunity BVI issued one certificate containing 10,000 common shares with no par value to KBS Strategic Opportunity Limited Partnership (the “Operating Partnership”), a Delaware limited partnership formed on December 10, 2008. The Company is the sole general partner of, and owns a 0.1% partnership interest in, the Operating Partnership. KBS Strategic Opportunity Holdings LLC (“REIT Holdings”), a Delaware limited liability company formed on December 9, 2008, owns the remaining 99.9% interest in the Operating Partnership and is its sole limited partner. The Company is the sole member and manager of REIT Holdings.

Subject to certain restrictions and limitations, the business of the Company is externally managed by KBS Capital Advisors LLC (the “Advisor”), an affiliate of the Company, pursuant to an advisory agreement the Company renewed with the Advisor on October 8, 2018 (the “Advisory Agreement”). The Advisor conducts the Company’s operations and manages its portfolio of real estate and other real estate-related investments.

On January 8, 2009, the Company filed a registration statement on Form S-11 with the Securities and Exchange Commission (the “SEC”) to offer a minimum of 250,000 shares and a maximum of 140,000,000 shares of common stock for sale to the public (the “Offering”), of which 100,000,000 shares were registered in a primary offering and 40,000,000 shares were registered to be sold under the Company’s dividend reinvestment plan. The SEC declared the Company’s registration statement effective on November 20, 2009. The Company ceased offering shares of common stock in its primary offering on November 14, 2012 and continues to offer shares under its dividend reinvestment plan.

The Company sold 56,584,976 shares of common stock in its primary offering for gross offering proceeds of \$561.7 million. As of June 30, 2019, the Company had sold 6,800,440 shares of common stock under its dividend reinvestment plan for gross offering proceeds of \$76.0 million. Also, as of June 30, 2019, the Company had redeemed 23,315,550 shares for \$280.5 million. As of June 30, 2019, the Company had issued 25,976,746 shares of common stock in connection with special dividends. Additionally, on December 29, 2011 and October 23, 2012, the Company issued 220,994 shares and 55,249 shares of common stock, respectively, for \$2.0 million and \$0.5 million, respectively, in private transactions exempt from the registration requirements pursuant to Section 4(2) of the Securities Act of 1933.

On March 2, 2016, KBS Strategic Opportunity BVI filed a final prospectus with the Israel Securities Authority for a proposed offering of up to 1,000,000,000 Israeli new Shekels of Series A debentures (the “Debentures”) at an annual interest rate not to exceed 4.25%. On March 1, 2016, KBS Strategic Opportunity BVI commenced the institutional tender of the Debentures and accepted application for 842.5 million Israeli new Shekels. On March 7, 2016, KBS Strategic Opportunity BVI commenced the public tender of the Debentures and accepted 127.7 million Israeli new Shekels. In the aggregate, KBS Strategic Opportunity BVI accepted 970.2 million Israeli new Shekels (approximately \$249.2 million as of March 8, 2016) in both the institutional and public tenders at an annual interest rate of 4.25%. KBS Strategic Opportunity BVI issued the Debentures on March 8, 2016.

In connection with the above-referenced offering, on March 8, 2016, the Operating Partnership assigned to KBS Strategic Opportunity BVI all of its interests in the subsidiaries through which the Company indirectly owns all of its real estate and real estate-related investments. The Operating Partnership owns all of the issued and outstanding equity of KBS Strategic Opportunity BVI. As a result of these transactions, the Company now holds all of its real estate and real estate-related investments indirectly through KBS Strategic Opportunity BVI.



**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

As of June 30, 2019, the Company consolidated seven office properties, one office portfolio consisting of four office buildings and 14 acres of undeveloped land, one retail property (which was held for sale), one apartment property and three investments in undeveloped land with approximately 1,000 developable acres and owned five investments in unconsolidated joint ventures and three investments in real estate equity securities.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

There have been no significant changes to the Company's accounting policies since it filed its audited financial statements in its Annual Report on Form 10-K for the year ended December 31, 2018, except for the Company's adoption of the lease accounting standards issued by the Financial Accounting Standards Board ("FASB") effective on January 1, 2019. For further information about the Company's accounting policies, refer to the Company's consolidated financial statements and notes thereto for the year ended December 31, 2018 included in the Company's Annual Report on Form 10-K filed with the SEC.

**Principles of Consolidation and Basis of Presentation**

The accompanying unaudited consolidated financial statements and condensed notes thereto have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information as contained within the FASB Accounting Standards Codification ("ASC") and the rules and regulations of the SEC, including the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the unaudited consolidated financial statements do not include all of the information and footnotes required by GAAP for audited financial statements. In the opinion of management, the financial statements for the unaudited interim periods presented include all adjustments, which are of a normal and recurring nature, necessary for a fair and consistent presentation of the results for such periods. Operating results for the three and six months ended June 30, 2019 are not necessarily indicative of the results that may be expected for the year ending December 31, 2019.

The consolidated financial statements include the accounts of the Company, REIT Holdings, the Operating Partnership, KBS Strategic Opportunity BVI and their direct and indirect wholly owned subsidiaries, joint ventures in which the Company has a controlling interest and VIEs in which the Company is the primary beneficiary. All significant intercompany balances and transactions are eliminated in consolidation.

**Use of Estimates**

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could materially differ from those estimates.

**Redeemable Common Stock**

The Company limits the dollar value of shares that may be redeemed under the share redemption program. During the six months ended June 30, 2019, the Company had redeemed \$5.1 million of common stock under the share redemption program. The Company processed all redemption requests received in good order and eligible for redemption through the June 2019 redemption date, except for 3,782,675 shares totaling \$35.6 million due to the limitations under the share redemption program. The Company recorded \$5.5 million and \$10.0 million of redeemable common stock payable on the Company's balance sheet as of June 30, 2019 and December 31, 2018, respectively, related to unfulfilled redemption requests received in good order under the share redemption program. Based on the eleventh amended and restated share redemption program, the Company has \$4.9 million available for redemptions in the remainder of 2019, including shares that are redeemed in connection with a stockholders' death, "qualifying disability" or "determination of incompetence," subject to the limitations under the share redemption program.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

**Reclassifications**

Certain amounts in the Company's prior period consolidated financial statements have been reclassified to conform to the current period presentation. These reclassifications have not changed the results of operations of prior periods. During the three months ended June 30, 2019, the Company classified one retail property as held for sale. As a result, certain assets and liabilities were reclassified to held for sale on the consolidated balance sheets for all periods presented. Upon adoption of the lease accounting standards of Topic 842 on January 1, 2019 (described below), the Company accounted for tenant reimbursements for property taxes, insurance and common area maintenance as variable lease payments and recorded these amounts as rental income on the statement of operations. For the three and six months ended June 30, 2018, the Company reclassified \$3.2 million and \$5.3 million of tenant reimbursement revenue for property taxes, insurance, and common area maintenance to rental income for comparability purposes.

**Revenue Recognition - Operating Leases**

***Real Estate***

On January 1, 2019, the Company adopted the lease accounting standards under Topic 842 including the package of practical expedients for all leases that commenced before the effective date of January 1, 2019. Accordingly, the Company (i) did not reassess whether any expired or existing contracts are or contain leases, (ii) did not reassess the lease classification for any expired or existing lease, and (iii) did not reassess initial direct costs for any existing leases. The Company did not elect the practical expedient related to using hindsight to reevaluate the lease term. In addition, the Company adopted the practical expedient for land easements and did not assess whether existing or expired land easements that were not previously accounted for as leases under the lease accounting standards of Topic 840 are or contain a lease under Topic 842.

In addition, Topic 842 provides an optional transition method to allow entities to apply the new lease accounting standards at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings. The Company adopted this transition method upon its adoption of the lease accounting standards of Topic 842, which did not result in a cumulative effect adjustment to the opening balance of retained earnings on January 1, 2019. The Company's comparative periods presented in the financial statements will continue to be reported under the lease accounting standards of Topic 840.

In accordance with Topic 842, tenant reimbursements for property taxes and insurance are included in the single lease component of the lease contract (the right of the lessee to use the leased space) and therefore are accounted for as variable lease payments and are recorded as rental income on the Company's statement of operations beginning January 1, 2019. In addition, the Company adopted the practical expedient available under Topic 842 to not separate nonlease components from the associated lease component and instead to account for those components as a single component if the nonlease components otherwise would be accounted for under the new revenue recognition standard (Topic 606) and if certain conditions are met, specifically related to tenant reimbursements for common area maintenance which would otherwise be accounted for under the revenue recognition standard. The Company believes the two conditions have been met for tenant reimbursements for common area maintenance as (i) the timing and pattern of transfer of the nonlease components and associated lease components are the same and (ii) the lease component would be classified as an operating lease. Accordingly, tenant reimbursements for common area maintenance are also accounted for as variable lease payments and recorded as rental income on the Company's statement of operations beginning January 1, 2019.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

The Company recognizes minimum rent, including rental abatements, lease incentives and contractual fixed increases attributable to operating leases, on a straight-line basis over the term of the related leases when collectibility is probable and records amounts expected to be received in later years as deferred rent receivable. If the lease provides for tenant improvements, the Company determines whether the tenant improvements, for accounting purposes, are owned by the tenant or the Company. When the Company is the owner of the tenant improvements, the tenant is not considered to have taken physical possession or have control of the physical use of the leased asset until the tenant improvements are substantially completed. When the tenant is the owner of the tenant improvements, any tenant improvement allowance (including amounts that can be taken in the form of cash or a credit against the tenant's rent) that is funded is treated as a lease incentive and amortized as a reduction of rental revenue over the lease term. Tenant improvement ownership is determined based on various factors including, but not limited to:

- whether the lease stipulates how a tenant improvement allowance may be spent;
- whether the lessee or lessor supervises the construction and bears the risk of cost overruns;
- whether the amount of a tenant improvement allowance is in excess of market rates;
- whether the tenant or landlord retains legal title to the improvements at the end of the lease term;
- whether the tenant improvements are unique to the tenant or general purpose in nature; and
- whether the tenant improvements are expected to have any residual value at the end of the lease.

The Company leases apartment units under operating leases with terms generally of one year or less. Generally, credit investigations will be performed for prospective residents and security deposits will be obtained. The Company recognizes rental revenue, net of concessions, on a straight-line basis over the term of the lease, when collectibility is determined to be probable.

In accordance with Topic 842, the Company makes a determination of whether the collectibility of the lease payments in an operating lease is probable. If the Company determines the lease payments are not probable of collection, the Company would fully reserve for any contractual lease payments, deferred rent receivable, and tenant reimbursements and would recognize rental income only if cash is received. Beginning January 1, 2019, these changes to the Company's collectibility assessment are reflected as an adjustment to rental income. Prior to January 1, 2019, bad debt expense related to uncollectible accounts receivable and deferred rent receivable was included in operating, maintenance, and management expense in the statement of operations. Any subsequent changes to the collectibility of the allowance for doubtful accounts as of December 31, 2018, which was recorded prior to the adoption of Topic 842, are recorded in operating, maintenance, and management expense in the statement of operations.

Beginning January 1, 2019, the Company, as a lessor, records costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained, such as legal costs incurred to negotiate an operating lease, as an expense and classify such costs as operating, maintenance, and management expense on the Company's consolidated statement of operations, as these costs are no longer capitalizable under the definition of initial direct costs under Topic 842.

**Segments**

The Company has invested in opportunistic real estate, non-performing loans and other real estate-related assets. In general, the Company intends to hold its investments in opportunistic real estate, non-performing loans and other real estate-related assets for capital appreciation. Traditional performance metrics of opportunistic real estate, non-performing loans and other real estate-related assets may not be meaningful as these investments are generally non-stabilized and do not provide a consistent stream of interest income or rental revenue. These investments exhibit similar long-term financial performance and have similar economic characteristics. These investments typically involve a higher degree of risk and do not provide a constant stream of ongoing cash flows. As a result, the Company's management views opportunistic real estate, non-performing loans and other real estate-related assets as similar investments. Substantially all of its revenue and net income (loss) is from opportunistic real estate, non-performing loans and other real estate-related assets, and therefore, the Company currently aggregates its operating segments into one reportable business segment.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

**Per Share Data**

Basic net income (loss) per share of common stock is calculated by dividing net income (loss) attributable to common stockholders by the weighted-average number of shares of common stock issued and outstanding during such period. Diluted net income (loss) per share of common stock equals basic net income (loss) per share of common stock as there were no potentially dilutive securities outstanding during the three and six months ended June 30, 2019 and 2018.

Distributions declared per share were \$0.00860000 and \$0.01720000 during the three and six months ended June 30, 2019, respectively, and \$0.01597500 and \$0.03195000 during the three and six months ended June 30, 2018, respectively.

**Square Footage, Occupancy and Other Measures**

Any references to square footage, occupancy or annualized base rent are unaudited and outside the scope of the Company's independent registered public accounting firm's review of the Company's financial statements in accordance with the standards of the United States Public Company Accounting Oversight Board.

**Recently Issued Accounting Standards Updates**

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses of Financial Instruments* ("ASU No. 2016-13"). ASU No. 2016-13 affects entities holding financial assets and net investments in leases that are not accounted for at fair value through net income. The amendments in ASU No. 2016-13 require a financial asset (or a group of financial assets) measured at amortized cost basis to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset. ASU No. 2016-13 also amends the impairment model for available-for-sale debt securities. An entity will recognize an allowance for credit losses on available-for-sale debt securities as a contra-account to the amortized cost basis rather than as a direct reduction of the amortized cost basis of the investment, as is currently required. ASU No. 2016-13 also requires new disclosures. For financial assets measured at amortized cost, an entity will be required to disclose information about how it developed its allowance for credit losses, including changes in the factors that influenced management's estimate of expected credit losses and the reasons for those changes. For financing receivables and net investments in leases measured at amortized cost, an entity will be required to further disaggregate the information it currently discloses about the credit quality of these assets by year of the asset's origination for as many as five annual periods. For available-for-sale debt securities, an entity will be required to provide a roll-forward of the allowance for credit losses and an aging analysis for securities that are past due. ASU No. 2016-13 is effective for annual periods beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is still evaluating the impact of adopting ASU No. 2016-13 on its financial statements.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

In August 2018, the FASB issued ASU No. 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement* (“ASU No. 2018-13”). The primary focus of ASU 2018-13 is to improve the effectiveness of the disclosure requirements for fair value measurements. ASU No. 2018-13 removes the requirement to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, the policy for the timing of transfers between levels and the valuation processes for Level 3 fair value measurements. It also adds a requirement to disclose changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period and to disclose the range and weighted average of significant unobservable inputs used to develop recurring and nonrecurring Level 3 fair value measurements. For certain unobservable inputs, entities may disclose other quantitative information in lieu of the weighted average if the other quantitative information would be a more reasonable and rational method to reflect the distribution of unobservable inputs used to develop the Level 3 fair value measurement. In addition, public entities are required to provide information about the measurement uncertainty of recurring Level 3 fair value measurements from the use of significant unobservable inputs if those inputs reasonably could have been different at the reporting date. ASU No. 2018-13 is effective for annual periods beginning after December 15, 2019, including interim periods within those fiscal years. Entities are permitted to early adopt either the entire standard or only the provisions that eliminate or modify the requirements. The amendments on changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements, and the narrative description of measurement uncertainty should be applied prospectively for only the most recent interim or annual period presented in the initial fiscal year of adoption. All other amendments should be applied retrospectively to all periods presented upon their effective date. The Company is still evaluating the impact of adopting ASU No. 2018-13 on its financial statements, but does not expect the adoption of ASU No. 2018-13 to have a material impact on its financial statements.

**3. REAL ESTATE HELD FOR INVESTMENT**

As of June 30, 2019, the Company owned seven office properties and one office portfolio consisting of four office buildings and 14 acres of undeveloped land, encompassing, in the aggregate, approximately 3.4 million rentable square feet. As of June 30, 2019, these properties were 77% occupied. In addition, the Company owned one apartment property, containing 317 units and encompassing approximately 0.3 million rentable square feet, which was 94% occupied. The Company also owned three investments in undeveloped land with approximately 1,000 developable acres. The following table summarizes the Company’s real estate held for investment as of June 30, 2019 and December 31, 2018, respectively (in thousands):

	June 30, 2019	December 31, 2018
Land	\$ 158,741	\$ 144,705
Buildings and improvements	592,898	503,383
Tenant origination and absorption costs	38,167	31,221
Total real estate, cost	789,806	679,309
Accumulated depreciation and amortization	(57,925)	(43,742)
Total real estate, net	\$ 731,881	\$ 635,567

**PART I. FINANCIAL INFORMATION (CONTINUED)**
**Item 1. Financial Statements (continued)**
**KBS STRATEGIC OPPORTUNITY REIT, INC.**
**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

The following table provides summary information regarding the Company's real estate held for investment as of June 30, 2019 (in thousands):

Property	Date Acquired or Foreclosed on	City	State	Property Type	Land	Building and Improvements	Tenant Origination and Absorption	Total Real Estate, at Cost	Accumulated Depreciation and Amortization	Total Real Estate, Net	Ownership %
Richardson Portfolio:											
Palisades Central I	11/23/2011	Richardson	TX	Office	\$ 1,037	\$ 10,990	\$ —	\$ 12,027	\$ (3,182)	\$ 8,845	90.0%
Palisades Central II	11/23/2011	Richardson	TX	Office	810	18,807	—	19,617	(4,912)	14,705	90.0%
Greenway I	11/23/2011	Richardson	TX	Office	561	2,145	—	2,706	(840)	1,866	90.0%
Greenway III	11/23/2011	Richardson	TX	Office	702	3,688	114	4,504	(1,337)	3,167	90.0%
Undeveloped Land	11/23/2011	Richardson	TX	Undeveloped Land	3,134	—	—	3,134	—	3,134	90.0%
Total Richardson Portfolio					6,244	35,630	114	41,988	(10,271)	31,717	
Park Highlands <sup>(1)</sup>	12/30/2011	North Las Vegas	NV	Undeveloped Land	32,572	—	—	32,572	—	32,572	100.0% <sup>(1)</sup>
Park Centre	03/28/2013	Austin	TX	Office	3,251	34,235	—	37,486	(5,398)	32,088	100.0%
1180 Raymond	08/20/2013	Newark	NJ	Apartment	8,292	39,029	—	47,321	(7,256)	40,065	100.0%
Park Highlands II <sup>(1)</sup>	12/10/2013	North Las Vegas	NV	Undeveloped Land	26,470	—	—	26,470	—	26,470	100.0% <sup>(1)</sup>
Richardson Land II	09/04/2014	Richardson	TX	Undeveloped Land	3,418	—	—	3,418	—	3,418	90.0%
Crown Pointe	02/14/2017	Dunwoody	GA	Office	22,590	66,822	4,956	94,368	(9,583)	84,785	100.0%
125 John Carpenter	09/15/2017	Irving	TX	Office	2,755	77,288	8,723	88,766	(7,956)	80,810	100.0%
The Marq <sup>(2)</sup>	03/01/2018	Minneapolis	MN	Office	10,387	77,399	4,271	92,057	(4,920)	87,137	100.0%
City Tower	03/06/2018	Orange	CA	Office	13,930	133,900	7,937	155,767	(9,109)	146,658	100.0%
Eight & Nine Corporate Centre	06/08/2018	Franklin	TN	Office	17,401	56,388	4,572	78,361	(2,848)	75,513	100.0%
Georgia 400 Center	05/23/2019	Alpharetta	GA	Office	11,431	72,207	7,594	91,232	(584)	90,648	100.0%
					<u>\$ 158,741</u>	<u>\$ 592,898</u>	<u>\$ 38,167</u>	<u>\$ 789,806</u>	<u>\$ (57,925)</u>	<u>\$ 731,881</u>	

<sup>(1)</sup> The Company owns 100% of the common members' equity of Park Highlands and Park Highlands II. On September 7, 2016 and January 8, 2019, a subsidiary of the Company that owns a portion of Park Highlands and Park Highlands II, sold 820 units of 10% Class A non-voting preferred membership units for \$0.8 million and 1,927 units of 10% Class A2 non-voting preferred membership units for \$1.9 million, respectively, to accredited investors. The amount of the Class A and A2 non-voting preferred membership units raised, net of offering costs, is included in other liabilities on the accompanying consolidated balance sheets.

