

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

FORM 10-Q

☒ 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: **000-54295**

Sterling Real Estate Trust
d/b/a Sterling Multifamily Trust
(Exact name of registrant as specified in its charter)

North Dakota
(State or other jurisdiction of incorporation or organization)

90-0115411
(I.R.S. Employer Identification No.)

1711 Gold Drive South, Suite 100, Fargo, North Dakota
(Address of principal executive offices)

58103
(Zip Code)

(701) 353-2720
(Registrant's telephone number, including area code)

(Former name, former address and formal fiscal year, if changed since last report)
Securities registered pursuant to Section 12(b) of the Act:

<u>Title of each class:</u>	<u>Trading Symbol</u>	<u>Name of each exchange on which registered:</u>
Common Shares, par value \$0.01 per share	N/A	N/A

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 (Section 232.405 of this chapter) during the preceding 12 months (or 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, 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.

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input checked="" type="checkbox"/>
Emerging growth company	<input type="checkbox"/>		

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 ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

<u>Class</u>	<u>Outstanding at August 2, 2019</u>
Common Shares of Beneficial Interest, \$0.01 par value per share	9,327,069.55

STERLING REAL ESTATE TRUST AND SUBSIDIARIES

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

STERLING REAL ESTATE TRUST AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS AS OF JUNE 30, 2019 (UNAUDITED) AND DECEMBER 31, 2018

	June 30, 2019	December 31, 2018
	(in thousands)	
ASSETS		
Real estate investments		
Land and land improvements	\$ 114,240	\$ 114,027
Building and improvements	675,218	675,308
Construction in progress	3,468	1,361
Real estate investments	792,926	790,696
Less accumulated depreciation	(137,297)	(128,112)
Real estate investments, net	655,629	662,584
Cash and cash equivalents	16,617	21,212
Restricted deposits	7,932	8,853
Investment in unconsolidated affiliates	2,641	2,691
Note receivable	1,006	—
Lease intangible assets, less accumulated amortization of \$14,669 in 2019 and \$13,715 in 2018	10,022	10,976
Other assets, net	7,242	8,151
Total Assets	\$ 701,089	\$ 714,467
LIABILITIES		
Mortgage notes payable, net	\$ 396,129	\$ 406,017
Dividends payable	7,062	6,828
Tenant security deposits payable	4,521	4,286
Lease intangible liabilities, less accumulated amortization of \$1,754 in 2019 and \$1,621 in 2018	1,335	1,468
Accrued expenses and other liabilities	10,266	12,117
Total Liabilities	419,313	430,716
COMMITMENTS and CONTINGENCIES - Note 14		
SHAREHOLDERS' EQUITY		
Beneficial interest	100,445	97,883
Noncontrolling interest		
Operating partnership	178,863	183,360
Partially owned properties	2,491	2,538
Accumulated other comprehensive loss	(23)	(30)
Total Shareholders' Equity	281,776	283,751
	\$ 701,089	\$ 714,467

See Notes to Consolidated Financial Statements

STERLING REAL ESTATE TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND OTHER COMPREHENSIVE INCOME
FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2019 AND 2018 (UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	(in thousands, except per share data)		(in thousands, except per share data)	
Income from rental operations				
Real estate rental income	\$ 30,270	\$ 27,125	\$ 60,102	\$ 54,614
Tenant reimbursements	—	1,521	—	3,133
	30,270	28,646	60,102	57,747
Expenses				
Expenses from rental operations				
Operating expenses, excluding real estate taxes	11,832	11,709	24,011	22,710
Real estate taxes	3,019	2,898	6,048	5,744
Depreciation and amortization	5,353	5,283	10,891	10,633
Interest	4,582	4,576	9,298	9,076
	24,786	24,466	50,248	48,163
Administration of REIT	971	1,089	2,082	2,243
Total expenses	25,757	25,555	52,330	50,406
Income from operations	4,513	3,091	7,772	7,341
Other income				
Equity in income of unconsolidated affiliates	262	127	394	284
Other income	46	55	116	160
Gain on sale of real estate and non-real estate investments	—	1,084	—	1,084
Gain on involuntary conversion	—	620	329	1,367
	308	1,886	839	2,895
Net income	\$ 4,821	\$ 4,977	\$ 8,611	\$ 10,236
Net income attributable to noncontrolling interest:				
Operating Partnership	3,191	3,376	5,723	6,912
Partially owned properties	(17)	(74)	(47)	(93)
Net income attributable to Sterling Real Estate Trust	\$ 1,647	\$ 1,675	\$ 2,935	\$ 3,417
Net income per common share, basic and diluted	\$ 0.18	\$ 0.19	\$ 0.32	\$ 0.39
Comprehensive income:				
Net income	\$ 4,821	\$ 4,977	\$ 8,611	\$ 10,236
Other comprehensive gain - change in fair value of interest rate swaps	3	10	7	23
Comprehensive income	4,824	4,987	8,618	10,259
Comprehensive income attributable to noncontrolling interest	3,176	3,309	5,681	6,835
Comprehensive income attributable to Sterling Real Estate Trust	\$ 1,648	\$ 1,678	\$ 2,937	\$ 3,424