<sup>(2)</sup> This property was formerly known as Marquette Plaza and was re-named The Marq in connection with the Company's re-branding strategy for this property.

**Operating Leases**

Certain of the Company's real estate properties are leased to tenants under operating leases for which the terms and expirations vary. As of June 30, 2019, the leases, excluding options to extend and apartment leases, which have terms that are generally one year or less, had remaining terms of up to 12.8 years with a weighted-average remaining term of 4.7 years. Some of the leases have provisions to extend the lease agreements, options for early termination after paying a specified penalty and other terms and conditions as negotiated. The Company retains substantially all of the risks and benefits of ownership of the real estate assets leased to tenants. Generally, upon the execution of a lease, the Company requires a security deposit from tenants in the form of a cash deposit and/or a letter of credit. The amount required as a security deposit varies depending upon the terms of the respective leases and the creditworthiness of the tenant, but generally are not significant amounts. Therefore, exposure to credit risk exists to the extent that a receivable from a tenant exceeds the amount of its security deposit. Security deposits received in cash and assumed in real estate acquisitions related to tenant leases are included in other liabilities in the accompanying consolidated balance sheets and totaled \$4.0 million and \$3.7 million as of June 30, 2019 and December 31, 2018, respectively.



**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

During the six months ended June 30, 2019 and 2018, the Company recognized deferred rent from tenants of \$2.2 million and \$1.7 million, respectively, net of lease incentive amortization. As of June 30, 2019 and December 31, 2018, the cumulative deferred rent receivable balance, including unamortized lease incentive receivables, was \$13.9 million and \$9.6 million, respectively, and is included in rents and other receivables on the accompanying balance sheets. The cumulative deferred rent balance included \$3.4 million and \$1.3 million of unamortized lease incentives as of June 30, 2019 and December 31, 2018, respectively.

As of June 30, 2019, the future minimum rental income from the Company's properties, excluding apartment leases, under non-cancelable operating leases was as follows (in thousands):

July 1, 2019 through December 31, 2019	\$	31,069
2020		61,681
2021		57,091
2022		49,585
2023		41,922
Thereafter		121,282
	<u>\$</u>	<u>362,630</u>

As of June 30, 2019, the Company's commercial real estate properties were leased to approximately 250 tenants over a diverse range of industries and geographic areas. The Company's highest tenant industry concentrations (greater than 10% of annualized base rent) were as follows:

Industry	Number of Tenants	Annualized Base Rent <sup>(1)</sup> (in thousands)	Percentage of Annualized Base Rent
Health Care and Social Services	19	\$ 8,595	13.1%
Insurance	26	7,212	11.0%
		<u>\$ 15,807</u>	<u>24.1%</u>

<sup>(1)</sup> Annualized base rent represents annualized contractual base rental income as of June 30, 2019, adjusted to straight-line any contractual tenant concessions (including free rent), rent increases and rent decreases from the lease's inception through the balance of the lease term.

No other tenant industries accounted for more than 10% of annualized base rent. No material tenant credit issues have been identified at this time. During the six months ended June 30, 2019, the Company recorded an adjustment to rental income of \$0.2 million for lease payments that were deemed not probable of collection. During the six months ended June 30, 2019 and 2018, the Company recorded bad debt recoveries of \$0.2 million and \$0.2 million, respectively, which were included in operating, maintenance and management expense in the accompanying consolidated statements of operations.

**Geographic Concentration Risk**

As of June 30, 2019, the Company's real estate investments in Georgia, Texas and California represented 17.2%, 14.5% and 14.4%, respectively, of the Company's total assets. As a result, the geographic concentration of the Company's portfolio makes it particularly susceptible to adverse economic developments in the Georgia, Texas and California real estate markets. Any adverse economic or real estate developments in these markets, such as business layoffs or downsizing, industry slowdowns, relocations of businesses, changing demographics and other factors, or any decrease in demand for office space resulting from the local business climate, could adversely affect the Company's operating results and its ability to make distributions to stockholders.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

**Recent Acquisition**

***Georgia 400 Center***

On May 23, 2019, the Company, through an indirect wholly owned subsidiary, acquired an office property consisting of three buildings containing an aggregate of 416,463 rentable square feet located on approximately 24.4 acres of land in Alpharetta, Georgia (“Georgia 400 Center”). The seller is not affiliated with the Company or the Advisor. The purchase price (net of closing credits) of Georgia 400 Center was \$90.3 million, which includes \$1.2 million of capitalized acquisition costs. The Company recorded this acquisition as an asset acquisition and recorded \$11.4 million to land, \$72.0 million to building and improvements, \$7.6 million to tenant origination and absorption costs and \$0.7 million to below-market lease liabilities. The intangible assets and liabilities acquired in connection with this acquisition have weighted-average amortization periods as of the date of acquisition of 5.8 years for tenant origination and absorption costs and 2.4 years for below-market lease liabilities.

**Sale of Real Estate**

As of December 31, 2018 and June 30, 2019, the Company had recorded contract liabilities of \$3.1 million related to deferred proceeds received from the buyers of the Park Highlands land sales and another developer for the value of land that was contributed to a master association that is consolidated by the Company, which was included in other liabilities on the accompanying consolidated balance sheets.



**PART I. FINANCIAL INFORMATION (CONTINUED)**
**Item 1. Financial Statements (continued)**
**KBS STRATEGIC OPPORTUNITY REIT, INC.**
**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

**4. TENANT ORIENTATION AND ABSORPTION COSTS, ABOVE-MARKET LEASE ASSETS AND BELOW-MARKET LEASE LIABILITIES**

As of June 30, 2019 and December 31, 2018, the Company's tenant origination and absorption costs, above-market lease assets and below-market lease liabilities (excluding fully amortized assets and liabilities and accumulated amortization) were as follows (in thousands):

	Tenant Origination and Absorption Costs		Above-Market Lease Assets		Below-Market Lease Liabilities	
	June 30, 2019	December 31, 2018	June 30, 2019	December 31, 2018	June 30, 2019	December 31, 2018
Cost	\$ 38,167	\$ 31,221	\$ 3,714	\$ 3,714	\$ (6,990)	\$ (6,418)
Accumulated Amortization	(9,796)	(7,133)	(539)	(337)	2,010	1,471
Net Amount	\$ 28,371	\$ 24,088	\$ 3,175	\$ 3,377	\$ (4,980)	\$ (4,947)

Increases (decreases) in net income as a result of amortization of the Company's tenant origination and absorption costs, above-market lease assets and below-market lease liabilities for the three and six months ended June 30, 2019 and 2018 were as follows (in thousands):

	Tenant Origination and Absorption Costs		Above-Market Lease Assets		Below-Market Lease Liabilities	
	For the Three Months Ended June 30,		For the Three Months Ended June 30,		For the Three Months Ended June 30,	
	2019	2018	2019	2018	2019	2018
Amortization	\$ (1,720)	\$ (2,088)	\$ (101)	\$ (111)	\$ 385	\$ 385

	Tenant Origination and Absorption Costs		Above-Market Lease Assets		Below-Market Lease Liabilities	
	For the Six Months Ended June 30,		For the Six Months Ended June 30,		For the Six Months Ended June 30,	
	2019	2018	2019	2018	2019	2018
Amortization	\$ (3,324)	\$ (3,625)	\$ (202)	\$ (155)	\$ 738	\$ 655

Additionally, as of June 30, 2019 and December 31, 2018, the Company had recorded tax abatement intangible assets, net of amortization, on real estate held for investment, which are included in prepaid expenses and other assets in the accompanying balance sheets, of \$1.3 million and \$1.6 million, respectively. Also, as of December 31, 2018, the Company had recorded tax abatement intangible assets, net of amortization, on real estate held for sale, which are included in assets related to real estate held for sale, net in the accompanying balance sheets, of \$2.7 million. During the three and six months ended June 30, 2019, the Company recorded amortization expense of \$0.1 million and \$0.3 million, respectively, related to tax abatement intangible assets. During the three and six months ended June 30, 2018, the Company recorded amortization expense of \$0.2 million and \$0.5 million, respectively, related to tax abatement intangible assets.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

**5. REAL ESTATE EQUITY SECURITIES**

As of June 30, 2019, the Company owned three investments in real estate equity securities. The following table sets forth the number of shares owned by the Company and the related carrying value of the shares as of June 30, 2019 and December 31, 2018 (dollars in thousands):

Real Estate Equity Security	June 30, 2019		December 31, 2018	
	Number of Shares Owned	Total Carrying Value	Number of Shares Owned	Total Carrying Value
Whitestone REIT	95,160	\$ 1,208	1,781,894	\$ 21,846
Keppel-KBS US REIT	56,979,352	43,589	56,979,352	34,757
Franklin Street Properties Corp.	2,773,729	20,470	2,772,529	17,273
	<u>59,848,241</u>	<u>\$ 65,267</u>	<u>61,533,775</u>	<u>\$ 73,876</u>

During the six months ended June 30, 2019, the Company sold 1,686,734 shares of common stock of Whitestone REIT (NYSE Ticker: WSR) for an aggregate sale price of \$24.1 million.

The following summarizes the portion of gain and loss for the period related to real estate equity securities held during the three and six months ended June 30, 2019 and 2018 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Net gain (loss) recognized during the period on real estate equity securities	\$ 4,294	\$ 8,724	\$ 15,459	\$ (7,287)
Less net gain recognized during the period on real estate equity securities sold during the period	—	—	(3,397)	—
Unrealized gain (loss) recognized during the reporting period on real estate equity securities held at the end of the period	<u>\$ 4,294</u>	<u>\$ 8,724</u>	<u>\$ 12,062</u>	<u>\$ (7,287)</u>

During the three and six months ended June 30, 2019, the Company recognized \$0.3 million and \$2.1 million, respectively, of dividend income from real estate equity securities. During the three and six months ended June 30, 2018, the Company recognized \$1.2 million and \$2.3 million, respectively, of dividend income from real estate equity securities.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**  
**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019  
(unaudited)

**6. REAL ESTATE DEBT SECURITIES**

The information for real estate debt securities as of June 30, 2019 and December 31, 2018 is set forth below (in thousands):

Debt Securities Name	Dates Acquired	Debt Securities Type	Outstanding Principal Balance as of June 30, 2019	Book Value as of June 30, 2019	Book Value as of December 31, 2018	Contractual Interest Rate	Annualized Effective Interest Rate	Maturity Date
Battery Point Series B Preferred Units <sup>(4)</sup>	10/28/2016 / 03/30/2017 / 05/12/2017	Series B Preferred Units	\$ —	\$ —	\$ 10,859	(1)	(1)	(1)
			<u>\$ —</u>	<u>\$ —</u>	<u>\$ 10,859</u>			

<sup>(1)</sup> On March 20, 2019, the Company, through an indirect wholly owned subsidiary, entered into a redemption agreement for the Battery Point Series B Preferred Units. The redemption agreement resulted in the redemption of 13,000 Series B Preferred Units with a per-unit price of \$1,000. The Company received \$8.6 million, of which \$0.9 million relates to accrued interest and an exit fee. In addition, the Company received 210,000 shares of Battery Point Series A-3 Preferred Units with a per-unit price of \$25. The Series A-3 Preferred Units were classified as an equity investment without a readily determinable fair value (see note 12 “Investment in Unconsolidated Joint Ventures” for further information).

The following summarizes the activity related to real estate debt securities for the six months ended June 30, 2019 (in thousands):

Real estate debt securities - December 31, 2018	\$ 10,859
Principal repayment of Series B Preferred Units	(7,750)
Redemptions of Series B Preferred Units in exchange for Series A-3 Preferred Units	(2,992)
Receipt of deferred interest receivable	(130)
Deferred interest receivable	4
Accretion of commitment fee, net of closing costs	9
Real estate debt securities - June 30, 2019	<u>\$ —</u>

For the three and six months ended June 30, 2019 and 2018, interest income from real estate debt securities consisted of the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Contractual interest income	\$ —	\$ 490	\$ 356	\$ 884
Interest accretion	—	9	4	104
Accretion of commitment fee, net of closing costs and acquisition fee	—	12	9	24
Interest income from real estate debt securities	<u>\$ —</u>	<u>\$ 511</u>	<u>\$ 369</u>	<u>\$ 1,012</u>

**PART I. FINANCIAL INFORMATION (CONTINUED)**
**Item 1. Financial Statements (continued)**
**KBS STRATEGIC OPPORTUNITY REIT, INC.**
**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

**7. REAL ESTATE HELD FOR SALE**

As of June 30, 2019, the Company classified one retail property as held for sale. During the six months ended June 30, 2019, the Company disposed of one apartment property. During the year ended December 31, 2018, the Company disposed of one office building and one office/flex/industrial portfolio consisting of 21 buildings.

On November 12, 2013, the Company, through an indirect wholly owned subsidiary, and EE 424 Bedford OM, LLC entered into an agreement to form a joint venture (the “424 Bedford Joint Venture”), and on January 31, 2014, the 424 Bedford Joint Venture acquired an apartment building containing 66 units in Brooklyn, New York (“424 Bedford”). On January 11, 2019, the 424 Bedford Joint Venture sold 424 Bedford to a purchaser unaffiliated with the Company or the Advisor, for \$43.8 million before closing costs and credits. The carrying value of 424 Bedford as of the disposition date was \$34.0 million, which was net of \$5.3 million of accumulated depreciation and amortization. The Company recognized a gain on sale of \$7.6 million related to the disposition of 424 Bedford.

The following summary presents the major components of assets and liabilities related to real estate held for sale as of June 30, 2019 and December 31, 2018 (in thousands):

	June 30, 2019	December 31, 2018
Assets related to real estate held for sale		
Real estate, cost	\$ 16,799	\$ 51,653
Accumulated depreciation and amortization	(2,718)	(6,100)
Real estate, net	14,081	45,553
Other assets	666	3,330
Total assets related to real estate held for sale	\$ 14,747	\$ 48,883
Liabilities related to real estate held for sale		
Notes payable, net	10,589	33,538
Other liabilities	42	58
Total liabilities related to real estate held for sale	\$ 10,631	\$ 33,596

The operations of these properties and gain on sales are included in continuing operations on the accompanying statements of operations. The following table summarizes certain revenue and expenses related to these properties for the three and six months ended June 30, 2019 and 2018 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Revenues				
Rental income	\$ 575	\$ 5,768	\$ 1,308	\$ 11,493
Other operating income	69	104	106	149
Total revenues	\$ 644	\$ 5,872	\$ 1,414	\$ 11,642
Expenses				
Operating, maintenance, and management	\$ 177	\$ 1,796	\$ 227	\$ 3,096
Real estate taxes and insurance	47	511	28	1,001
Asset management fees to affiliate	74	472	150	935
Depreciation and amortization	58	2,176	249	5,001
Interest expense	130	1,726	303	3,340
Total expenses	\$ 486	\$ 6,681	\$ 957	\$ 13,373

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

**8. NOTES AND BONDS PAYABLE**

As of June 30, 2019 and December 31, 2018, the Company's notes and bonds payable, including notes payable related to real estate held for sale, consisted of the following (dollars in thousands):

	Book Value as of June 30, 2019	Book Value as of December 31, 2018	Contractual Interest Rate as of June 30, 2019 <sup>(1)</sup>	Effective Interest Rate at June 30, 2019 <sup>(1)</sup>	Payment Type	Maturity Date <sup>(2)</sup>
Richardson Portfolio Mortgage Loan	\$ 36,000	\$ 36,000	One-Month LIBOR + 2.50%	4.94%	Interest Only <sup>(3)</sup>	11/01/2021
Park Centre Mortgage Loan <sup>(4)</sup>	21,970	8,404	One-Month LIBOR + 1.75%	4.19%	Interest Only	06/27/2022
Burbank Collection Mortgage Loan	10,595	10,716	One-Month LIBOR + 2.35%	4.79%	Principal & Interest	09/30/2019
1180 Raymond Mortgage Loan	30,446	30,637	One-Month LIBOR + 2.25%	4.69%	Principal & Interest	12/01/2019
1180 Raymond Bond Payable	6,180	6,280	6.50%	6.50%	Principal & Interest	09/01/2036
424 Bedford Mortgage Loan <sup>(5)</sup>	—	23,710	(5)	(5)	(5)	(5)
KBS SOR (BVI) Holdings, Ltd. Series A Debentures <sup>(6)</sup>	217,418	259,516	4.25%	4.25%	(6)	03/01/2023
Crown Pointe Mortgage Loan	51,171	51,171	One-Month LIBOR + 2.60%	5.04%	Interest Only	02/13/2020
125 John Carpenter Mortgage Loan	53,204	53,204	One-Month LIBOR + 1.75%	4.19%	Interest Only	10/01/2022
City Tower Mortgage Loan	89,000	89,000	One-Month LIBOR + 1.55%	3.99%	Interest Only	03/05/2021
The Marq Mortgage Loan	53,408	50,800	One-Month LIBOR + 1.55%	3.99%	Interest Only	06/06/2021
Eight & Nine Corporate Centre Mortgage Loan	43,880	43,880	One-Month LIBOR + 1.60%	4.04%	Interest Only	06/08/2021
Georgia 400 Center Mortgage Loan	59,690	—	One-Month LIBOR + 1.55%	3.98%	Interest Only	05/22/2023
Total Notes and Bonds Payable principal outstanding	672,962	663,318				
Net Premium/(Discount) on Notes and Bonds Payable <sup>(7)</sup>	835	198				
Deferred financing costs, net	(7,264)	(8,044)				
Total Notes and Bonds Payable, net	\$ 666,533	\$ 655,472				

<sup>(1)</sup> Contractual interest rate represents the interest rate in effect under the loan as of June 30, 2019. Effective interest rate is calculated as the actual interest rate in effect as of June 30, 2019 (consisting of the contractual interest rate and contractual floor rates), using interest rate indices at June 30, 2019, where applicable.

<sup>(2)</sup> Represents the initial maturity date or the maturity date as extended as of June 30, 2019; subject to certain conditions, the maturity dates of certain loans may be extended beyond the date shown.

<sup>(3)</sup> Represents the payment type required under the loan as of June 30, 2019. Certain future monthly payments due under this loan also include amortizing principal payments. For more information of the Company's contractual obligations under its notes and bonds payable, see five-year maturity table below.

<sup>(4)</sup> On June 27, 2019, the Company closed on the refinancing of the Park Centre Mortgage Loan.

<sup>(5)</sup> On January 11, 2019, in connection with the disposition of 424 Bedford, the buyer assumed the mortgage loan secured by 424 Bedford with an outstanding principal balance of \$23.7 million at the time of the sale.

<sup>(6)</sup> See "– Israeli Bond Financing" below.

<sup>(7)</sup> Represents the unamortized premium/discount on notes and bonds payable due to the above- and below-market interest rates when the debt was assumed. The discount/premium is amortized over the remaining life of the notes and bonds payable.

**PART I. FINANCIAL INFORMATION (CONTINUED)****Item 1. Financial Statements (continued)****KBS STRATEGIC OPPORTUNITY REIT, INC.****CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

During the three and six months ended June 30, 2019, the Company incurred \$7.2 million and \$14.4 million, respectively, of interest expense. Included in interest expense for the three and six months ended June 30, 2019 was \$0.8 million and \$1.7 million, respectively, of amortization of deferred financing costs. Additionally, during the three and six months ended June 30, 2019, the Company capitalized \$0.7 million and \$1.4 million, respectively, of interest related to its investments in undeveloped land. During the three and six months ended June 30, 2018, the Company incurred \$7.8 million and \$14.4 million, respectively, of interest expense. Included in interest expense for the three and six months ended June 30, 2018 was \$0.9 million and \$1.7 million, respectively, of amortization of deferred financing costs. Additionally, during the three and six months ended June 30, 2018, the Company capitalized \$0.6 million and \$1.3 million, respectively, of interest related to its investments in undeveloped land.

As of June 30, 2019 and December 31, 2018, the Company's interest payable was \$4.7 million and \$5.2 million, respectively.

The following is a schedule of maturities, including principal amortization payments, for all notes and bonds payable outstanding as of June 30, 2019 (in thousands):

July 1, 2019 through December 31, 2019	\$	41,142
2020		105,882
2021		276,717
2022		129,768
2023		114,298
Thereafter		5,155
	<u>\$</u>	<u>672,962</u>

The Company's notes payable contain financial debt covenants. As of June 30, 2019, the Company was in compliance with all of these debt covenants.

***Israeli Bond Financing***

On March 2, 2016, KBS Strategic Opportunity BVI, a wholly owned subsidiary of the Company, filed a final prospectus with the Israel Securities Authority for a proposed offering of up to 1,000,000,000 Israeli new Shekels of the Debentures at an annual interest rate not to exceed 4.25%. On March 1, 2016, KBS Strategic Opportunity BVI commenced the institutional tender of the Debentures and accepted application for 842.5 million Israeli new Shekels. On March 7, 2016, KBS Strategic Opportunity BVI commenced the public tender of the Debentures and accepted 127.7 million Israeli new Shekels. In the aggregate, KBS Strategic Opportunity BVI accepted 970.2 million Israeli new Shekels (approximately \$249.2 million as of March 8, 2016) in both the institutional and public tenders at an annual interest rate of 4.25%. KBS Strategic Opportunity BVI issued the Debentures on March 8, 2016. The terms of the Debentures require five equal annual installment principal payments on March 1st of each year from 2019 to 2023. On March 1, 2019, the Company paid the first principal installment payment of 194.0 million Israeli new Shekels (approximately \$53.6 million as of March 1, 2019). As of June 30, 2019, the Company had one foreign currency collar for an aggregate notional amount of 776.2 million Israeli new Shekels to hedge its exposure to foreign currency exchange rate movements. See note 9, "Derivative Instruments" for a further discussion on the Company's foreign currency collar.

The deed of trust that governs the terms of the Debentures contains various financial covenants. As of June 30, 2019, the Company was in compliance with all of these financial debt covenants.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

**9. DERIVATIVE INSTRUMENTS**

The Company enters into derivative instruments for risk management purposes to hedge its exposure to cash flow variability caused by changing interest rates and foreign currency exchange rate movements. The primary goal of the Company's risk management practices related to interest rate risk is to prevent changes in interest rates from adversely impacting the Company's ability to achieve its investment return objectives. The Company does not enter into derivatives for speculative purposes.

The Company enters into foreign currency options and foreign currency collars to mitigate its exposure to foreign currency exchange rate movements on its bonds payable outstanding denominated in Israeli new Shekels. A foreign currency collar consists of a purchased call option to buy and a sold put option to sell Israeli new Shekels. A foreign currency collar guarantees that the exchange rate of the currency will not fluctuate beyond the range of the options' strike prices. A foreign currency option consists of a call option to buy Israeli new Shekels.

The following table summarizes the notional amount and other information related to the Company's foreign currency collar as of June 30, 2019 and December 31, 2018. The notional amount is an indication of the extent of the Company's involvement in each instrument at that time, but does not represent exposure to credit, interest rate or market risks (currency in thousands):

Derivative Instruments	June 30, 2019		December 31, 2018		Strike Price	Trade Date	Maturity Date
	Number of Instruments	Notional Amount	Number of Instruments	Notional Amount			
<i>Derivative instruments not designated as hedging instruments</i>							
Foreign currency collar	1	776,182 ILS	—	— ILS	3.49 - 3.62 ILS - USD	02/27/2019	08/23/2019
Foreign currency collar	—	— ILS	1	776,182 ILS	3.54 - 3.66 ILS - USD	08/20/2018	02/28/2019

The Company enters into interest rate caps to mitigate its exposure to rising interest rates on its variable rate notes payable. The values of interest rate caps are primarily impacted by interest rates, market expectations about interest rates, and the remaining life of the instrument. In general, increases in interest rates, or anticipated increases in interest rates, will increase the value of interest rate caps. As the remaining life of an interest rate cap decreases, the value of the instrument will generally decrease towards zero.

As of June 30, 2019, the Company had entered into three interest rate caps, which were not designated as a hedging instruments. The following table summarizes the notional amounts and other information related to the Company's derivative instruments as of June 30, 2019. The notional amount is an indication of the extent of the Company's involvement in the instrument at that time, but does not represent exposure to credit, interest rate or market risks (dollars in thousands):

Derivative Instrument	Effective Date	Maturity Date	Notional Value	Reference Rate
Interest rate cap	02/21/2017	02/13/2020	\$ 46,875	One-month LIBOR at 3.00%
Interest rate cap	04/02/2018	03/05/2021	\$ 77,513	One-month LIBOR at 3.50%
Interest rate cap	06/21/2019	05/22/2023	\$ 51,252	One-month LIBOR at 4.00%

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

The following table sets forth the fair value of the Company's derivative instruments as well as their classification on the consolidated balance sheets as of June 30, 2019 and December 31, 2018 (dollars in thousands):

Derivative Instruments	Balance Sheet Location	June 30, 2019		December 31, 2018	
		Number of Instruments	Fair Value	Number of Instruments	Fair Value
<i>Derivative instruments not designated as hedging instruments</i>					
Interest rate caps	Prepaid expenses and other assets	3	\$ 26	2	\$ 34
Foreign currency collar	Other liabilities	1	\$ (169)	1	\$ (4,393)

The change in fair value of foreign currency options and collars that are not designated as cash flow hedges are recorded as foreign currency transaction gains or losses in the accompanying consolidated statements of operations. During the three months ended June 30, 2019, the Company recognized a \$1.2 million gain related to the foreign currency collars, which is shown net against \$3.7 million of foreign currency transaction loss in the accompanying consolidated statements of operations as foreign currency transaction loss, net. During the six months ended June 30, 2019, the Company recognized a \$4.2 million gain related to the foreign currency collars, which is shown net against \$9.5 million of foreign currency transaction loss in the accompanying consolidated statements of operations as foreign currency transaction loss, net. During the three months ended June 30, 2018, the Company recognized a \$2.2 million loss related to a foreign currency option, which is shown net against \$12.3 million of foreign currency transaction gain in the accompanying consolidated statements of operations as foreign currency transaction loss, net. During the six months ended June 30, 2018, the Company recognized a \$4.3 million loss related to a foreign currency option, which is shown net against \$13.4 million of foreign currency transaction gain in the accompanying consolidated statements of operations as foreign currency transaction loss, net.

During the three and six months ended June 30, 2019, the Company recorded unrealized losses of \$7,000 and \$37,000, respectively, on interest rate caps, which was included in interest expense on the accompanying consolidated statements of operations. During the three and six months ended June 30, 2018, the Company recorded unrealized losses of \$62,000 and \$31,000, respectively, on interest rate caps, which was included as an offset to interest expense on the accompanying consolidated statements of operations.

**10. FAIR VALUE DISCLOSURES**

Under GAAP, the Company is required to measure certain financial instruments at fair value on a recurring basis. In addition, the Company is required to measure other non-financial and financial assets at fair value on a non-recurring basis (e.g., carrying value of impaired real estate loans receivable and long-lived assets). Fair value is defined as the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The GAAP fair value framework uses a three-tiered approach. Fair value measurements are classified and disclosed in one of the following three categories:

- Level 1: unadjusted quoted prices in active markets that are accessible at the measurement date for identical assets or liabilities;
- Level 2: quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which significant inputs and significant value drivers are observable in active markets; and
- Level 3: prices or valuation techniques where little or no market data is available that requires inputs that are both significant to the fair value measurement and unobservable.



**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

The fair value for certain financial instruments is derived using valuation techniques that involve significant management judgment. The price transparency of financial instruments is a key determinant of the degree of judgment involved in determining the fair value of the Company's financial instruments. Financial instruments for which actively quoted prices or pricing parameters are available and for which markets contain orderly transactions will generally have a higher degree of price transparency than financial instruments for which markets are inactive or consist of non-orderly trades. The Company evaluates several factors when determining if a market is inactive or when market transactions are not orderly. The following is a summary of the methods and assumptions used by management in estimating the fair value of each class of financial instruments for which it is practicable to estimate the fair value:

*Cash and cash equivalents, restricted cash, rent and other receivables and accounts payable and accrued liabilities:* These balances approximate their fair values due to the short maturities of these items.

*Real estate equity securities:* The Company's real estate equity securities are presented at fair value on the accompanying consolidated balance sheet. The fair values of the real estate equity securities were based on quoted prices in an active market on a major stock exchange. The Company classifies these inputs as Level 1 inputs.

*Real estate debt securities:* The Company's real estate debt securities are presented in the accompanying consolidated balance sheets at their amortized cost net of recorded loss reserves (if any) and not at fair value. The fair value of real estate debt securities was estimated using an internal valuation model that considers the expected cash flows for the debt securities, underlying collateral values (for collateral dependent securities) and estimated yield requirements of institutional investors for real estate debt securities with similar characteristics, including remaining term, type of collateral and other credit enhancements. The Company classifies these inputs as Level 3 inputs.

*Notes and bonds payable:* The fair values of the Company's notes and bonds payable are estimated using a discounted cash flow analysis based on management's estimates of current market interest rates for instruments with similar characteristics, including remaining loan term, loan-to-value ratio, type of collateral and other credit enhancements. Additionally, when determining the fair value of liabilities in circumstances in which a quoted price in an active market for an identical liability is not available, the Company measures fair value using (i) a valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities or similar liabilities when traded as assets or (ii) another valuation technique that is consistent with the principles of fair value measurement, such as the income approach or the market approach. The Company classifies these inputs as Level 3 inputs. The Company's bonds issued in Israel are publicly traded on the Tel-Aviv Stock Exchange. The Company used the quoted price as of June 30, 2019 for the fair value of its bonds issued in Israel. The Company classifies this input as a Level 1 input.

*Derivative instruments:* The Company's derivative instruments are presented at fair value on the accompanying consolidated balance sheets. The valuation of these instruments is determined using a proprietary model that utilizes observable inputs. As such, the Company classifies these inputs as Level 2 inputs. The fair value of interest rate caps (floors) are determined using the market standard methodology of discounting the future expected cash payments (receipts) which would occur if variable interest rates rise above (below) the strike rate of the caps (floors). The variable interest rates used in the calculation of projected payments (receipts) on the cap (floor) are based on an expectation of future interest rates derived from observed market interest rate curves and volatilities. The fair value of foreign currency option and collar is based on a Black-Scholes model tailored for currency derivatives.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

The following were the face values, carrying amounts and fair values of the Company's financial instruments as of June 30, 2019 and December 31, 2018, which carrying amounts do not approximate the fair values (in thousands):

	June 30, 2019			December 31, 2018		
	Face Value	Carrying Amount	Fair Value	Face Value	Carrying Amount	Fair Value
<b>Financial assets:</b>						
Real estate debt securities <sup>(1)</sup>	\$ —	\$ —	\$ —	\$ 13,000	\$ 10,859	\$ 10,859
<b>Financial liabilities:</b>						
Notes and bond payable	\$ 455,544	\$ 452,766	\$ 458,480	\$ 403,802	\$ 400,470	\$ 407,449
KBS SOR (BVI) Holdings, Ltd. Series A Debentures	\$ 217,418	\$ 213,767	\$ 218,686	\$ 259,516	\$ 255,002	\$ 255,814

<sup>(1)</sup> Carrying amount of real estate debt securities includes other-than-temporary impairment.

Disclosure of the fair value of financial instruments is based on pertinent information available to the Company as of the period end and requires a significant amount of judgment. This has made the estimation of fair values difficult and, therefore, both the actual results and the Company's estimate of value at a future date could be materially different.

As of June 30, 2019, the Company measured the following assets at fair value (in thousands):

	Total	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Recurring Basis:</b>				
Real estate equity securities	\$ 65,267	\$ 65,267	\$ —	\$ —
Asset derivative - interest rate caps	\$ 26	\$ —	\$ 26	\$ —
Liability derivative - foreign currency collar	\$ (169)	\$ —	\$ (169)	\$ —

**11. RELATED PARTY TRANSACTIONS**

The Advisory Agreement entitles the Advisor to specified fees upon the provision of certain services with regard to the investment of funds in real estate and real estate-related investments and the disposition of real estate and real estate-related investments (including the discounted payoff of non-performing loans) among other services, as well as reimbursement of certain costs incurred by the Advisor in providing services to the Company. The Advisory Agreement may also entitle the Advisor to certain back-end cash flow participation fees. The Company also entered into a fee reimbursement agreement (the "AIP Reimbursement Agreement") with KBS Capital Markets Group LLC, the dealer manager for the Company's initial public offering (the "Dealer Manager"), pursuant to which the Company agreed to reimburse the Dealer Manager for certain fees and expenses it incurs for administering the Company's participation in the Depository Trust & Clearing Corporation Alternative Investment Product Platform with respect to certain accounts of the Company's investors serviced through the platform. The Advisor and Dealer Manager also serve as, or previously served as, the advisor and dealer manager, respectively, for KBS Real Estate Investment Trust, Inc. ("KBS REIT I"), KBS Real Estate Investment Trust II, Inc. ("KBS REIT II"), KBS Real Estate Investment Trust III, Inc. ("KBS REIT III"), KBS Legacy Partners Apartment REIT, Inc. ("KBS Legacy Partners Apartment REIT"), KBS Strategic Opportunity REIT II, Inc. ("KBS Strategic Opportunity REIT II") and KBS Growth & Income REIT, Inc. ("KBS Growth & Income REIT").

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

On January 6, 2014, the Company, together with KBS REIT I, KBS REIT II, KBS REIT III, KBS Legacy Partners Apartment REIT, KBS Strategic Opportunity REIT II, the Dealer Manager, the Advisor and other KBS-affiliated entities, entered into an errors and omissions and directors and officers liability insurance program where the lower tiers of such insurance coverage are shared. The cost of these lower tiers is allocated by the Advisor and its insurance broker among each of the various entities covered by the program, and is billed directly to each entity. In June 2015, KBS Growth & Income REIT was added to the insurance program at terms similar to those described above. KBS REIT I elected to cease participation in the program at the June 2017 renewal and obtained separate insurance coverage. At renewal in June 2018, the Company, KBS Strategic Opportunity REIT II and KBS Legacy Partners Apartment REIT elected to cease participation in the program and obtain separate insurance coverage. The Company, together with KBS Strategic Opportunity REIT II, entered into an errors and omissions and directors and officers liability insurance program where the lower tiers of such insurance coverage are shared. The cost of these lower tiers is allocated by the Advisor and its insurance broker among each REIT covered by the program, and is billed directly to each REIT. The program is effective through June 30, 2020.

During the three and six months ended June 30, 2019 and 2018, no other business transactions occurred between the Company and these other KBS-sponsored programs.

Pursuant to the terms of these agreements, summarized below are the related-party costs incurred by the Company for the three and six months ended June 30, 2019 and 2018, respectively, and any related amounts payable as of June 30, 2019 and December 31, 2018 (in thousands):

	Incurred				Payable as of	
	Three Months Ended June 30,		Six Months Ended June 30,		June 30, 2019	December 31, 2018
	2019	2018	2019	2018		
<b>Expensed</b>						
Asset management fees	\$ 1,971	\$ 2,217	\$ 3,861	\$ 4,043	\$ —	\$ —
Reimbursable operating expenses <sup>(1)</sup>	83	115	172	198	48	29
Disposition fees <sup>(2)</sup>	—	—	394	—	—	—
<b>Capitalized</b>						
Acquisition fees on real estate	897	734	897	3,094	—	—
Acquisition fee on investment in unconsolidated joint venture	50	—	50	—	50	—
Acquisition fees on real estate equity securities	—	9	—	157	—	7
	<u>\$ 3,001</u>	<u>\$ 3,075</u>	<u>\$ 5,374</u>	<u>\$ 7,492</u>	<u>\$ 98</u>	<u>\$ 36</u>

<sup>(1)</sup> The Advisor may seek reimbursement for certain employee costs under the Advisory Agreement. The Company has reimbursed the Advisor for the Company's allocable portion of the salaries, benefits and overhead of internal audit department personnel providing services to the Company. These amounts totaled \$62,000 and \$133,000 for the three and six months ended June 30, 2019, respectively, and \$78,000 and \$161,000 for the three and six months ended June 30, 2018, respectively, and were the only employee costs reimbursed under the Advisory Agreement during these periods. The Company will not reimburse for employee costs in connection with services for which the Advisor earns acquisition, origination or disposition fees (other than reimbursement of travel and communication expenses) or for the salaries or benefits the Advisor or its affiliates may pay to the Company's executive officers. In addition to the amounts above, the Company reimburses the Advisor for certain of the Company's direct costs incurred from third parties that were initially paid by the Advisor on behalf of the Company.

<sup>(2)</sup> Disposition fees with respect to real estate sold are included in the gain on sale of real estate in the accompanying consolidated statements of operations.

During the three and six months ended June 30, 2018, the Advisor reimbursed the Company \$0.1 million for a property insurance rebate.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

On November 8, 2017, the Company sold 11 of its properties to various subsidiaries of Keppel-KBS US REIT (the “SREIT”). On November 30, 2018, the Company sold a portfolio of 21 office/flex/industrial buildings to the SREIT. The SREIT is externally managed by a joint venture (the “Manager”) between (i) an entity in which Keith D. Hall, the Company’s Chief Executive Officer and a director, and Peter McMillan III, the Company’s President and Chairman of the board of directors, have an indirect ownership interest and (ii) Keppel Capital Holding Pte. Ltd., which is not affiliated with the Company. The SREIT is expected to pay certain purchase and sale commissions and asset management fees to the Manager in exchange for the provision of certain management services.

On March 20, 2019, Pacific Oak Battery Point Holdings, LLC, a real estate asset management company formed in 2019, and its family of companies (collectively, “Pacific Oak”), acquired all the common equity interests in BPT Holdings, LLC (“Battery Point Holdings”). Battery Point Holdings owns (a) the common stock in Battery Point Trust, Inc. (“Battery Point”), (b) all the service entities that provide advisory, servicing and property management services to Battery Point Holdings generally named “DayMark”, and (c) 40% of additional DayMark entities that purchase, renovate, lease and sell single-family residential homes to Battery Point. As owner of Battery Point Holdings, Pacific Oak will be responsible for funding the ongoing operations of Battery Point Holdings and its subsidiaries. The affiliated DayMark service entities will be paid annual asset management fees equal to 1.5% of the gross asset value of Battery Point, annual property management fees equal to 8% of tenants’ rents received by Battery Point, and acquisition fees of 1% of the gross purchase price of properties acquired. The affiliated DayMark service entities will also receive fees from tenants upon execution of leases and a 1% commission from sellers of properties into the program, if it acts as the broker for the seller.

Pacific Oak is a group of companies founded and owned by Keith D. Hall, the Company’s Chief Executive Officer and a director, and Peter McMillan III, the Company’s President and Chairman of the Board of Directors. As of June 30, 2019, the Company had 210,000 shares of Battery Point Series A-3 Preferred Units with a per-unit price of \$25.