See Notes to Consolidated Financial Statements

STERLING REAL ESTATE TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2019 (UNAUDITED)

For the Three Months Ended June 30, 2019

	Common Shares	Paid-in Capital	Accumulated Distributions in Excess of Earnings	Total Beneficial Interest	Noncontrolling Interest		Accumulated	
					Operating Partnership	Partially Owned Properties	Comprehensive Income (Loss)	Total
(in thousands)								
BALANCE AT MARCH 31, 2019	9,087	\$ 124,835	\$ (25,827)	\$ 99,008	\$ 180,602	\$ 2,508	\$ (26)	\$ 282,092
Shares/units redeemed	(9)	(154)	—	(154)	(273)	—	—	(427)
Dividends declared	—	—	(2,405)	(2,405)	(4,657)	—	—	(7,062)
Dividends reinvested - stock dividend	86	1,554	—	1,554	—	—	—	1,554
Issuance of shares under optional purchase plan	42	795	—	795	—	—	—	795
Change in fair value of interest rate swaps	—	—	—	—	—	—	3	3
Net income	—	—	1,647	1,647	3,191	(17)	—	4,821
BALANCE AT JUNE 30, 2019	9,206	\$ 127,030	\$ (26,585)	\$ 100,445	\$ 178,863	\$ 2,491	\$ (23)	\$ 281,776

For the Six Months Ended June 30, 2019

	Common Shares	Paid-in Capital	Accumulated Distributions in Excess of Earnings	Total Beneficial Interest	Noncontrolling Interest		Accumulated	
					Operating Partnership	Partially Owned Properties	Comprehensive Income (Loss)	Total
(in thousands)								
BALANCE AT DECEMBER 31, 2018	8,967	\$ 122,624	\$ (24,741)	\$ 97,883	\$ 183,360	\$ 2,538	\$ (30)	\$ 283,751
Shares/units redeemed	(20)	(351)	—	(351)	(902)	—	—	(1,253)
Dividends declared	—	—	(4,779)	(4,779)	(9,318)	—	—	(14,097)
Dividends reinvested - stock dividend	168	3,033	—	3,033	—	—	—	3,033
Issuance of shares under optional purchase plan	91	1,724	—	1,724	—	—	—	1,724
Change in fair value of interest rate swaps	—	—	—	—	—	—	7	7
Net income	—	—	2,935	2,935	5,723	(47)	—	8,611
BALANCE AT JUNE 30, 2019	9,206	\$ 127,030	\$ (26,585)	\$ 100,445	\$ 178,863	\$ 2,491	\$ (23)	\$ 281,776

See Notes to Consolidated Financial Statements

STERLING REAL ESTATE TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOW S
FOR THE SIX MONTHS ENDED JUNE 30, 2019 AND 2018 (UNAUDITED)

	Six Months Ended June 30,	
	2019	2018
	(in thousands)	
OPERATING ACTIVITIES		
Net income	\$ 8,611	\$ 10,236
Adjustments to reconcile net income to net cash from operating activities		
Gain on sale of real estate investments	—	(1,084)
Gain on involuntary conversion	(329)	(1,367)
Equity in income of unconsolidated affiliates	(394)	(284)
Distributions of earnings of unconsolidated affiliates	394	284
Allowance for uncollectible accounts receivable	200	(706)
Depreciation	9,906	9,505
Amortization	959	1,099
Amortization of debt issuance costs	310	338
Effects on operating cash flows due to changes in		
Other assets	1,136	14
Tenant security deposits payable	235	5
Accrued expenses and other liabilities	(1,892)	(1,022)
NET CASH PROVIDED BY OPERATING ACTIVITIES	19,136	17,018
INVESTING ACTIVITIES		
Purchase of real estate investment properties	—	(2,979)
Capital expenditures and tenant improvements	(4,005)	(4,548)
Proceeds from sale of real estate investments and non-real estate investments	—	5,200
Proceeds from involuntary conversion	1,065	330
Distributions in excess of earnings received from unconsolidated affiliates	50	124
Notes receivable issued	(1,006)	—
NET CASH USED IN INVESTING ACTIVITIES	(3,896)	(1,873)
FINANCING ACTIVITIES		
Payments for financing, debt issuance and lease costs	—	(149)
Principal payments on special assessments payable	(239)	(269)
Proceeds from issuance of mortgage notes payable and subordinated debt	—	7,064
Principal payments on mortgage notes payable	(10,160)	(8,223)
Advances on lines of credit	—	2,964
Payments on lines of credit	—	(2,964)
Proceeds from issuance of shares under optional purchase plan	1,724	2,159
Shares/units redeemed	(1,253)	(1,663)
Dividends/distributions paid	(10,828)	(10,301)
NET CASH USED IN FINANCING ACTIVITIES	(20,756)	(11,382)
NET CHANGE IN CASH AND CASH EQUIVALENTS AND RESTRICTED DEPOSITS	(5,516)	3,763
CASH AND CASH EQUIVALENTS AND RESTRICTED DEPOSITS AT BEGINNING OF PERIOD	30,065	20,553
CASH AND CASH EQUIVALENTS AND RESTRICTED DEPOSITS AT END OF PERIOD	\$ 24,549	\$ 24,316
CASH AND CASH EQUIVALENTS AND RESTRICTED DEPOSITS AT END OF PERIOD		
Cash and cash equivalents	\$ 16,617	\$ 13,809
Restricted deposits	7,932	10,507
TOTAL CASH AND CASH EQUIVALENTS AND RESTRICTED DEPOSITS, END OF PERIOD	\$ 24,549	\$ 24,316

See Notes to Consolidated Financial Statements

STERLING REAL ESTATE TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX MONTHS ENDED JUNE 30, 2019 AND 2018 (UNAUDITED) (Continued)

	Six Months Ended	
	June 30,	
	2019	2018
	(in thousands)	
SCHEDULE OF CASH FLOW INFORMATION		
Cash paid during the period for interest, net of capitalized interest	\$ 9,334	\$ 9,068
SUPPLEMENTARY SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Dividends reinvested	\$ 3,033	\$ 2,798
Dividends declared and not paid	2,405	2,217
UPREIT distributions declared and not paid	4,657	4,465
Acquisition of assets in exchange for the issuance of noncontrolling interest units in UPREIT	—	1,546
Increase in land improvements due to increase in special assessments payable	213	251
Unrealized gain on interest rate swaps	7	23
Acquisition of assets through assumption of debt and liabilities	—	54
Capitalized interest and real estate taxes related to construction in progress	23	97
Acquisition of assets with accounts payable	—	752

See Notes to Consolidated Financial Statements

STERLING REAL ESTATE TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018 (UNAUDITED)

(Dollar amounts in thousands, except share and per share data)

NOTE 1 - ORGANIZATION

Sterling Real Estate Trust (“Sterling”, “the Trust” or “the Company”) is a registered, but unincorporated business trust organized in North Dakota in December 2002. Sterling has elected to be taxed as a Real Estate Investment Trust (“REIT”) under Sections 856-860 of the Internal Revenue Code, which requires that 75% of the assets of a REIT must consist of real estate assets and that 75% of its gross income must be derived from real estate. The net income of the REIT is allocated in accordance with the stock ownership in the same fashion as a regular corporation.

Sterling previously established an operating partnership (“Sterling Properties, LLLP”) and transferred all of its assets and liabilities to the operating partnership in exchange for general partnership units. As the general partner, Sterling has management responsibility for all activities of the operating partnership. As of June 30, 2019 and December 31, 2018, Sterling owned approximately 34.06% and 33.41%, respectively, of the operating partnership.

NOTE 2 – PRINCIPAL ACTIVITY AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2018, which have previously been filed with the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been omitted from this report on Form 10-Q pursuant to the rules and regulations of the SEC.

The results for the interim periods shown in this report are not necessarily indicative of future financial results. The accompanying consolidated balance sheet as of June 30, 2019 and consolidated statements of operations and other comprehensive income, consolidated statement of shareholders’ equity, and consolidated statements of cash flows for the three and six months ended June 30, 2019 and 2018, as applicable, have not been audited by our independent registered public accounting firm. In the opinion of management, the accompanying unaudited consolidated financial statements include all adjustments necessary to present fairly our consolidated financial statements as of and for the three and six months ended June 30, 2019. These adjustments are of a normal recurring nature.