On June 27, 2019, the Company made a \$5.0 million investment in the Pacific Oak Opportunity Zone Fund I (defined below). Pacific Oak Opportunity Zone Fund I is sponsored by Pacific Oak. Pacific Oak is entitled to certain fees in connection with the fund. The fund will pay an acquisition fee equal to 1.5% of the purchase price of each asset (including any debt incurred or assumed and significant capital improvement costs budgeted as of the date of acquisition) with a purchase price less than or equal to \$25.0 million plus 1.0% of the purchase price in excess of \$25.0 million; a quarterly asset management fee equal to 0.25% of the total purchase price of all assets (including any debt incurred or assumed and significant capital improvement costs budgeted as of the date of acquisition) as of the end of the applicable quarter; and a financing fee equal to 0.5% of the original principal amount of any indebtedness they incur (reduced by any financing fee previously paid with respect to indebtedness being refinanced). In the case of investments made through joint ventures, the fees above will be determined based on our proportionate share of the investment. Pacific Oak is also entitled to certain distributions paid by the Pacific Oak Opportunity Zone Fund I after the Class A Members have received their preferred return. These fees and distributions have been waived for the Company’s \$5.0 million investment.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

**12. INVESTMENT IN UNCONSOLIDATED JOINT VENTURES**

As of June 30, 2019 and December 31, 2018, the Company's investments in unconsolidated joint ventures were composed of the following (dollars in thousands):

Joint Venture	Number of Properties at June 30, 2019	Location	Ownership %	Investment Balance at	
				June 30, 2019	December 31, 2018
NIP Joint Venture	2	Various	Less than 5.0%	\$ 1,225	\$ 1,476
110 William Joint Venture	1	New York, New York	60.0%	—	325
353 Sacramento Joint Venture	1	San Francisco, California	55.0%	42,689	43,068
Battery Point Series A-3 Preferred Units	N/A	N/A	N/A	2,992	—
Pacific Oak Opportunity Zone Fund I	N/A	N/A	N/A	5,050	—
				<u>\$ 51,956</u>	<u>\$ 44,869</u>

***Investment in National Industrial Portfolio Joint Venture***

On May 18, 2012, the Company, through an indirect wholly owned subsidiary, entered into a joint venture (the "NIP Joint Venture") with OCM NIP JV Holdings, L.P. and HC KBS NIP JV, LLC ("HC-KBS"). The NIP Joint Venture has invested in a portfolio of industrial properties. The Company made an initial capital contribution of \$8.0 million, which represents less than a 5.0% ownership interest in the NIP Joint Venture as of June 30, 2019.

Prior to January 17, 2018, KBS REIT I, an affiliate of the Advisor, was a member of HC-KBS and had a participation interest in certain future potential profits generated by the NIP Joint Venture. However, KBS REIT I did not have any equity interest in the NIP Joint Venture. On January 17, 2018, KBS REIT I assigned its participation interest in the NIP Joint Venture to one of the other joint venture partners in the NIP Joint Venture. None of the other joint venture partners are affiliated with the Company or the Advisor.

During the three and six months ended June 30, 2019, the Company received a distribution of \$0.3 million related to its investment in the NIP Joint Venture, which is reflected as a return of capital from the NIP Joint Venture. During the three months ended June 30, 2018, the Company received a distribution of \$0.9 million related to its investment in the NIP Joint Venture. The Company recognized \$0.1 million of income distributions and \$0.8 million of return of capital from the NIP Joint Venture. During the six months ended June 30, 2018, the Company received a distribution of \$1.3 million related to its investment in the NIP Joint Venture. The Company recognized \$0.2 million of income distributions and \$1.1 million of return of capital from the NIP Joint Venture.

***Investment in 110 William Joint Venture***

On December 23, 2013, the Company, through an indirect wholly owned subsidiary, entered into an agreement with SREF III 110 William JV, LLC (the "110 William JV Partner") to form a joint venture (the "110 William Joint Venture"). On May 2, 2014, the 110 William Joint Venture acquired an office property containing 928,157 rentable square feet located on approximately 0.8 acres of land in New York, New York ("110 William Street"). Each of the Company and the 110 William JV Partner hold a 60% and 40% ownership interest in the 110 William Joint Venture, respectively.

The Company exercises significant influence over the operations, financial policies and decision making with respect to the 110 William Joint Venture but significant decisions require approval from both members. Accordingly, the Company has accounted for its investment in the 110 William Joint Venture under the equity method of accounting. Income, losses, contributions and distributions are generally allocated based on the members' respective equity interests.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

As of December 31, 2018, the book value of the Company's investment in the 110 William Joint Venture was \$0.3 million, which includes \$1.4 million of unamortized acquisition fees and expenses incurred directly by the Company. During the three and six months ended June 30, 2018, the Company recorded \$1.5 million and \$3.1 million equity in loss from the 110 William Joint Venture, respectively. During the three and six months ended June 30, 2018, the Company did not receive any distributions related to its investment in the 110 William Joint Venture.

As of June 30, 2019, the book value of the Company's investment in the 110 William Joint Venture was \$0. During the six months ended June 30, 2019, the Company recorded \$7.5 million equity in income from the 110 William Joint Venture, which includes a \$7.8 million gain related to a distribution received, net of the Company's share of net losses of \$0.3 million. During the six months ended June 30, 2019, the 110 William Joint Venture made a \$7.8 million distribution to the Company and a \$5.2 million distribution to the 110 William JV Partner funded with proceeds from the 110 William refinancing (discussed below). The distribution exceeded the book value of the Company's investment in the 110 William Joint Venture, and the Company recorded the \$7.8 million distribution as a gain included in equity in income of unconsolidated joint ventures during the six months ended June 30, 2019. This gain was recorded because the Company determined that the distribution is not refundable and it does not have an implicit or explicit commitment to fund the 110 William Joint Venture. The Company will suspend the equity method of accounting and will not record the Company's share of losses and will not record the Company's share of any subsequent income for the 110 William Joint Venture until the Company's share of net income exceeds the gain recorded and the Company's share of the net losses not recognized during the period the equity method was suspended.

Summarized financial information for the 110 William Joint Venture follows (in thousands):

	June 30, 2019	December 31, 2018
<b>Assets:</b>		
Real estate assets, net of accumulated depreciation and amortization	\$ 241,767	\$ 235,613
Other assets	32,485	37,337
Total assets	<u>\$ 274,252</u>	<u>\$ 272,950</u>
<b>Liabilities and equity:</b>		
Notes payable, net	\$ 284,818	\$ 267,311
Other liabilities	8,624	7,485
Partners' deficit	(19,190)	(1,846)
Total liabilities and equity	<u>\$ 274,252</u>	<u>\$ 272,950</u>

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Revenues	\$ 9,442	\$ 9,951	\$ 17,701	\$ 19,760
<b>Expenses:</b>				
Operating, maintenance, and management	2,280	2,296	4,452	4,763
Real estate taxes and insurance	1,725	1,655	3,430	3,290
Depreciation and amortization	2,839	4,126	5,503	8,345
Interest expense	4,124	4,418	8,732	8,535
Total expenses	<u>10,968</u>	<u>12,495</u>	<u>22,117</u>	<u>24,933</u>
Total other income	39	24	71	38
Net loss	<u>\$ (1,487)</u>	<u>\$ (2,520)</u>	<u>\$ (4,345)</u>	<u>\$ (5,135)</u>
Company's share of net loss <sup>(1)</sup>	<u>\$ (892)</u>	<u>\$ (1,512)</u>	<u>\$ (2,607)</u>	<u>\$ (3,081)</u>

<sup>(1)</sup> During the three and six months ended June 30, 2019, the Company recorded \$0 and \$0.3 million of net losses in equity in income of unconsolidated joint ventures and suspended the recording of the Company's remaining share of net losses.



**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

***110 William Street Refinancing***

On March 7, 2019, the 110 William Joint Venture closed on refinancing of the 110 William Street existing loans (the “Refinancing”). The 110 William Joint Venture repaid \$268.0 million of principal related to the existing 110 William Street loans. The Refinancing is comprised of a mortgage loan with Invesco CMI Investments, L.P., an unaffiliated lender, for borrowings of up to \$261.4 million, which is secured by 110 William Street (the “110 William Street Mortgage Loan”) and a mezzanine loan with Invesco CMI Investments, L.P., an unaffiliated lender, for borrowings of up to \$87.1 million (the “110 William Street Mezzanine Loan”). The 110 William Street Mortgage Loan is comprised of a senior mortgage loan of \$215.5 million (the “Senior Mortgage Loan”) and an amended and restated building loan of \$45.9 million (the “Building Loan”) to be used for future tenant improvements, leasing commissions and capital expenditures.

The 110 William Street Mortgage Loan and the 110 William Street Mezzanine Loan mature on April 9, 2021, with three one-year extension options. The 110 William Street Mortgage Loan bears interest at a rate of the greater of (a) 3.5% or (b) 150 basis points over one-month LIBOR. The 110 William Street Mezzanine Loan bears interest at a rate of the greater of (a) 6.9% or (b) 490 basis points over one-month LIBOR. The 110 William Joint Venture entered into an interest rate cap that effectively limits one-month LIBOR at 3.75% on \$348.5 million, effective March 7, 2019 through March 15, 2021. The 110 William Street Mortgage Loan and the 110 William Street Mezzanine Loan have monthly payments that are interest-only with the entire unpaid principal balance and all outstanding interest and fees due at maturity. The 110 William Joint Venture has the right to prepay the loans at any time in whole, but not in part, subject to a prepayment fee if prepaid prior to May 9, 2020 and subject to certain other conditions contained in the loan documents. At closing, \$210.8 million of the Senior Mortgage Loan and \$70.3 million of the 110 William Street Mezzanine Loan was funded with \$4.7 million of the Senior Mortgage Loan, \$45.9 million of the Building Loan and \$16.8 million of the 110 William Street Mezzanine Loan available for future funding, subject to certain terms and conditions contained in the loan documents.

***Investment in 353 Sacramento Joint Venture***

On July 6, 2017, the Company, through an indirect wholly owned subsidiary, entered into an agreement with the Migdal Members to form a joint venture (the “353 Sacramento Joint Venture”). On July 6, 2017, the Company sold a 45% equity interest in an entity that owns an office building containing 284,751 rentable square feet located on approximately 0.35 acres of land in San Francisco, California (“353 Sacramento”) to the Migdal Members. The sale resulted in 353 Sacramento being owned by the 353 Sacramento Joint Venture, in which the Company indirectly owns 55% of the equity interests and the Migdal Members indirectly own 45% in the aggregate of the equity interests.

The Company exercises significant influence over the operations, financial policies and decision making with respect to the 353 Sacramento Joint Venture but significant decisions require approval from both members. Accordingly, the Company has accounted for its investment in the 353 Sacramento Joint Venture under the equity method of accounting. Income, losses, contributions and distributions are generally allocated based on the members’ respective equity interests.

During the three and six months ended June 30, 2019, the Company did not receive any distributions related to its investment in the 353 Sacramento Joint Venture. During the three and six months ended June 30, 2018, the Company made a \$1.3 million contribution to the 353 Sacramento Joint Venture.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

Summarized financial information for the 353 Sacramento Joint Venture follows (in thousands):

	June 30, 2019	December 31, 2018
<b>Assets:</b>		
Real estate assets, net of accumulated depreciation and amortization	\$ 179,347	\$ 180,852
Other assets	12,573	13,123
Total assets	<u>\$ 191,920</u>	<u>\$ 193,975</u>
<b>Liabilities and equity:</b>		
Notes payable, net	\$ 109,994	\$ 105,593
Other liabilities	5,223	10,863
Partners' capital	76,703	77,519
Total liabilities and equity	<u>\$ 191,920</u>	<u>\$ 193,975</u>

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Revenues	\$ 4,187	\$ 2,627	\$ 8,345	\$ 5,296
<b>Expenses:</b>				
Operating, maintenance, and management	939	891	1,769	1,769
Real estate taxes and insurance	694	605	1,395	1,217
Depreciation and amortization	1,563	1,387	3,131	2,837
Interest expense	1,447	1,348	2,866	2,587
Total expenses	<u>4,643</u>	<u>4,231</u>	<u>9,161</u>	<u>8,410</u>
Net loss	(456)	(1,604)	(816)	(3,114)
Company's equity in loss of unconsolidated joint venture	<u>\$ (215)</u>	<u>\$ (851)</u>	<u>\$ (379)</u>	<u>\$ (1,649)</u>

***Battery Point Series A-3 Preferred Units***

Beginning October 28, 2016, the Company invested in Battery Point Series B Preferred Units which were classified as real estate debt securities on the Company's accompanying balance sheets (see note 6 "Real Estate Debt Securities" for further information). On March 20, 2019, the Company, through an indirect wholly owned subsidiary, entered into a redemption agreement for the Battery Point Series B Preferred Units. The redemption agreement resulted in the redemption of the Company's entire investment of 13,000 Series B Preferred Units with a per-unit price of \$1,000 with an aggregate outstanding principal balance of \$13 million. The Company received a principal paydown of \$7.7 million plus accrued interest and an exit fee. In addition, the Company received 210,000 shares of Battery Point Series A-3 Preferred Units with a per-unit price of \$25 with an aggregate face amount of \$5.3 million. The Battery Point Series A-3 Preferred Units are entitled to a monthly dividend based on an annual rate of 7.5%. The annual dividend rate increases to 10% for the Battery Point Series A-3 Preferred Units not redeemed by February 28, 2020 and to 11% for the Battery Point Series A-3 Preferred Units not redeemed by February 28, 2021. On each monthly dividend payment date, Battery Point has the obligation to use 20% of the net proceeds of any and all future equity capital raising to redeem the Series A-3 Preferred Units. The Battery Point Series A-3 Preferred Units are redeemable at any time by Battery Point and holders of Series A-3 Preferred Shares may elect to redeem their units beginning on February 28, 2021, subject to Battery Point's board of directors' determination that the company has sufficient cash.



**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

The Company does not have a unilateral right to redeem the Battery Point Series A-3 Preferred Units on a stated redemption date, therefore the Company classified the Series A-3 Preferred Units as an equity investment without a readily determinable fair value. In accordance with FASB ASC 321, *Investments - Equity Securities*, the Company may elect to measure an equity investment without a readily determinable value that does not qualify for the practical expedient to estimate fair value using the net asset value per share, at its cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. The Company elected to measure its investment in the Battery Point Series A-3 Preferred Units in accordance with the above accounting guidance and recorded its investment in the Battery Point Series A-3 Preferred Units as of June 30, 2019, at a carrying value of \$3.0 million. During the three and six months ended June 30, 2019, the Company received a distribution of \$0.1 million, which was recognized as dividend income from real estate equity securities.

**Investment in Pacific Oak Opportunity Zone Fund I**

On June 27, 2019, the Company acquired 22 Class A Units for \$5.0 million in Pacific Oak Opportunity Zone Fund I, LLC (“Pacific Oak Opportunity Zone Fund I”). As of June 30, 2019, the book value of the Company’s investment in Pacific Oak Opportunity Zone Fund I was \$5.1 million, which includes \$0.1 million of acquisition fees. As of June 30, 2019, Pacific Oak Opportunity Zone Fund I consolidated one joint venture with real estate under development. As of June 30, 2019, the Company has concluded that Pacific Oak Opportunity Zone Fund I qualifies as a Variable Interest Entity (“VIE”) because there is insufficient equity at risk to finance the entity’s activities and the entity is structured with non-substantive voting rights. The Company concluded it is not the primary beneficiary of this VIE since it does not have the power to direct the activities that most significantly impact the entity’s economic performance and will account for its investment under the equity method of accounting.

The Company’s maximum exposure to loss as a result of its involvement with this VIE is limited to the carrying value of the investment in Pacific Oak Opportunity Zone Fund I which totaled \$5.1 million as of June 30, 2019.

**13. SUPPLEMENTAL CASH FLOW AND SIGNIFICANT NONCASH TRANSACTION DISCLOSURES**

Supplemental cash flow and significant noncash transaction disclosures were as follows (in thousands):

	<b>Six Months Ended June 30,</b>	
	<b>2019</b>	<b>2018</b>
<b>Supplemental Disclosure of Cash Flow Information:</b>		
Interest paid, net of capitalized interest of \$1,389 and \$1,282 for the six months ended June 30, 2019 and 2018, respectively	\$ 13,156	\$ 12,247
<b>Supplemental Disclosure of Significant Noncash Transactions:</b>		
Accrued improvements to real estate	5,286	4,982
Mortgage loan assumed by buyer in connection with sale of real estate	23,663	—
Redeemable common stock payable	5,463	421
Distributions paid to common stockholders through common stock issuances pursuant to the dividend reinvestment plan	564	964
Distributions paid to common stockholders through common stock issuances pursuant to the December 2017 special dividend	—	150,299
Redemption of Series B Preferred Units in exchange for Series A-3 Preferred Units	2,992	—

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

**14. COMMITMENTS AND CONTINGENCIES**

**Economic Dependency**

The Company is dependent on the Advisor for certain services that are essential to the Company, including the identification, evaluation, negotiation, origination, acquisition and disposition of investments; management of the daily operations of the Company's investment portfolio; and other general and administrative responsibilities. In the event that the Advisor is unable to provide these services, the Company will be required to obtain such services from other sources.

**Environmental**

As an owner of real estate, the Company is subject to various environmental laws of federal, state and local governments. Although there can be no assurance, the Company is not aware of any environmental liability that could have a material adverse effect on its financial condition or results of operations as of June 30, 2019. However, changes in applicable environmental laws and regulations, the uses and conditions of properties in the vicinity of the Company's properties, the activities of its tenants and other environmental conditions of which the Company is unaware with respect to the properties could result in future environmental liabilities.

**Legal Matters**

From time to time, the Company is a party to legal proceedings that arise in the ordinary course of its business. Management is not aware of any legal proceedings of which the outcome is probable or reasonably possible to have a material adverse effect on the Company's results of operations or financial condition, which would require accrual or disclosure of the contingency and the possible range of loss. Additionally, the Company has not recorded any loss contingencies related to legal proceedings in which the potential loss is deemed to be remote.

**Participation Fee Liability**

Pursuant to the Advisory Agreement currently in effect with the Advisor, the Advisor is due a subordinated participation in the Company's net cash flows (the "Incentive Fee") if, after the stockholders have received, together as a collective group, aggregate distributions (including distributions that may constitute a return of capital for federal income tax purposes) sufficient to provide (i) a return of their net invested capital, or the amount calculated by multiplying the total number of shares purchased by stockholders by the issue price, reduced by any amounts to repurchase shares pursuant to the share redemption program, and (ii) a 7.0% per year cumulative, noncompounded return on such net invested capital, the Advisor is entitled to receive 15.0% of the Company's net cash flows, whether from continuing operations, net sale proceeds or otherwise. Net sales proceeds means the net cash proceeds realized by the Company after deduction of all expenses incurred in connection with a sale, including disposition fees paid to the Advisor. The 7.0% per year cumulative, noncompounded return on net invested capital is calculated on a daily basis. In making this calculation, the net invested capital is reduced to the extent distributions in excess of a cumulative, noncompounded, annual return of 7.0% are paid (from whatever source), except to the extent such distributions would be required to supplement prior distributions paid in order to achieve a cumulative, noncompounded, annual return of 7.0% (invested capital is only reduced as described in this sentence; it is not reduced simply because a distribution constitutes a return of capital for federal income tax purposes). The 7.0% per year cumulative, noncompounded return is not based on the return provided to any individual stockholder. Accordingly, it is not necessary for each of the stockholders to have received any minimum return in order for the Advisor to participate in the Company's net cash flows. In fact, if the Advisor is entitled to participate in the Company's net cash flows, the returns of the stockholders will differ, and some may be less than a 7.0% per year cumulative, noncompounded return. This fee is payable only if we are not listed on an exchange.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 1. Financial Statements (continued)**

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

June 30, 2019

(unaudited)

On April 4, 2018, the Company's stockholders approved the acceleration of the payment of such incentive compensation, subject to certain conditions. Such accelerated payment would require approval by a special committee of the Company's board of directors in connection with the anticipated conversion of the Company into a net asset value REIT. The Advisor estimated the fair value of this liability to be as much as \$43 million as of June 30, 2019, based on a hypothetical liquidation of the assets and liabilities at their estimated fair values, after considering the impact of any potential closing costs and fees related to the disposition of real estate properties. The fair value of the Incentive Fee liability as of June 30, 2019 is based on the estimated fair values of the Company's assets and liabilities as of that date and changes to the fair values of assets and liabilities could have a material impact to the Incentive Fee calculation. The Incentive Fee is not currently payable to the Advisor, as it remains subject to further approval by the special committee and the Company's conversion to a perpetual-life NAV REIT, and there is no guarantee that it will ever be payable.

**15. SUBSEQUENT EVENTS**

The Company evaluates subsequent events up until the date the consolidated financial statements are issued.

**Distribution Declared**

On August 8, 2019, the Company's board of directors authorized a distribution in the amount of \$0.00860000 per share of common stock to stockholders of record as of the close of business on September 13, 2019. The Company expects to pay this distribution on or about September 18, 2019.

**Real Estate Disposition Subsequent to June 30, 2019**

***Burbank Collection***

On July 19, 2019, the Burbank Collection joint venture sold the Burbank Collection to a purchaser unaffiliated with the Company or the Advisor, for \$25.9 million before closing costs. As of June 30, 2019, the carrying value of the Burbank Collection was \$14.7 million, which was net of \$2.7 million of accumulated depreciation and amortization.

On July 19, 2019, in connection with the disposition of the Burbank Collection, the Burbank Collection joint venture repaid \$10.6 million of the outstanding principal balance due under the Burbank Collection mortgage loan.

## **PART I. FINANCIAL INFORMATION (CONTINUED)**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis should be read in conjunction with the accompanying financial statements of KBS Strategic Opportunity REIT, Inc. and the notes thereto. As used herein, the terms “we,” “our” and “us” refer to KBS Strategic Opportunity REIT, Inc., a Maryland corporation, and, as required by context, KBS Strategic Opportunity Limited Partnership, a Delaware limited partnership, which we refer to as the “Operating Partnership,” and to their subsidiaries.

#### **Forward-Looking Statements**

Certain statements included in this Quarterly Report on Form 10-Q are forward-looking statements. Those statements include statements regarding the intent, belief or current expectations of KBS Strategic Opportunity REIT, Inc. and members of our management team, as well as the assumptions on which such statements are based, and generally are identified by the use of words such as “may,” “will,” “seeks,” “anticipates,” “believes,” “estimates,” “expects,” “plans,” “intends,” “should” or similar expressions. Actual results may differ materially from those contemplated by such forward-looking statements. Further, forward-looking statements speak only as of the date they are made, and we undertake no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes to future operating results over time, unless required by law.

The following are some of the risks and uncertainties, although not all of the risks and uncertainties, that could cause our actual results to differ materially from those presented in our forward-looking statements:

- We depend on our advisor to conduct our operations and eventually dispose of our investments.
- We depend on tenants for our revenue and, accordingly, our revenue is dependent upon the success and economic viability of our tenants. Revenues from our property investments could decrease due to a reduction in tenants (caused by factors including, but not limited to, tenant defaults, tenant insolvency, early termination of tenant leases and non-renewal of existing tenant leases) and/or lower rental rates, limiting our ability to pay distributions to our stockholders.
- Our opportunistic investment strategy involves a higher risk of loss than would a strategy of investing in some other types of real estate and real estate-related investments.
- We have paid distributions from financings and in the future we may not pay distributions solely from our cash flow from operations or gains from asset sales. To the extent that we pay distributions from sources other than our cash flow from operations or gains from asset sales, we will have less funds available for investment in loans, properties and other assets, the overall return to our stockholders may be reduced and subsequent investors may experience dilution.
- All of our executive officers and some of our directors and other key real estate and debt finance professionals are also officers, directors, managers, key professionals and/or holders of a direct or indirect controlling interest in our advisor, our dealer manager and other KBS-affiliated entities. As a result, they face conflicts of interest, including significant conflicts created by our advisor’s compensation arrangements with us and other KBS-advised programs and investors and conflicts in allocating time among us and these other programs and investors. These conflicts could result in unanticipated actions. Fees paid to our advisor in connection with transactions involving the origination, acquisition and management of our investments are based on the cost of the investment, not on the quality of the investment or services rendered to us. This arrangement could influence our advisor to recommend riskier transactions to us.
- We pay substantial fees to and expenses of our advisor and its affiliates. These payments increase the risk that our stockholders will not earn a profit on their investment in us and increase our stockholders’ risk of loss.
- We cannot predict with any certainty how much, if any, of our dividend reinvestment plan proceeds will be available for general corporate purposes, including, but not limited to, the redemption of shares under our share redemption program, future funding obligations under any real estate loans receivable we acquire, the funding of capital expenditures on our real estate investments or the repayment of debt. If such funds are not available from the dividend reinvestment plan offering, then we may have to use a greater proportion of our cash flow from operations to meet these cash requirements, which would reduce cash available for distributions and could limit our ability to redeem shares under our share redemption program.
- We have focused, and may continue to focus, our investments in non-performing real estate and real estate-related loans, real estate-related loans secured by non-stabilized assets and real estate-related securities, which involve more risk than investments in performing real estate and real estate-related assets

All forward-looking statements should be read in light of the risks identified in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2018, as filed with the Securities and Exchange Commission (the “SEC”).

## **PART I. FINANCIAL INFORMATION (CONTINUED)**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

#### **Overview**

We were formed on October 8, 2008 as a Maryland corporation, elected to be taxed as a real estate investment trust (“REIT”) beginning with the taxable year ended December 31, 2010 and intend to operate in such manner. KBS Capital Advisors LLC (“KBS Capital Advisors”) is our advisor. As our advisor, KBS Capital Advisors manages our day-to-day operations and our portfolio of investments. KBS Capital Advisors also has the authority to make all of the decisions regarding our investments, subject to the limitations in our charter and the direction and oversight of our board of directors. KBS Capital Advisors also provides asset-management, marketing, investor-relations and other administrative services on our behalf. We have sought to invest in and manage a diverse portfolio of real estate-related loans, opportunistic real estate, real estate-related debt securities and other real estate-related investments. We conduct our business primarily through our operating partnership, of which we are the sole general partner.

On January 8, 2009, we filed a registration statement on Form S-11 with the SEC to offer a minimum of 250,000 shares and a maximum of 140,000,000 shares of common stock for sale to the public, of which 100,000,000 shares were registered in our primary offering and 40,000,000 shares were registered under our dividend reinvestment plan. We ceased offering shares of common stock in our primary offering on November 14, 2012. We sold 56,584,976 shares of common stock in the primary offering for gross offering proceeds of \$561.7 million. We continue to offer shares of common stock under the dividend reinvestment plan. As of June 30, 2019, we had sold 6,800,440 shares of common stock under the dividend reinvestment plan for gross offering proceeds of \$76.0 million. Also as of June 30, 2019, we had redeemed 23,315,550 of the shares sold in our offering for \$280.5 million. As of June 30, 2019, we had issued 25,976,746 shares of common stock in connection with special dividends. Additionally, on December 29, 2011 and October 23, 2012, we issued 220,994 shares and 55,249 shares of common stock, respectively, for \$2.0 million and \$0.5 million, respectively, in private transactions exempt from the registration requirements pursuant to Section 4(2) of the Securities Act of 1933, as amended.

On March 2, 2016, KBS Strategic Opportunity (BVI) Holdings, Ltd. (“KBS Strategic Opportunity BVI”), our wholly owned subsidiary, filed a final prospectus with the Israel Securities Authority for a proposed offering of up to 1,000,000,000 Israeli new Shekels of Series A debentures (the “Debentures”) at an annual interest rate not to exceed 4.25%. On March 1, 2016, KBS Strategic Opportunity BVI commenced the institutional tender of the Debentures and accepted application for 842.5 million Israeli new Shekels. On March 7, 2016, KBS Strategic Opportunity BVI commenced the public tender of the Debentures and accepted 127.7 million Israeli new Shekels. In the aggregate, KBS Strategic Opportunity BVI accepted 970.2 million Israeli new Shekels (approximately \$249.2 million as of March 8, 2016) in both the institutional and public tenders at an annual interest rate of 4.25%. KBS Strategic Opportunity BVI issued the Debentures on March 8, 2016. The terms of the Debentures require five equal principal installment payments annually on March 1st of each year from 2019 to 2023.

As of June 30, 2019, we consolidated seven office properties, one office portfolio consisting of four office buildings and 14 acres of undeveloped land, one retail property, one apartment property and three investments in undeveloped land with approximately 1,000 developable acres and owned five investments in unconsolidated joint ventures and three investments in real estate equity securities.

#### **Market Outlook – Real Estate and Real Estate Finance Markets**

Volatility in global financial markets and changing political environments can cause fluctuations in the performance of the U.S. commercial real estate markets. Possible future declines in rental rates, slower or potentially negative net absorption of leased space and expectations of future rental concessions, including free rent to renew tenants early, to retain tenants who are up for renewal or to attract new tenants, may result in decreases in cash flows from investment properties. To the extent there are increases in the cost of financing due to higher interest rates, this may cause difficulty in refinancing debt obligations at terms as favorable as the terms of existing indebtedness. Further, increases in interest rates would increase the amount of our debt payments on our variable rate debt to the extent the interest rates on such debt are not limited by interest rate caps. Market conditions can change quickly, potentially negatively impacting the value of real estate investments. Management continuously reviews our investment and debt financing strategies to optimize our portfolio and the cost of our debt exposure.

## **PART I. FINANCIAL INFORMATION (CONTINUED)**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

#### **Liquidity and Capital Resources**

Our principal demand for funds during the short and long-term is and will be for the acquisition of real estate and real estate-related investments, payment of operating expenses, capital expenditures and general and administrative expenses, payments under debt obligations, redemptions and purchases of our common stock and payments of distributions to stockholders. To date, we have had six primary sources of capital for meeting our cash requirements:

- Proceeds from the primary portion of our initial public offering;
- Proceeds from our dividend reinvestment plan;
- Proceeds from our public bond offering in Israel;
- Debt financing;
- Proceeds from the sale of real estate and the repayment of real estate-related investments; and
- Cash flow generated by our real estate and real estate-related investments.

We sold 56,584,976 shares of common stock in the primary portion of our initial public offering for gross offering proceeds of \$561.7 million. We ceased offering shares in the primary portion of our initial public offering on November 14, 2012. We continue to offer shares of common stock under the dividend reinvestment plan. As of June 30, 2019, we had sold 6,800,440 shares of common stock under the dividend reinvestment plan for gross offering proceeds of \$76.0 million. To date, we have invested all of the net proceeds from our initial public offering in real estate and real estate-related investments. We intend to use our cash on hand, proceeds from asset sales, proceeds from debt financing, cash flow generated by our real estate operations and real estate-related investments and proceeds from our dividend reinvestment plan as our primary sources of immediate and long-term liquidity.

Our investments in real estate generate cash flow in the form of rental revenues and tenant reimbursements, which are reduced by operating expenditures and corporate general and administrative expenses. Cash flow from operations from our real estate investments is primarily dependent upon the occupancy levels of our properties, the net effective rental rates on our leases, the collectibility of rent and operating recoveries from our tenants and how well we manage our expenditures. As of June 30, 2019, our office and retail properties were collectively 77% occupied and our apartment property was 94% occupied.

Investments in real estate equity securities generate cash flow in the form of dividend income, which is reduced by asset management fees. As of June 30, 2019, we had three investments in real estate equity securities outstanding with a total carrying value of \$65.3 million.

Under our charter, we are required to limit our total operating expenses to the greater of 2% of our average invested assets or 25% of our net income for the four most recently completed fiscal quarters, as these terms are defined in our charter, unless the conflicts committee of our board of directors has determined that such excess expenses were justified based on unusual and non-recurring factors. Operating expense reimbursements for the four fiscal quarters ended June 30, 2019 did not exceed the charter-imposed limitation.

For the six months ended June 30, 2019, our cash needs for capital expenditures, redemptions of common stock and debt servicing were met with proceeds from dispositions of real estate and undeveloped land, proceeds from debt financing, proceeds from our dividend reinvestment plan and cash on hand. Operating cash needs during the same period were met through cash flow generated by our real estate and real estate-related investments and cash on hand. As of June 30, 2019, we had outstanding debt obligations in the aggregate principal amount of \$673.0 million, with a weighted-average remaining term of 2.2 years. As of June 30, 2019, we had a total of \$146.8 million of debt obligations scheduled to mature within 12 months of that date. We plan to exercise our extension options available under our loan agreements or pay down or refinance the related notes payable prior to their maturity dates.

We have elected to be taxed as a REIT and intend to operate as a REIT. To maintain our qualification as a REIT, we are required to make aggregate annual distributions to our stockholders of at least 90% of our REIT taxable income (computed without regard to the dividends paid deduction and excluding net capital gain). Our board of directors may authorize distributions in excess of those required for us to maintain REIT status depending on our financial condition and such other factors as our board of directors deems relevant. We have not established a minimum distribution level.



## **PART I. FINANCIAL INFORMATION (CONTINUED)**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

#### ***Cash Flows from Operating Activities***

As of June 30, 2019, we consolidated seven office properties, one office portfolio consisting of four office buildings and 14 acres of undeveloped land, one retail property (which was held for sale), one apartment property and three investments in undeveloped land with approximately 1,000 developable acres and owned five investments in unconsolidated joint ventures and three investments in real estate equity securities. During the six months ended June 30, 2019, net cash used in operating activities was \$3.4 million. We expect that our cash flows from operating activities will increase in future periods as a result of leasing additional space that is currently unoccupied and anticipated future acquisitions of real estate and real estate-related investments. However, our cash flows from operating activities may decrease to the extent that we dispose of additional assets.

#### ***Cash Flows from Investing Activities***

Net cash provided by investing activities was \$55.4 million for the six months ended June 30, 2019 and primarily consisted of the following:

- Acquisition of an office property of \$90.3 million;
- Proceeds from the sale of real estate equity securities of \$24.1 million;
- Improvements to real estate of \$18.2 million;
- Proceeds from the sale of one apartment property of \$17.9 million;
- Distribution of capital from an unconsolidated joint venture of \$8.1 million;
- Proceeds from the principal repayment on real estate debt securities of \$7.8 million;
- Contributions to unconsolidated joint venture of \$5.0 million; and
- Insurance proceeds received for property damages of \$0.4 million.

#### ***Cash Flows from Financing Activities***

Net cash used in financing activities was \$15.0 million for the six months ended June 30, 2019 and consisted primarily of the following:

- \$20.7 million of net cash provided by debt and other financings as a result of proceeds from notes payable of \$84.3 million, partially offset by principal payments on notes and bonds payable of \$62.5 million and payments of deferred financing costs of \$1.1 million;
- \$5.1 million of cash used for redemptions of common stock;
- \$1.8 million of distributions to noncontrolling interests;
- \$1.8 million of net cash provided by the issuance of \$1.9 million of preferred membership units of our subsidiary, partially offset by sale commissions and other costs of \$0.1 million; and
- \$0.6 million of net cash distributions to stockholders, after giving effect to distributions reinvested by stockholders of \$0.6 million.

In order to execute our investment strategy, we utilize secured debt and we may, to the extent available, utilize unsecured debt, to finance a portion of our investment portfolio. Management remains vigilant in monitoring the risks inherent with the use of debt in our portfolio and is taking actions to ensure that these risks, including refinancing and interest risks, are properly balanced with the benefit of using leverage. There is no limitation on the amount we may borrow for any single investment. Our charter limits our total liabilities such that our total liabilities may not exceed 75% of the cost of our tangible assets; however, we may exceed that limit if a majority of the conflicts committee approves each borrowing in excess of our charter limitation and we disclose such borrowing to our common stockholders in our next quarterly report with an explanation from the conflicts committee of the justification for the excess borrowing. As of June 30, 2019, our borrowings and other liabilities were approximately 69% of the cost (before depreciation and other noncash reserves) and 68% of the book value (before depreciation) of our tangible assets.

In March 2016, we, through a wholly-owned subsidiary, issued 970.2 million Israeli new Shekels (approximately \$249.2 million as of March 8, 2016) in 4.25% bonds to investors in Israel pursuant to a public offering registered in Israel. The bonds have a seven year term, with principal payable in five equal annual installments from 2019 to 2023. On March 1, 2019, we paid the first principal installment payment of 194.0 million Israeli new Shekels (approximately \$53.6 million as of March 1, 2019). We have used the proceeds from the issuance of these bonds to make additional investments.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

In addition to making investments in accordance with our investment objectives, we use or have used our capital resources to make certain payments to our advisor and our dealer manager. During our offering stage, these payments included payments to our dealer manager for selling commissions and dealer manager fees related to sales in our primary offering and payments to our dealer manager and our advisor for reimbursement of certain organization and other offering expenses related both to the primary offering and the dividend reinvestment plan. During our acquisition and development stage, we expect to continue to make payments to our advisor in connection with the selection and origination or purchase of investments, the management of our assets and costs incurred by our advisor in providing services to us as well as for any dispositions of assets (including the discounted payoff of non-performing loans).

The advisory agreement has a one-year term but may be renewed for an unlimited number of successive one-year periods upon the mutual consent of our advisor and our conflicts committee. We may terminate the advisory agreement without cause or penalty upon providing 30 days' written notice and our advisor may terminate the advisory agreement without cause or penalty upon providing 90 days' written notice.

Among the fees payable to our advisor is an asset management fee. With respect to investments in loans and any investments other than real property, the asset management fee is a monthly fee calculated, each month, as one-twelfth of 0.75% of the lesser of (i) the amount actually paid or allocated to acquire or fund the loan or other investment, inclusive of fees and expenses related thereto and the amount of any debt associated with or used to acquire or fund such investment and (ii) the outstanding principal amount of such loan or other investment, plus the fees and expenses related to the acquisition or funding of such investment, as of the time of calculation. With respect to investments in real property, the asset management fee is a monthly fee equal to one-twelfth of 0.75% of the sum of the amount paid or allocated to acquire the investment, plus the cost of any subsequent development, construction or improvements to the property, and inclusive of fees and expenses related thereto and the amount of any debt associated with or used to acquire such investment. In the case of investments made through joint ventures, the asset management fee will be determined based on our proportionate share of the underlying investment, inclusive of our proportionate share of any fees and expenses related thereto.

**Contractual Commitments and Contingencies**

The following is a summary of our contractual obligations as of June 30, 2019 (in thousands):

Contractual Obligations	Total	Payments Due During the Years Ending December 31,			
		Remainder of 2019	2020-2021	2022-2023	Thereafter
Outstanding debt obligations <sup>(1)</sup>	\$ 672,962	\$ 41,142	\$ 382,599	\$ 244,066	\$ 5,155
Interest payments on outstanding debt obligations <sup>(2)</sup>	62,558	14,282	37,277	8,569	2,430

<sup>(1)</sup> Amounts include principal payments only.

<sup>(2)</sup> Projected interest payments are based on the outstanding principal amounts, maturity dates, foreign currency rates and interest rates in effect at June 30, 2019. We incurred interest expense of \$14.1 million, excluding amortization of deferred financing costs of \$1.7 million and including interest capitalized of \$1.4 million, for the six months ended June 30, 2019.