Principles of Consolidation

The consolidated financial statements include the accounts of Sterling, Sterling Properties, LLLP, and wholly-owned limited liability companies. All significant intercompany transactions and balances have been eliminated in consolidation.

Additionally, we evaluate the need to consolidate affiliates based on standards set forth in the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 810, Consolidation (“ASC 810”). In determining whether we have a requirement to consolidate the accounts of an entity, management considers factors such as our ownership interest, our authority to make decisions and contractual and substantive participating rights of the limited partners and shareholders, as well as whether the entity is a variable interest entity (“VIE”) for which we have both: a) the power to direct the activities of the VIE that most significantly impact the entity’s economic performance, and b) the obligation to absorb losses or the right to receive benefits from the VIE that could be potentially significant to the VIE.

STERLING REAL ESTATE TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018 (UNAUDITED)

(Dollar amounts in thousands, except share and per share data)

Principal Business Activity

Sterling currently owns directly and indirectly 173 properties. The Trust's 125 residential properties are located in North Dakota, Minnesota, Missouri and Nebraska and are principally multifamily apartment buildings. The Trust owns 48 commercial properties primarily located in North Dakota with others located in Arkansas, Colorado, Iowa, Louisiana, Michigan, Minnesota, Mississippi, Nebraska and Wisconsin. The commercial properties include retail, office, industrial, restaurant and medical properties. Presently, the Trust's mix of properties is 73.2% residential and 26.8% commercial (based on cost) and total \$655,629 in real estate investments at June 30, 2019. Sterling's current acquisition strategy and focus is on multifamily apartment properties. We currently have no plans to actively market our existing commercial properties for sale. We will consider unsolicited offers for purchase of non-multifamily properties on a case by case basis. Sterling up until June 30, 2019 has not accounted for mezzanine and storage space square footage on their commercial properties. As of June 30, 2019 this change led to an additional 36,000 square feet of commercial property.

Residential Property	Location	No. of Properties	Units
	North Dakota	105	6,160
	Minnesota	16	3,033
	Missouri	1	164
	Nebraska	3	495
		125	9,852

Commercial Property	Location	No. of Properties	Sq. Ft
	North Dakota	20	780,000
	Arkansas	2	28,000
	Colorado	1	17,000
	Iowa	1	33,000
	Louisiana	1	15,000
	Michigan	1	12,000
	Minnesota	15	680,000
	Mississippi	1	15,000
	Nebraska	1	19,000
	Wisconsin	5	63,000
		48	1,662,000

Concentration of Credit Risk

Our cash balances are maintained in various bank deposit accounts. The bank deposit amounts in these accounts may exceed federally insured limits at various times throughout the year.

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

STERLING REAL ESTATE TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018 (UNAUDITED)

(Dollar amounts in thousands, except share and per share data)

Real Estate Investments

Real estate investments are recorded at cost less accumulated depreciation. Ordinary repairs and maintenance are expensed as incurred.

The Company allocates the purchase price of each acquired investment property accounted for as a business combination based upon the estimated acquisition date fair value of the individual assets acquired and liabilities assumed, which generally include (i) land, (ii) building and other improvements, (iii) in-place lease value intangibles, (iv) acquired above and below market lease intangibles, (v) any assumed financing that is determined to be above or below market, (vi) the value of customer relationships and (vii) goodwill, if any. Transaction costs related to acquisitions accounted for as business combinations are expensed as incurred and included within "Administration of REIT expenses" in the accompanying consolidated statements of operations and other comprehensive income.

For tangible assets acquired, including land, building and other improvements, the Company considers available comparable market and industry information in estimating acquisition date fair value. Key factors considered in the calculation of fair value of both real property and intangible assets include the current market rent values, "dark" periods (building in vacant status), direct costs estimated with obtaining a new tenant, discount rates, escalation factors, standard lease terms, and tenant improvement costs. The Company allocates a portion of the purchase price to the estimated acquired in-place lease value intangibles based on factors available in third party appraisals or cash flow estimates of the property prepared by our internal analysis. These estimates are based upon cash flow projections for the property, existing leases, lease origination costs for similar leases as well as lost rental payments during an assumed lease-up period. The Company also evaluates each acquired lease as compared to current market rates. If an acquired lease is determined to be above or below market, the Company allocates a portion of the purchase price to such above or below market leases based upon the present value of the difference between the contractual lease payments and estimated market rent payments over the remaining lease term. Renewal periods are included within the lease term in the calculation of above and below market lease values if, based upon factors known at the acquisition date, market participants would consider it reasonably assured that the lessee would exercise such options. Fair value estimates used in acquisition accounting, including the discount rate used, require the Company to consider various factors, including, but not limited to, market knowledge, demographics, age and physical condition of the property, geographic location, and size and location of tenant spaces within the acquired investment property.