## **PART I. FINANCIAL INFORMATION (CONTINUED)**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

#### ***Participation Fee Liability***

Pursuant to the advisory agreement currently in effect with our advisor, our advisor is due a subordinated participation in our net cash flows (the "Incentive Fee") if, after the stockholders have received, together as a collective group, aggregate distributions (including distributions that may constitute a return of capital for federal income tax purposes) sufficient to provide (i) a return of their net invested capital, or the amount calculated by multiplying the total number of shares purchased by stockholders by the issue price, reduced by any amounts to repurchase shares pursuant to the share redemption program, and (ii) a 7.0% per year cumulative, noncompounded return on such net invested capital, our advisor is entitled to receive 15.0% of our net cash flows, whether from continuing operations, net sale proceeds or otherwise. Net sales proceeds means the net cash proceeds we realized after deduction of all expenses incurred in connection with a sale, including disposition fees paid to our advisor. The 7.0% per year cumulative, noncompounded return on net invested capital is calculated on a daily basis. In making this calculation, the net invested capital is reduced to the extent distributions in excess of a cumulative, noncompounded, annual return of 7.0% are paid (from whatever source), except to the extent such distributions would be required to supplement prior distributions paid in order to achieve a cumulative, noncompounded, annual return of 7.0% (invested capital is only reduced as described in this sentence; it is not reduced simply because a distribution constitutes a return of capital for federal income tax purposes). The 7.0% per year cumulative, noncompounded return is not based on the return provided to any individual stockholder. Accordingly, it is not necessary for each of the stockholders to have received any minimum return in order for our advisor to participate in our net cash flows. In fact, if our advisor is entitled to participate in our net cash flows, the returns of the stockholders will differ, and some may be less than a 7.0% per year cumulative, noncompounded return. This fee is payable only if we are not listed on an exchange.

On April 4, 2018, our stockholders approved the acceleration of the payment of such incentive compensation, subject to certain conditions. Such accelerated payment would require approval by a special committee of our board of directors in connection with our anticipated conversion into a net asset value REIT. Our advisor estimated the fair value of this liability to be as much as \$43 million as of June 30, 2019, based on a hypothetical liquidation of the assets and liabilities at their estimated fair values, after considering the impact of any potential closing costs and fees related to the disposition of real estate properties. The fair value of the Incentive Fee liability as of June 30, 2019 is based on the estimated fair values of our assets and liabilities as of that date and changes to the fair values of assets and liabilities could have a material impact to the Incentive Fee calculation. The Incentive Fee is not currently payable to our advisor, as it remains subject to further approval by the special committee and our conversion to a perpetual-life NAV REIT, and there is no guarantee that it will ever be payable.

#### **Results of Operations**

##### ***Overview***

As of June 30, 2018, we consolidated seven office properties (of which one office property was held for sale), one office portfolio consisting of four office buildings and 14 acres of undeveloped land, one office/flex/industrial portfolio consisting of 21 buildings, one retail property, two apartment properties and three investments in undeveloped land with approximately 1,100 developable acres and owned three investments in unconsolidated joint ventures, an investment in real estate debt securities and three investments in real estate equity securities. As of June 30, 2019, we consolidated seven office properties, one office portfolio consisting of four office buildings and 14 acres of undeveloped land, one retail property, one apartment property and three investments in undeveloped land with approximately 1,000 developable acres and owned five investments in unconsolidated joint ventures and three investments in real estate equity securities. Our results of operations for the three and six months ended June 30, 2019 may not be indicative of those in future periods due to acquisition and disposition activities. Additionally, the occupancy in our properties has not been stabilized. As of June 30, 2019, our office and retail properties were collectively 77% occupied and our apartment property was 94% occupied. However, due to the amount of near-term lease expirations, we do not put significant emphasis on quarterly changes in occupancy (positive or negative) in the short run. Our underwriting and valuations are generally more sensitive to "terminal values" that may be realized upon the disposition of the assets in the portfolio and less sensitive to ongoing cash flows generated by the portfolio in the years leading up to an eventual sale. There are no guarantees that occupancies of our assets will increase, or that we will recognize a gain on the sale of our assets. In general, we expect that our income and expenses related to our portfolio will increase in future periods as a result of leasing additional space and acquiring additional assets but decrease due to disposition activity.

**PART I. FINANCIAL INFORMATION (CONTINUED)**
**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**
*Comparison of the three months ended June 30, 2019 versus the three months ended June 30, 2018*

The following table provides summary information about our results of operations for the three months ended June 30, 2019 and 2018 (dollar amounts in thousands):

	Three Months Ended June 30,		Increase (Decrease)	Percentage Change	\$ Change Due to Acquisitions/ Dispositions <sup>(1)</sup>	\$ Change Due to Investments Held Throughout Both Periods <sup>(2)</sup>
	2019	2018				
Rental income	\$ 19,837	\$ 22,091	\$ (2,254)	(10)%	\$ (2,667)	\$ 413
Other operating income	1,509	1,479	30	2 %	(34)	64
Interest income from real estate debt securities	—	511	(511)	(100)%	(511)	—
Dividend income from real estate equity securities	343	1,209	(866)	(72)%	(866)	—
Operating, maintenance, and management costs	6,826	7,571	(745)	(10)%	(899)	154
Real estate taxes and insurance	3,301	3,435	(134)	(4)%	(92)	(42)
Asset management fees to affiliate	1,971	2,217	(246)	(11)%	(288)	42
General and administrative expenses	2,015	2,250	(235)	(10)%	n/a	n/a
Foreign currency transaction loss (gain), net	2,474	(10,111)	12,585	(124)%	n/a	n/a
Depreciation and amortization	8,357	9,042	(685)	(8)%	(788)	103
Interest expense	7,249	7,819	(570)	(7)%	(954)	384
Income from unconsolidated joint venture	—	131	(131)	(100)%	—	(131)
Equity in loss of unconsolidated joint ventures, net	(215)	(2,373)	2,158	(91)%	—	2,158
Other interest income	636	419	217	52 %	n/a	n/a
Gain on real estate equity securities	4,294	8,724	(4,430)	(51)%	(4,430)	—
(Loss) gain on sale of real estate	(6)	25	(31)	(124)%	(31)	—

<sup>(1)</sup> Represents the dollar amount increase (decrease) for the three months ended June 30, 2019 compared to the three months ended June 30, 2018 related to real estate and real estate-related investments acquired or disposed on or after April 1, 2018.

<sup>(2)</sup> Represents the dollar amount increase (decrease) for the three months ended June 30, 2019 compared to the three months ended June 30, 2018 with respect to real estate and real estate-related investments owned by us during the entirety of both periods presented.

Rental income decreased from \$22.1 million for the three months ended June 30, 2018 to \$19.8 million for the three months ended June 30, 2019, primarily as a result of properties disposed in 2018 and 2019, partially offset by properties acquired in 2018 and 2019 and an overall increase in rental rates. The occupancy of our office and retail properties, collectively, held throughout both periods remained consistent at 75% as of June 30, 2018 and June 30, 2019. Annualized base rent per square foot increased from \$23.28 as of June 30, 2018 to \$24.06 as of June 30, 2019 related to properties (excluding apartments) held throughout both periods. We expect rental income to increase in future periods as a result of owning the property acquired during 2019 for an entire period, leasing additional space and to the extent we acquire additional properties, but to decrease to the extent we dispose of properties.

Other operating income remained consistent at \$1.5 million for the three months ended June 30, 2018. We expect other operating income to increase in future periods as a result of owning the property acquired during 2019 for an entire period, leasing additional space, increases in parking income as we stabilize properties and to the extent we acquire additional properties.

Interest income from real estate debt securities decreased from \$0.5 million for the three months ended June 30, 2018 to \$0 for the three months ended June 30, 2019, primarily as a result of the redemption of real estate debt securities on March 20, 2019.

Dividend income from real estate equity securities decreased from \$1.2 million for the three months ended June 30, 2018 to \$0.3 million for the three months ended June 30, 2019, primarily as a result of the sale of real estate equity securities in 2018 and 2019. We expect dividend income from real estate equity securities to vary in future periods as a result of the timing of dividends declared and investment activity.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

Property operating costs and real estate taxes and insurance decreased from \$7.6 million and \$3.4 million, respectively, for the three months ended June 30, 2018 to \$6.8 million and \$3.3 million, respectively, for the three months ended June 30, 2019, primarily as a result of properties disposed in 2018 and 2019, partially offset by properties acquired in 2018 and 2019. We expect property operating costs and real estate taxes and insurance to increase in future periods as a result of owning the property acquired during 2019 for an entire period, to the extent we acquire additional properties, increasing occupancy of our real estate assets and general inflation, but to decrease to the extent we dispose of properties.

Asset management fees decreased from \$2.2 million for the three months ended June 30, 2018 to \$2.0 million for the three months ended June 30, 2019, primarily as a result of properties disposed in 2018 and 2019, partially offset by properties acquired in 2018 and 2019. We expect asset management fees to increase in future periods as a result of owning the property acquired during 2019 for an entire period and capital expenditures and to the extent we acquire additional properties, but to decrease to the extent we dispose of properties. All asset management fees incurred as of June 30, 2019 have been paid.

General and administrative expenses decreased from \$2.3 million for the three months ended June 30, 2018 to \$2.0 million for the three months ended June 30, 2019, primarily due to decreased legal expenses incurred to evaluate certain strategic transactions. We expect general and administrative expenses to fluctuate in future periods based on investment and disposition activity as well as costs incurred to evaluate strategic transactions.

We recognized \$2.5 million of foreign currency transaction loss, net for the three months ended June 30, 2019 and \$10.1 million of foreign currency transaction gain, net, for the three months ended June 30, 2018, related to the Series A debentures in Israel. These debentures are denominated in Israeli new Shekels and we expect to recognize foreign transaction gains and losses based on changes in foreign currency exchange rates, but expect our exposure to be limited to the extent that we have entered into foreign currency options and foreign currency collars. As of June 30, 2019, we had entered into one foreign currency collar to hedge against a change in the exchange rate of the Israeli new Shekel versus the U.S. Dollar. The foreign currency collar expires in August 2019 and has an aggregate Israeli new Shekels notional amount of 776.2 million. During the three months ended June 30, 2019, we recognized a \$1.2 million gain related to the foreign currency collars, which is shown net against \$3.7 million of foreign currency transaction loss in the accompanying consolidated statements of operations as foreign currency transaction loss, net. During the three months ended June 30, 2018, we recognized a \$2.2 million loss related to the foreign currency option, which is shown net against \$12.3 million of foreign currency transaction gain in the accompanying consolidated statements of operations as foreign currency transaction loss, net.

Depreciation and amortization decreased from \$9.0 million for the three months ended June 30, 2018 to \$8.4 million for the three months ended June 30, 2019, primarily as a result of properties disposed in 2018 and 2019, partially offset by properties acquired in 2018 and 2019. We expect depreciation and amortization to increase in future periods as a result of owning the property acquired during 2019 for an entire period and to the extent we acquire additional properties, but to decrease as a result of amortization of tenant origination costs related to lease expirations and disposition of properties.

Interest expense decreased from \$7.8 million for the three months ended June 30, 2018 to \$7.2 million for the three months ended June 30, 2019, primarily as a result of the paydown of debt on properties disposed in 2018 and 2019 and the March 1, 2019 Debentures principal installment payment of 194.0 million Israeli new Shekels (approximately \$53.6 million as of March 1, 2019), partially offset by increased borrowings related to properties acquired in 2018 and increased one-month LIBOR rates during the three months ended June 30, 2019. Excluded from interest expense was \$0.7 million and \$0.6 million of interest capitalized to our investments in undeveloped land during the three months ended June 30, 2019 and 2018, respectively. Our interest expense in future periods will vary based on interest rate fluctuations, the amount of interest capitalized and our level of future borrowings, which will depend on the availability and cost of debt financing and the opportunity to acquire real estate and real estate-related investments meeting our investment objectives and will decrease to the extent we dispose of properties and paydown debt, including annual principal installment payments on the Debentures.

During the three months ended June 30, 2019, we received a distribution of \$0.3 million related to our investment in the NIP Joint Venture. We recognized \$0.3 million of return of capital from the NIP Joint Venture. During the three months ended June 30, 2018, we received a distribution of \$0.9 million related to our investment in the NIP Joint Venture. We recognized \$0.1 million of income distributions and \$0.8 million of return of capital from the NIP Joint Venture.

Equity in loss of unconsolidated joint ventures decreased from a loss of \$2.4 million for the three months ended June 30, 2018 to a loss of \$0.2 million for the three months ended June 30, 2019, primarily as a result of the 110 William Joint Venture not recording any equity in loss for the three months ended June 30, 2019 and an increase in occupancy at 353 Sacramento Street. See the results of operations for the six months ended June 30, 2019 and 2018 for further discussion.

**PART I. FINANCIAL INFORMATION (CONTINUED)**
**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

Other interest income increased from \$0.4 million for the three months ended June 30, 2018 to \$0.6 million for the three months ended June 30, 2019, primarily as a result of increased dividends from money market mutual funds due to our increased investment balance in these funds.

Gain on real estate equity securities was \$8.7 million for the three months ended June 30, 2018. Gain on real estate equity securities was \$4.3 million for the three months ended June 30, 2019. We expect gain (loss) on real estate equity securities to fluctuate in future periods as a result of changes in share prices of our investments in real estate equity securities.

*Comparison of the six months ended June 30, 2019 versus the six months ended June 30, 2018*

The following table provides summary information about our results of operations for the six months ended June 30, 2019 and 2018 (dollar amounts in thousands):

	Six Months Ended June 30,		Increase (Decrease)	Percentage Change	\$ Change Due to Acquisitions/ Dispositions <sup>(1)</sup>	\$ Change Due to Investments Held Throughout Both Periods <sup>(2)</sup>
	2019	2018				
Rental income	\$ 38,210	\$ 39,439	\$ (1,229)	(3)%	\$ (1,858)	\$ 629
Other operating income	2,902	2,214	688	31 %	551	137
Interest income from real estate debt securities	369	1,012	(643)	(64)%	(643)	—
Dividend income from real estate equity securities	2,119	2,260	(141)	(6)%	(141)	—
Operating, maintenance, and management costs	13,098	13,058	40	— %	(204)	244
Real estate taxes and insurance	6,279	5,773	506	9 %	360	146
Asset management fees to affiliate	3,861	4,043	(182)	(5)%	(219)	37
General and administrative expenses	3,548	4,302	(754)	(18)%	n/a	n/a
Foreign currency transaction loss (gain), net	5,290	(9,114)	14,404	(158)%	n/a	n/a
Depreciation and amortization	16,037	16,307	(270)	(2)%	(474)	204
Interest expense	14,417	14,410	7	— %	(18)	25
Income from unconsolidated joint venture	—	185	(185)	(100)%	—	(185)
Equity in income (loss) of unconsolidated joint ventures, net	7,096	(4,751)	11,847	(249)%	—	11,847
Other interest income	1,327	1,349	(22)	(2)%	n/a	n/a
Gain (loss) on real estate equity securities	15,459	(7,287)	22,746	(312)%	22,746	—
Gain on sale of real estate	7,569	649	6,920	1,066 %	6,920	—
Loss on extinguishment of debt	(856)	—	(856)	n/a	(856)	—

<sup>(1)</sup> Represents the dollar amount increase (decrease) for the six months ended June 30, 2019 compared to the six months ended June 30, 2018 related to real estate and real estate-related investments acquired or disposed on or after January 1, 2018.

<sup>(2)</sup> Represents the dollar amount increase (decrease) for the six months ended June 30, 2019 compared to the six months ended June 30, 2018 with respect to real estate and real estate-related investments owned by us during the entirety of both periods presented.

Rental income decreased from \$39.4 million for the six months ended June 30, 2018 to \$38.2 million for the six months ended June 30, 2019, primarily as a result of properties disposed in 2018 and 2019, partially offset by properties acquired in 2018 and 2019 and an overall increase in rental rates. The occupancy of our office and retail properties, collectively, held throughout both periods decreased from 76% as of June 30, 2018 to 75% as of June 30, 2019. Annualized base rent per square foot increased from \$21.85 as of June 30, 2018 to \$22.63 as of June 30, 2019 related to properties (excluding apartments) held throughout both periods. We expect rental income to increase in future periods as a result of owning the property acquired during 2019 for an entire period, leasing additional space and to the extent we acquire additional properties, but to decrease to the extent we dispose of properties.

Other operating income increased from \$2.2 million for the six months ended June 30, 2018 to \$2.9 million for the six months ended June 30, 2019, primarily as a result of properties acquired in 2018 and 2019, partially offset by properties disposed in 2018 and 2019. We expect other operating income to increase in future periods as a result of owning the property acquired during 2019 for an entire period, leasing additional space, increases in parking income as we stabilize properties and to the extent we acquire additional properties.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

Interest income from real estate debt securities decreased from \$1.0 million for the six months ended June 30, 2018 to \$0.4 million for the six months ended June 30, 2019, primarily as a result of a decrease in average principal balance outstanding. We expect interest income from real estate debt securities to decrease as a result of the redemption of real estate debt securities on March 20, 2019.

Dividend income from real estate equity securities decreased from \$2.3 million for the six months ended June 30, 2018 to \$2.1 million for the six months ended June 30, 2019, primarily as a result of the sale of real estate equity securities in 2018 and 2019, partially offset by the timing of the Keppel-KBS US REIT dividends declared in 2019 and additional real estate equity securities acquired in 2018. We expect dividend income from real estate equity securities to vary in future periods as a result of the timing of dividends declared and investment activity.

Property operating costs and real estate taxes and insurance increased from \$13.1 million and \$5.8 million, respectively, for the six months ended June 30, 2018 to \$13.1 million and \$6.3 million, respectively, for the six months ended June 30, 2019, primarily as a result of properties disposed in 2018 and 2019, partially offset by properties acquired in 2018 and 2019. Real estate taxes and insurance related to properties held through both periods increased during the six months ended June 30, 2019 primarily as a result of a property tax reassessment of 125 John Carpenter. We expect property operating costs and real estate taxes and insurance to increase in future periods as a result of owning the property acquired during 2019 for an entire period, to the extent we acquire additional properties, increasing occupancy of our real estate assets and general inflation, but to decrease to the extent we dispose of properties.

Asset management fees decreased from \$4.0 million for the six months ended June 30, 2018 to \$3.9 million for the six months ended June 30, 2019, primarily as a result of properties disposed in 2018 and 2019, partially offset by properties acquired in 2018 and 2019. We expect asset management fees to increase in future periods as a result of owning the property acquired during 2019 for an entire period and capital expenditures and to the extent we acquire additional properties, but to decrease to the extent we dispose of properties. All asset management fees incurred as of June 30, 2019 have been paid.

General and administrative expenses decreased from \$4.3 million for the six months ended June 30, 2018 to \$3.5 million for the six months ended June 30, 2019, primarily due to decreased legal expenses incurred to evaluate certain strategic transactions. We expect general and administrative expenses to fluctuate in future periods based on investment and disposition activity as well as costs incurred to evaluate strategic transactions.

We recognized \$5.3 million of foreign currency transaction loss, net, for the six months ended June 30, 2019 and \$9.1 million of foreign currency transaction gain, net, related to the Series A debentures in Israel. These debentures are denominated in Israeli new Shekels and we expect to recognize foreign transaction gains and losses based on changes in foreign currency exchange rates, but expect our exposure to be limited to the extent that we have entered into foreign currency options and foreign currency collars. As of June 30, 2019, we had entered into one foreign currency collar to hedge against a change in the exchange rate of the Israeli new Shekel versus the U.S. Dollar. The foreign currency collar expires in August 2019 and has an aggregate Israeli new Shekels notional amount of 776.2 million. During the six months ended June 30, 2019, we recognized a \$4.2 million gain related to the foreign currency collars, which is shown net against \$9.5 million of foreign currency transaction loss in the accompanying consolidated statements of operations as foreign currency transaction loss, net. During the six months ended June 30, 2018, we recognized a \$4.3 million loss related to a foreign currency option, which is shown net against \$13.4 million of foreign currency transaction gain in the accompanying consolidated statements of operations as foreign currency transaction loss, net.

Depreciation and amortization decreased from \$16.3 million for the six months ended June 30, 2018 to \$16.0 million for the six months ended June 30, 2019, primarily as a result of properties disposed in 2018 and 2019, partially offset by properties acquired in 2018 and 2019. We expect depreciation and amortization to increase in future periods as a result of owning the property acquired during 2019 for an entire period and to the extent we acquire additional properties, but to decrease as a result of amortization of tenant origination costs related to lease expirations and disposition of properties.



## **PART I. FINANCIAL INFORMATION (CONTINUED)**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

Interest expense remained consistent at \$14.4 million for the six months ended June 30, 2018 and 2019, primarily as a result of increased borrowings related to properties acquired in 2018 and 2019 and increased one-month LIBOR rates during the six months ended June 30, 2019, partially offset by the paydown of debt on properties disposed in 2018 and 2019 and the March 1, 2019 Debentures principal installment payment of 194.0 million Israeli new Shekels (approximately \$53.6 million as of March 1, 2019). Excluded from interest expense was \$1.4 million and \$1.3 million of interest capitalized to our investments in undeveloped land during the six months ended June 30, 2019 and 2018, respectively. Our interest expense in future periods will vary based on interest rate fluctuations, the amount of interest capitalized and our level of future borrowings, which will depend on the availability and cost of debt financing and the opportunity to acquire real estate and real estate-related investments meeting our investment objectives and will decrease to the extent we dispose of properties and paydown debt, including annual principal installment payments on the Debentures.

During the six months ended June 30, 2019, we received a distribution of \$0.3 million related to our investment in the NIP Joint Venture. We recognized \$0.3 million of return of capital from the NIP Joint Venture. During the six months ended June 30, 2018, we received a distribution of \$1.3 million related to our investment in the NIP Joint Venture. We recognized \$0.2 million of income distributions and \$1.1 million of return of capital from the NIP Joint Venture.

Equity in loss of unconsolidated joint ventures was \$4.8 million for the six months ended June 30, 2018. Equity in income of unconsolidated joint ventures was \$7.1 million for the six months ended June 30, 2019, primarily as a result of a \$7.8 million distribution from the 110 William Joint Venture funded with proceeds from the 110 William refinancing. During the six months ended June 30, 2019, we recorded \$7.5 million equity in income from the 110 William Joint Venture, which includes a \$7.8 million gain related to a distribution received, net of our share of net losses of \$0.3 million. We will not record any subsequent equity in income for the 110 William Joint Venture until subsequent equity in income equals the gain recorded. Equity in loss of unconsolidated joint ventures decreased from a loss of \$1.6 million to a loss of \$0.4 million related to the 353 Sacramento Joint Venture primarily due to an increase in occupancy.

Other interest income remained consistent at \$1.3 million for the six months ended June 30, 2018 and 2019.

Loss on real estate equity securities was \$7.3 million for the six months ended June 30, 2018, all of which was unrealized loss. Gain on real estate equity securities was \$15.5 million for the six months ended June 30, 2019, which was made up of \$12.1 million unrealized gain on real estate securities held at June 30, 2019 and a \$3.4 million realized gain on real estate securities sold during the six months ended June 30, 2019. We expect gain (loss) on real estate equity securities to fluctuate in future periods as a result of changes in share prices of our investments in real estate equity securities.

During the six months ended June 30, 2018, we sold 26 acres of undeveloped land that resulted in a gain on sale of \$0.6 million, which was net of deferred profit of \$0.3 million related to proceeds received from the purchaser for the value of land that was contributed to a master association that we consolidated. During the six months ended June 30, 2019, we sold one apartment property, which resulted in a gain on sale of \$7.6 million.

During the six months ended June 30, 2019, we recognized loss on extinguishment of debt of \$0.9 million related to debt repayments in connection with a real estate disposition.

### **Funds from Operations, Modified Funds from Operations and Adjusted Modified Funds from Operations**

We believe that funds from operations (“FFO”) is a beneficial indicator of the performance of an equity REIT. We compute FFO in accordance with the current National Association of Real Estate Investment Trusts (“NAREIT”) definition. FFO represents net income, excluding gains and losses from sales of real estate assets (which can vary among owners of identical assets in similar conditions based on historical cost accounting and useful-life estimates), impairment losses on real estate assets, depreciation and amortization of real estate assets, and adjustments for unconsolidated partnerships and joint ventures. In addition, we elected the option to exclude mark-to-market changes in value recognized on equity securities in the calculation of FFO. We believe FFO facilitates comparisons of operating performance between periods and among other REITs. However, our computation of FFO may not be comparable to other REITs that do not define FFO in accordance with the NAREIT definition or that interpret the current NAREIT definition differently than we do. Our management believes that historical cost accounting for real estate assets in accordance with U.S. Generally Accepted Accounting Principles (“GAAP”) implicitly assumes that the value of real estate assets diminishes predictably over time. Since real estate values have historically risen or fallen with market conditions, many industry investors and analysts have considered the presentation of operating results for real estate companies that use historical cost accounting to be insufficient by themselves. As a result, we believe that the use of FFO, together with the required GAAP presentations, provides a more complete understanding of our performance relative to our competitors and provides a more informed and appropriate basis on which to make decisions involving operating, financing, and investing activities.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

Changes in accounting rules have resulted in a substantial increase in the number of non-operating and non-cash items included in the calculation of FFO. As a result, our management also uses modified funds from operations (“MFFO”) as an indicator of our ongoing performance as well as our dividend sustainability. MFFO excludes from FFO: acquisition fees and expenses (to the extent that such fees and expenses have been recorded as operating expenses); adjustments related to contingent purchase price obligations; amounts relating to straight-line rents and amortization of above- and below-market intangible lease assets and liabilities; accretion of discounts and amortization of premiums on debt investments; amortization of closing costs relating to debt investments; impairments of real estate-related investments; mark-to-market adjustments included in net income; and gains or losses included in net income for the extinguishment or sale of debt or hedges. We compute MFFO in accordance with the definition of MFFO included in the practice guideline issued by the Institute for Portfolio Alternatives (“IPA”) in November 2010 as interpreted by management. Our computation of MFFO may not be comparable to other REITs that do not compute MFFO in accordance with the current IPA definition or that interpret the current IPA definition differently than we do.

In addition, our management uses an adjusted MFFO (“Adjusted MFFO”) as an indicator of our ongoing performance, as well as our dividend sustainability. Adjusted MFFO provides adjustments to reduce MFFO related to operating expenses that are capitalized with respect to certain of our investments in undeveloped land.

We believe that MFFO and Adjusted MFFO are helpful as measures of ongoing operating performance because they exclude costs that management considers more reflective of investing activities and other non-operating items included in FFO. Management believes that excluding acquisition costs, prior to our early adoption of ASU No. 2017-01 on January 1, 2017, from MFFO and Adjusted MFFO provides investors with supplemental performance information that is consistent with management’s analysis of the operating performance of the portfolio over time, including periods after our acquisition stage. MFFO and Adjusted MFFO also exclude non-cash items such as straight-line rental revenue. Additionally, we believe that MFFO and Adjusted MFFO provide investors with supplemental performance information that is consistent with the performance indicators and analysis used by management, in addition to net income and cash flows from operating activities as defined by GAAP, to evaluate the sustainability of our operating performance. MFFO provides comparability in evaluating the operating performance of our portfolio with other non-traded REITs which typically have limited lives with short and defined acquisition periods and targeted exit strategies. MFFO, or an equivalent measure, is routinely reported by non-traded REITs, and we believe often used by analysts and investors for comparison purposes.

FFO, MFFO and Adjusted MFFO are non-GAAP financial measures and do not represent net income as defined by GAAP. Net income as defined by GAAP is the most relevant measure in determining our operating performance because FFO, MFFO and Adjusted MFFO include adjustments that investors may deem subjective, such as adding back expenses such as depreciation and amortization and the other items described above. Accordingly, FFO, MFFO and Adjusted MFFO should not be considered as alternatives to net income as an indicator of our current and historical operating performance. In addition, FFO, MFFO and Adjusted MFFO do not represent cash flows from operating activities determined in accordance with GAAP and should not be considered an indication of our liquidity. We believe FFO, MFFO and Adjusted MFFO, in addition to net income and cash flows from operating activities as defined by GAAP, are meaningful supplemental performance measures.



**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

Although MFFO includes other adjustments, the exclusion of straight-line rent, the amortization of above- and below-market leases, the accretion of interest income on real estate debt securities, mark to market foreign currency transaction adjustments and extinguishment of debt are the most significant adjustments for the periods presented. We have excluded these items based on the following economic considerations:

- *Adjustments for straight-line rent.* These are adjustments to rental revenue as required by GAAP to recognize contractual lease payments on a straight-line basis over the life of the respective lease. We have excluded these adjustments in our calculation of MFFO to more appropriately reflect the current economic impact of our in-place leases, while also providing investors with a useful supplemental metric that addresses core operating performance by removing rent we expect to receive in a future period or rent that was received in a prior period;
- *Amortization of above- and below-market leases.* Similar to depreciation and amortization of real estate assets and lease related costs that are excluded from FFO, GAAP implicitly assumes that the value of intangible lease assets and liabilities diminishes predictably over time and requires that these charges be recognized currently in revenue. Since market lease rates in the aggregate have historically risen or fallen with local market conditions, management believes that by excluding these charges, MFFO provides useful supplemental information on the realized economics of the real estate;
- *Accretion of interest income on real estate debt securities.* Discounts and closing costs related to debt investments are accreted/amortized over the term of the loan as an adjustment to interest income. This application results in income recognition that is different than the underlying contractual terms of the debt investments. We have excluded the accretion of interest income on real estate debt securities in our calculation of MFFO to more appropriately reflect the economic impact of our debt investments, as discounts will not be economically recognized until the loan is repaid and closing costs are essentially the same as acquisition fees and expenses on real estate. We believe excluding these items provides investors with a useful supplemental metric that directly addresses core operating performance;
- *Mark-to-market foreign currency transaction adjustments.* The U.S. Dollar is our functional currency. Transactions denominated in currency other than our functional currency are recorded upon initial recognition at the exchange rate on the date of the transaction. After initial recognition, monetary assets and liabilities denominated in foreign currency are remeasured at each reporting date into the foreign currency at the exchange rate on that date. In addition, we have entered into foreign currency collars and foreign currency options that results in a foreign currency transaction adjustment. These amounts can increase or reduce net income. We exclude them from MFFO to more appropriately present the ongoing operating performance of our real estate investments on a comparative basis; and
- *Loss on extinguishment of debt.* A loss on extinguishment of debt, which includes prepayment fees related to the extinguishment of debt, represents the difference between the carrying value of any consideration transferred to the lender in return for the extinguishment of a debt and the net carrying value of the debt at the time of settlement. We have excluded the loss from extinguishment of debt in our calculation of MFFO because these losses do not impact the current operating performance of our investments and do not provide an indication of future operating performance.

Adjusted MFFO includes adjustments to reduce MFFO related to real estate taxes, property insurance and financing costs which are capitalized with respect to certain of our investments in undeveloped land. We have included adjustments for the costs incurred necessary to bring these investments to their intended use, as these costs are recurring operating costs that are capitalized in accordance with GAAP and not reflected in our net (loss) income, FFO and MFFO.

**PART I. FINANCIAL INFORMATION (CONTINUED)**
**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

Our calculation of FFO, which we believe is consistent with the calculation of FFO as defined by NAREIT, is presented in the following table, along with our calculations of MFFO and Adjusted MFFO, for the three and six months ended June 30, 2019 and 2018 (in thousands). No conclusions or comparisons should be made from the presentation of these periods.

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2019	2018	2019	2018
Net (loss) income attributable to common stockholders	\$ (6,249)	\$ 10,036	\$ 10,532	\$ (13,645)
Depreciation of real estate assets	4,858	4,878	9,282	8,996
Amortization of lease-related costs	3,499	4,164	6,755	7,311
Loss (gain) on sale of real estate <sup>(1)</sup>	6	(25)	(7,569)	(649)
(Gain) loss on real estate equity securities	(4,294)	(8,724)	(15,459)	7,287
Adjustments for noncontrolling interests - consolidated entities <sup>(2)</sup>	(79)	(122)	625	(243)
Adjustments for investments in unconsolidated entities <sup>(3)</sup>	1,671	3,249	(5,058)	6,588
FFO attributable to common stockholders	(588)	13,456	(892)	15,645
Straight-line rent and amortization of above- and below-market leases	(1,244)	(1,199)	(2,766)	(2,100)
Accretion of interest income on real estate debt securities	—	(21)	(13)	(128)
Amortization of net premium/discount on bond and notes payable	(26)	15	(46)	29
Loss on extinguishment of debt	—	—	856	—
Unrealized loss on interest rate caps	7	62	37	31
Mark-to-market foreign currency transaction loss (gain), net	2,474	(10,111)	5,290	(9,114)
Adjustments for noncontrolling interests - consolidated entities <sup>(2)</sup>	(94)	(1)	(92)	2
Adjustments for investments in unconsolidated entities <sup>(3)</sup>	(1,389)	(440)	(3,006)	(1,096)
MFFO attributable to common stockholders	(860)	1,761	(632)	3,269
Other capitalized operating expenses <sup>(4)</sup>	(772)	(693)	(1,536)	(1,439)
Casualty-related loss	506	—	506	—
Adjustments for noncontrolling interests - consolidated entities <sup>(2)</sup>	(51)	—	(51)	—
Adjusted MFFO attributable to common stockholders	\$ (1,177)	\$ 1,068	\$ (1,713)	\$ 1,830

<sup>(1)</sup> Reflects an adjustment to eliminate gain on sale of real estate, which includes undepreciated land sales.

<sup>(2)</sup> Reflects adjustments to eliminate the noncontrolling interest holders' share of the adjustments to convert our net (loss) income attributable to common stockholders to FFO, MFFO and Adjusted MFFO.

<sup>(3)</sup> Reflects adjustments to add back our noncontrolling interest share of the adjustments to convert our net (loss) income attributable to common stockholders to FFO, MFFO and Adjusted MFFO for our equity investments in unconsolidated joint ventures.

<sup>(4)</sup> Reflects real estate taxes, property insurance and financing costs that are capitalized with respect to certain of our investments in undeveloped land. During the periods in which we are incurring costs necessary to bring these investments to their intended use, certain normal recurring operating costs are capitalized in accordance with GAAP and not reflected in our net (loss) income, FFO and MFFO.

FFO, MFFO and Adjusted MFFO may also be used to fund all or a portion of certain capitalizable items that are excluded from FFO, MFFO and Adjusted MFFO, such as tenant improvements, building improvements and deferred leasing costs. We expect FFO, MFFO and Adjusted MFFO to improve in future periods to the extent that we continue to lease up vacant space and acquire additional assets. We expect FFO, MFFO and Adjusted MFFO to decrease as a result of dispositions.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

**Distributions**

Distributions declared, distributions paid and cash flows provided by operations were as follows for the first and second quarters of 2019 (in thousands, except per share amounts):

Period	Distribution Declared	Distributions Declared Per Share	Distributions Paid <sup>(1)</sup>			Cash Flows (Used In) Provided by Operations
			Cash	Reinvested	Total	
First Quarter 2019	\$ 578	\$ 0.009	\$ 292	\$ 286	\$ 578	\$ (7,573)
Second Quarter 2019	573	0.009	295	278	573	4,159
	\$ 1,151	\$ 0.018	\$ 587	\$ 564	\$ 1,151	\$ (3,414)

On March 7, 2019, our board of directors authorized a distribution in the amount of \$0.00860000 per share of common stock to stockholders of record as of the close of business on March 14, 2019. We paid this distribution on March 19, 2019 and this was the only distribution declared during the first quarter of 2019.

On May 13, 2019, our board of directors authorized a distribution in the amount of \$0.00860000 per share of common stock to stockholders of record as of the close of business on June 14, 2019. We paid this distribution on June 19, 2019 and this was the only distribution declared during the second quarter of 2019.

For the six months ended June 30, 2019, we paid aggregate distributions of \$1.2 million, including \$0.6 million of distributions paid in cash and \$0.6 million of distributions reinvested through our dividend reinvestment plan. Our net income attributable to common stockholders for the six months ended June 30, 2019 was \$10.5 million and our cash flows used in operations were \$3.4 million. Our cumulative distributions paid and net income attributable to common stockholders from inception through June 30, 2019 were \$194.2 million and \$197.2 million, respectively. We have funded our cumulative distributions paid, which includes net cash distributions and distributions reinvested by stockholders, with proceeds from debt financing of \$18.7 million, proceeds from the dispositions of property of \$83.4 million and cash provided by operations of \$92.1 million. To the extent that we pay distributions from sources other than our cash flow from operations or gains from asset sales, we will have fewer funds available for investment in real estate-related loans, opportunistic real estate, real estate-related debt securities and other real estate-related investments, the overall return to our stockholders may be reduced and subsequent investors may experience dilution.

**Critical Accounting Policies**

Our consolidated interim financial statements have been prepared in accordance with GAAP and in conjunction with the rules and regulations of the SEC. The preparation of our financial statements requires significant management judgments and assumptions, require estimates about matters that are inherently uncertain and because they are important for understanding and evaluating our reported financial results. These judgments will affect the reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. With different estimates or assumptions, materially different amounts could be reported in our financial statements. Additionally, other companies may utilize different estimates that may impact the comparability of our results of operations to those of companies in similar businesses. A discussion of the accounting policies that management considers critical in that they involve significant management judgments, assumptions and estimates is included in our Annual Report on Form 10-K for the year ended December 31, 2018 filed with the SEC. There have been no significant changes to our policies during 2019, except for our adoption of the lease accounting standards issued by the Financial Accounting Standards Board effective on January 1, 2019.

**Revenue Recognition - Operating Leases**

**Real Estate**

On January 1, 2019, we adopted the lease accounting standards under Topic 842 including the package of practical expedients for all leases that commenced before the effective date of January 1, 2019. Accordingly, we (i) did not reassess whether any expired or existing contracts are or contain leases, (ii) did not reassess the lease classification for any expired or existing lease, and (iii) did not reassess initial direct costs for any existing leases. We did not elect the practical expedient related to using hindsight to reevaluate the lease term. In addition, we adopted the practical expedient for land easements and did not assess whether existing or expired land easements that were not previously accounted for as leases under the lease accounting standards of Topic 840 are or contain a lease under Topic 842.

## **PART I. FINANCIAL INFORMATION (CONTINUED)**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

In addition, Topic 842 provides an optional transition method to allow entities to apply the new lease accounting standards at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings. We adopted this transition method upon its adoption of the lease accounting standards of Topic 842, which did not result in a cumulative effect adjustment to the opening balance of retained earnings on January 1, 2019. Our comparative periods presented in the financial statements will continue to be reported under the lease accounting standards of Topic 840.

In accordance with Topic 842, tenant reimbursements for property taxes and insurance are included in the single lease component of the lease contract (the right of the lessee to use the leased space) and therefore are accounted for as variable lease payments and are recorded as rental income on our statement of operations beginning January 1, 2019. In addition, we adopted the practical expedient available under Topic 842 to not separate nonlease components from the associated lease component and instead to account for those components as a single component if the nonlease components otherwise would be accounted for under the new revenue recognition standard (Topic 606) and if certain conditions are met, specifically related to tenant reimbursements for common area maintenance which would otherwise be accounted for under the revenue recognition standard. We believe the two conditions have been met for tenant reimbursements for common area maintenance as (i) the timing and pattern of transfer of the nonlease components and associated lease components are the same and (ii) the lease component would be classified as an operating lease. Accordingly, tenant reimbursements for common area maintenance are also accounted for as variable lease payments and recorded as rental income on our statement of operations beginning January 1, 2019.

We recognize minimum rent, including rental abatements, lease incentives and contractual fixed increases attributable to operating leases, on a straight-line basis over the term of the related leases when collectibility is probable and records amounts expected to be received in later years as deferred rent receivable. If the lease provides for tenant improvements, we determine whether the tenant improvements, for accounting purposes, are owned by the tenant or by us. When we are the owner of the tenant improvements, the tenant is not considered to have taken physical possession or have control of the physical use of the leased asset until the tenant improvements are substantially completed. When the tenant is the owner of the tenant improvements, any tenant improvement allowance (including amounts that can be taken in the form of cash or a credit against the tenant's rent) that is funded is treated as a lease incentive and amortized as a reduction of rental revenue over the lease term. Tenant improvement ownership is determined based on various factors including, but not limited to:

- whether the lease stipulates how a tenant improvement allowance may be spent;
- whether the lessee or lessor supervises the construction and bears the risk of cost overruns;
- whether the amount of a tenant improvement allowance is in excess of market rates;
- whether the tenant or landlord retains legal title to the improvements at the end of the lease term;
- whether the tenant improvements are unique to the tenant or general purpose in nature; and
- whether the tenant improvements are expected to have any residual value at the end of the lease.

We lease apartment units under operating leases with terms generally of one year or less. Generally, credit investigations will be performed for prospective residents and security deposits will be obtained. We recognize rental revenue, net of concessions, on a straight-line basis over the term of the lease, when collectibility is determined to be probable.

In accordance with Topic 842, we make a determination of whether the collectibility of the lease payments in an operating lease is probable. If we determine the lease payments are not probable of collection, we would fully reserve for any contractual lease payments, deferred rent receivable, and tenant reimbursements and would recognize rental income only if cash is received. Beginning January 1, 2019, these changes to our collectibility assessment are reflected as an adjustment to rental income. Prior to January 1, 2019, bad debt expense related to uncollectible accounts receivable and deferred rent receivable was included in operating, maintenance, and management expense in the statement of operations. Any subsequent changes to the collectibility of the allowance for doubtful accounts as of December 31, 2018, which was recorded prior to the adoption of Topic 842, are recorded in operating, maintenance, and management expense in the statement of operations.

Beginning January 1, 2019, we, as a lessor, record costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained, such as legal costs incurred to negotiate an operating lease as an expense and classify such costs as operating, maintenance, and management expense on our consolidated statement of operations, as these costs are no longer capitalizable under the definition of initial direct costs under Topic 842.

**PART I. FINANCIAL INFORMATION (CONTINUED)**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

**Subsequent Events**

We evaluate subsequent events up until the date the consolidated financial statements are issued.

***Distribution Declared***

On August 8, 2019, our board of directors authorized a distribution in the amount of \$0.00860000 per share of common stock to stockholders of record as of the close of business on September 13, 2019. We expect to pay this distribution on or about September 18, 2019.

***Real Estate Disposition Subsequent to June 30, 2019***

***Burbank Collection***

On July 19, 2019, the Burbank Collection joint venture sold the Burbank Collection to a purchaser unaffiliated with us or our advisor, for \$25.9 million before closing costs. As of June 30, 2019, the carrying value of the Burbank Collection was \$14.7 million, which was net of \$2.7 million of accumulated depreciation and amortization.

On July 19, 2019, in connection with the disposition of the Burbank Collection, the Burbank Collection joint venture repaid \$10.6 million of the outstanding principal balance due under the Burbank Collection mortgage loan.

**PART I. FINANCIAL INFORMATION (CONTINUED)****Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We are exposed to the effects of interest rate changes as a result of borrowings used to maintain liquidity, fund distributions and to fund the refinancing of our real estate investment portfolio and operations. We may also be exposed to the effects of changes in interest rates as a result of the acquisition and origination of mortgage, mezzanine, bridge and other loans and the acquisition of real estate securities. We are also exposed to the effects of foreign currency changes in Israel with respect to the 4.25% bonds issued to investors in Israel in March 2016. Our profitability and the value of our investment portfolio may be adversely affected during any period as a result of interest rate changes and foreign currency changes. Our interest rate risk management objectives are to limit the impact of interest rate changes on earnings, prepayment penalties and cash flows and to lower overall borrowing costs. We may manage interest rate risk by maintaining a ratio of fixed rate, long-term debt such that floating rate exposure is kept at an acceptable level. In addition, we may utilize a variety of financial instruments, including interest rate caps, floors, and swap agreements, in order to limit the effects of changes in interest rates on our operations. In order to limit the effects of changes in foreign currency on our operations, we may utilize a variety of foreign currency hedging strategies such as cross currency swaps, forward contracts, puts or calls. When we use these types of derivatives to hedge the risk of interest-earning assets or interest-bearing liabilities, we may be subject to certain risks, including the risk that losses on a hedge position will reduce the funds available for payments to holders of our common stock and the risk that the losses may exceed the amount we invested in the instruments. Additionally, certain of these strategies may cause us to fund a margin account periodically to offset changes in foreign currency rates which may also reduce the funds available for payments to holders of our common stock.

As of June 30, 2019, we had entered into one foreign currency collar to hedge against a change in the exchange rate of the Israeli new Shekel versus the U.S. Dollar. The foreign currency collar expires in August 2019 and has an aggregate Israeli new Shekels notional amount of 776.2 million. The foreign currency collar consists of a purchased call option to buy Israeli new Shekels at 3.4860 and a sold put option to sell the Israeli new Shekels at 3.6185. The foreign currency collar is intended to permit us to exchange, on the settlement date of the collar, 776.2 million Israeli new Shekels for an amount ranging from \$214.5 million to \$222.7 million.

As of June 30, 2019, we held 20,000 Israeli new Shekels and 21.8 million Israeli new Shekels in cash and restricted cash, respectively. In addition, as of June 30, 2019, we had bonds outstanding and the related interest payable in the amounts of 776.2 million Israeli new Shekels and 11.0 million Israeli new Shekels, respectively. Foreign currency exchange rate risk is the possibility that our financial results could be better or worse than planned because of changes in foreign currency exchange rates. Based solely on the remeasurement for the six months ended June 30, 2019, if foreign currency exchange rates were to increase or decrease by 10%, our net income would increase or decrease by approximately \$19.5 million and \$(23.8) million, respectively, for the same period. The foreign currency transaction income or loss as a result of the change in foreign currency exchange rates does not take into account any gains or losses on our foreign currency collar as a result of such change, which would reduce our foreign currency exposure.

We borrow funds at a combination of fixed and variable rates. Interest rate fluctuations will generally not affect our future earnings or cash flows on our fixed rate debt unless such instruments mature or are otherwise terminated. However, interest rate changes will affect the fair value of our fixed rate instruments. As of June 30, 2019, the fair value of our KBS SOR (BVI) Holdings, Ltd. Series A Debentures was \$218.7 million and the outstanding principal balance was \$217.4 million. As of June 30, 2019, excluding the KBS SOR (BVI) Holdings, Ltd. Series A Debentures, the fair value of our fixed rate debt was \$7.8 million and the outstanding principal balance of our fixed rate debt was \$6.2 million. The fair value estimate of our KBS SOR (BVI) Holdings, Ltd. Series A Debentures was calculated using the quoted bond price as of June 30, 2019 on the Tel Aviv Stock Exchange of 102.00 Israeli new Shekels. The fair value estimate of our fixed rate debt was calculated using a discounted cash flow analysis utilizing rates we would expect to pay for debt of a similar type and remaining maturity if the loans were originated as of June 30, 2019. As we expect to hold our fixed rate instruments to maturity and the amounts due under such instruments would be limited to the outstanding principal balance and any accrued and unpaid interest, we do not expect that fluctuations in interest rates, and the resulting changes in fair value of our fixed rate instruments, would have a significant impact on our operations.

Conversely, movements in interest rates on variable rate debt would change our future earnings and cash flows, but would not significantly affect the fair value of those instruments. However, changes in required risk premiums would result in changes in the fair value of floating rate instruments. As of June 30, 2019, we had entered into three separate interest rate caps with an aggregate notional of \$175.7 million which effectively limits our exposure to increases in one-month LIBOR above certain thresholds. Based on interest rates as of June 30, 2019, if interest rates were 100 basis points higher or lower during the 12 months ending June 30, 2020, interest expense on our variable rate debt would increase by \$4.3 million or decrease by \$4.5 million, respectively.



## **PART I. FINANCIAL INFORMATION (CONTINUED)**

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk (continued)**

The weighted-average interest rates of our fixed rate debt and variable rate debt as of June 30, 2019 were 4.3%. The interest rate and weighted-average interest rate represent the actual interest rate in effect as of June 30, 2019 (consisting of the contractual interest rate and the effect of contractual floor rates, if applicable), using interest rate indices as of June 30, 2019 where applicable.

We are exposed to financial market risk with respect to our real estate equity securities. Financial market risk is the risk that we will incur economic losses due to adverse changes in our real estate equity security prices. Our exposure to changes in real estate equity security prices is a result of our investment in these types of securities. Market prices are subject to fluctuation and, therefore, the amount realized in the subsequent sale of an investment may significantly differ from the reported market value. Fluctuation in the market prices of a real estate equity security may result from any number of factors, including perceived changes in the underlying fundamental characteristics of the issuer, the relative price of alternative investments, interest rates, default rates and general market conditions. In addition, amounts realized in the sale of a particular security may be affected by the relative quantity of the real estate equity security being sold. We do not currently engage in derivative or other hedging transactions to manage our real estate equity security price risk. As of June 30, 2019, we owned real estate equity securities with a book value of \$65.3 million. Based solely on the prices of real estate equity securities as of June 30, 2019, if prices were to increase or decrease by 10%, our net income would increase or decrease, respectively, by approximately \$6.5 million.

### **Item 4. Controls and Procedures**

#### **Disclosure Controls and Procedures**

As of the end of the period covered by this report, management, including our principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Based upon, and as of the date of, the evaluation, our principal executive officer and principal financial officer concluded that the disclosure controls and procedures were effective as of the end of the period covered by this report to ensure that information required to be disclosed in the reports we file and submit under the Securities Exchange Act of 1934, as amended (the “Exchange Act”) is recorded, processed, summarized and reported as and when required. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports we file and submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and our principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

#### **Internal Control Over Financial Reporting**

There have been no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

None.

### **Item 1A. Risk Factors**

Please see the risks discussed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2018, as filed with the SEC.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

- a) During the period covered by this Form 10-Q, we did not sell any equity securities that were not registered under the Securities Act of 1933, as amended.
- b) Not applicable.
- c) We have adopted a share redemption program that may enable stockholders to sell their shares to us in limited circumstances.

Pursuant to the share redemption program there are several limitations on our ability to redeem shares:

- Unless the shares are being redeemed in connection with a stockholder's death, "qualifying disability" or "determination of incompetence" (each as defined under the share redemption program), we may not redeem shares until the stockholder has held the shares for one year.
- During any calendar year, we may redeem no more than 5% of the weighted-average number of shares outstanding during the prior calendar year.
- We have no obligation to redeem shares if the redemption would violate the restrictions on distributions under Maryland law, which prohibits distributions that would cause a corporation to fail to meet statutory tests of solvency.

*During 2019:*

- We may redeem no more than \$2.0 million of shares in connection with a stockholder's death, "qualifying disability" or "determination of incompetence."
- We may redeem no more than \$2.0 million of shares per fiscal quarter, excluding shares redeemed in connection with a stockholder's death, "qualifying disability" or "determination of incompetence." To the extent any of such capacity is unused in a fiscal quarter, it will be carried over to the next fiscal quarter for redemption of shares excluding shares redeemed in connection with a stockholder's death, "qualifying disability" or "determination of incompetence." In addition, to the extent extra capacity from the bullet above is available with respect to redemptions in the last month of 2019, such capacity will be made available for redemption of shares other than in connection with a stockholder's death, "qualifying disability" or "determination of incompetence."

**PART II. OTHER INFORMATION (CONTINUED)**

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds (continued)**

*After 2019:*

- During any calendar year, we may redeem only the number of shares that we can purchase with the amount of net proceeds from the sale of shares under our dividend reinvestment plan during the prior calendar year; provided, however, that this limit may be increased or decreased by us upon ten business days' notice to our stockholders. To the extent that we redeem less than the number of shares that we can purchase in any calendar year with the amount of net proceeds from the sale of shares under our dividend reinvestment plan during the prior calendar year plus any additional funds approved by us, such excess capacity to redeem shares during any calendar year shall be added to our capacity to otherwise redeem shares during the subsequent calendar year. Furthermore, during any calendar year, once we have received requests for redemptions, whether in connection with a stockholder's death, "qualifying disability" or "determination of incompetence", or otherwise, that if honored, and when combined with all prior redemptions made during the calendar year, would result in the amount of remaining funds available for the redemption of additional shares in such calendar year being \$1.0 million or less, the last \$1.0 million of available funds shall be reserved exclusively for shares being redeemed in connection with a stockholder's death, "qualifying disability" or "determination of incompetence." To the extent that, in the last month of any calendar year, the amount of redemption requests in connection with a stockholder's death, "qualifying disability" or "determination of incompetence" is less than the amount of available funds reserved for such redemptions in accordance with the previous sentence, any excess funds may be used to redeem shares not in connection with a stockholder's death, "qualifying disability" or "determination of incompetence" during such month.
- We may not redeem more than \$3.0 million of shares in a given quarter (excluding shares redeemed in connection with a stockholder's death, "qualifying disability" or "determination of incompetence"). To the extent that, in a given fiscal quarter, we redeem less than the sum of (a) \$3.0 million of shares (excluding shares redeemed in connection with a stockholder's death, "qualifying disability" or "determination of incompetence") and (b) any excess capacity carried over to such fiscal quarter from a prior fiscal quarter as described below, any remaining excess capacity to redeem shares in such fiscal quarter will be added to our capacity to otherwise redeem shares (excluding shares redeemed in connection with a stockholder's death, "qualifying disability" or "determination of incompetence") during succeeding fiscal quarter. We may increase or decrease this limit upon ten business days' notice to stockholders.

We may amend, suspend or terminate the program upon ten business days' notice to our stockholders. We may provide notice to our stockholders by including such information in a Current Report on Form 8-K or in our annual or quarterly reports, all publicly filed with the SEC, or by a separate mailing to our stockholders.

**PART II. OTHER INFORMATION (CONTINUED)**

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds (continued)**

During the six months ended June 30, 2019, we fulfilled redemption requests eligible for redemption under our share redemption program and received in good order and funded redemptions under our share redemption program with the net proceeds from our dividend reinvestment plan and cash on hand. We redeemed shares pursuant to our share redemption program as follows:

Month	Total Number of Shares Redeemed	Average Price Paid Per Share <sup>(1)</sup>	Approximate Dollar Value of Shares Available That May Yet Be Redeemed Under the Program
January 2019	—	\$ —	(2)
February 2019	13,633	\$ 9.91	(2)
March 2019	253,283	\$ 9.49	(2)
April 2019	11,327	\$ 9.91	(2)
May 2019	38,577	\$ 9.91	(2)
June 2019	218,744	\$ 9.42	(2)
Total	535,564		

<sup>(1)</sup> On November 12, 2018, our board of directors approved an estimated value per share of our common stock of \$9.91. The change in the redemption price became effective for the December 2018 redemption date and is effective until the estimated value per share is updated. We expect to update our estimated value per share no later than December 2019.

On December 4, 2018, our board of directors adopted an eleventh amended and restated share redemption program (the “Eleventh SRP”). The Eleventh SRP changed the funding limits for the share redemption program in calendar year 2019, after which they will revert back to the prior limits. Absent these changes, based on the amount of net proceeds raised from the sale of shares under the dividend reinvestment plan during 2018, we would have had \$1.4 million available for redemptions during 2019, including shares that are redeemed in connection with a stockholders’ death, “qualifying disability” or “determination of incompetence.” As amended, the following will apply during the calendar year 2019:

- We may redeem no more than \$2.0 million of shares in connection with a stockholder’s death, “qualifying disability” or “determination of incompetence.”
- We may redeem no more than \$2.0 million of shares per fiscal quarter, excluding shares redeemed in connection with a stockholder’s death, “qualifying disability” or “determination of incompetence.” To the extent any of such capacity is unused in a fiscal quarter, it will be carried over to the next fiscal quarter for redemption of shares excluding shares redeemed in connection with a stockholder’s death, “qualifying disability” or “determination of incompetence.” In addition, to the extent extra capacity from the bullet above is available with respect to redemptions in the last month of 2019, such capacity will be made available for redemption of shares other than in connection with a stockholder’s death, “qualifying disability” or “determination of incompetence.”

There were no other changes to the share redemption program. The Eleventh SRP became effective for any redemption request received after December 21, 2018, which was the last day for a request to be received and processed in 2018 under the Tenth Amended Share Redemption Program.

<sup>(2)</sup> We limit the dollar value of shares that may be redeemed under the program as described above. During the six months ended June 30, 2019, we redeemed \$5.1 million of common stock under the program, which represented all redemption requests received in good order and eligible for redemption through the June 2019 redemption date, except for the \$35.6 million of shares in connection with redemption requests not made upon a stockholder’s death, “qualifying disability” or “determination of incompetence,” which redemption requests will be fulfilled subject to the limitations described above. Based on the Eleventh SRP, we have \$4.9 million available for redemptions in the remainder of 2019, including shares that are redeemed in connection with a stockholders’ death, “qualifying disability” or “determination of incompetence,” subject to the limitations described above.

In addition to the redemptions under the share redemption program described above, during the six months ended June 30, 2019, we repurchased 1,256 shares of our common stock at \$9.41 per share for an aggregate price of approximately \$12,000.

**PART II. OTHER INFORMATION (CONTINUED)**

**Item 3. Defaults upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

None.

**Item 5. Other Information**

None.

<b>Ex.</b>	<b>Description</b>
3.1	<a href="#">Second Articles of Amendment and Restatement, incorporated by reference to Exhibit 3.1 of the Company's Current Report on Form 8-K filed February 4, 2010</a>
3.2	<a href="#">Second Amended and Restated Bylaws, incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed November 17, 2016</a>
4.1	<a href="#">Statement regarding restrictions on transferability of shares of common stock (to appear on stock certificate or to be sent upon request and without charge to stockholders issued shares without certificates), incorporated by reference to Exhibit 4.2 to Pre-Effective Amendment No. 1 to the Company's Registration Statement on Form S-11, Commission File No. 333-156633 filed February 25, 2009</a>
4.2	<a href="#">Fifth Amended and Restated Dividend Reinvestment Plan, incorporated by reference to Exhibit 4.2 to the Company's Quarterly Report on Form 10-Q filed May 14, 2015</a>
31.1	<a href="#">Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</a>
31.2	<a href="#">Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</a>
32.1	<a href="#">Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002</a>
32.2	<a href="#">Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002</a>
99.1	<a href="#">Eleventh Amended and Restated Share Redemption Program, incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed December 7, 2018</a>
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**KBS STRATEGIC OPPORTUNITY REIT, INC.**

Date: August 9, 2019

By: /S/ KEITH D. HALL

**Keith D. Hall**

*Chief Executive Officer and Director*

(principal executive officer)

Date: August 9, 2019

By: /S/ JEFFREY K. WALDVOGEL

**Jeffrey K. Waldvogel**

*Chief Financial Officer, Treasurer and Secretary*

(principal financial officer)



**Certification of Chief Financial Officer pursuant to  
Section 302 of the Sarbanes-Oxley Act of 2002**

I, Jeffrey K. Waldvogel, certify that:

1. I have reviewed this quarterly report on Form 10-Q of KBS Strategic Opportunity REIT, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2019

By: \_\_\_\_\_ /S/ JEFFREY K. WALDVOGEL

**Jeffrey K. Waldvogel**  
*Chief Financial Officer*  
(principal financial officer)