The portion of the purchase price allocated to acquired in-place lease value intangibles is amortized on a straight-line basis over the life of the related lease as amortization expense. The Company incurred amortization expense pertaining to acquired in-place lease value intangibles of \$418 and \$503 for the three months ended June 30, 2019 and 2018, respectively and \$847 and \$1,043 for the six months ended June 30, 2019 and 2018, respectively.

The portion of the purchase price allocated to acquired above and below market lease intangibles is amortized on a straight-line basis over the life of the related lease as an adjustment to real estate rental income. Amortization pertaining to above market lease intangibles of \$54 and \$55 for the three months ended June 30, 2019 and 2018, respectively, was recorded as a reduction to real estate rental income. Amortization pertaining to below market lease intangibles of \$66 and \$70 for the three months ended June 30, 2019 and 2018, respectively, was recorded as an increase to real estate rental income. Amortization pertaining to above market lease intangibles of \$107 and \$111 for the six months ended June 30, 2019 and 2018, respectively, was recorded as a reduction to real estate rental income. Amortization pertaining to below market lease intangibles of \$133 and \$140 for the six months ended June 30, 2019 and 2018, respectively, was recorded as an increase to real estate rental income.

STERLING REAL ESTATE TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018 (UNAUDITED)

(Dollar amounts in thousands, except share and per share data)

Furniture and fixtures are stated at cost less accumulated depreciation. Expenditures for renewals and improvements that significantly add to the productive capacity or extend the useful life of an asset are capitalized. Expenditures for routine maintenance and repairs, which do not add to the value or extend useful lives, are charged to expense as incurred.

Depreciation is provided for over the estimated useful lives of the individual assets using the straight-line method over the following estimated useful lives:

Buildings and improvements	40 years
Furniture, fixtures and equipment	5-9 years

Depreciation expense for the three months ended June 30, 2019 and 2018 totaled \$4,893 and \$4,738, respectively. Depreciation expense for the six months ended June 30, 2019 and 2018 totaled \$9,906 and \$9,505, respectively.

The Company's investment properties are reviewed for potential impairment at the end of each reporting period whenever events or changes in circumstances indicate that the carrying value may not be recoverable. At the end of each reporting period, the Company separately determines whether impairment indicators exist for each property.

Examples of situations considered to be impairment indicators include, but are not limited to:

- a substantial decline or continued low occupancy rate;
- continued difficulty in leasing space;
- significant financially troubled tenants;
- a change in plan to sell a property prior to the end of its useful life or holding period;
- a significant decrease in market price not in line with general market trends; and
- any other quantitative or qualitative events or factors deemed significant by the Company's management or board of trustees.

If the presence of one or more impairment indicators as described above is identified at the end of the reporting period or throughout the year with respect to an investment property, the asset is tested for recoverability by comparing its carrying value to the estimated future undiscounted cash flows. An investment property is considered to be impaired when the estimated future undiscounted cash flows are less than its current carrying value. When performing a test for recoverability or estimating the fair value of an impaired investment property, the Company makes complex or subjective assumptions which include, but are not limited to:

- projected operating cash flows considering factors such as vacancy rates, rental rates, lease terms, tenant financial strength, demographics, holding period and property location;
- projected capital expenditures and lease origination costs;
- projected cash flows from the eventual disposition of an operating property using a property specific capitalization rate;
- comparable selling prices; and
- property specific discount rates for fair value estimates as necessary.

To the extent impairment has occurred, the Company will record an impairment charge calculated as the excess of the carrying value of the asset over its fair value for impairment of investment properties. There were no impairment losses during the six months ended June 30, 2019 and 2018.

STERLING REAL ESTATE TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018 (UNAUDITED)

(Dollar amounts in thousands, except share and per share data)

Properties Held for Sale

We account for our properties held for sale in accordance with ASC 360, Property, Plant and Equipment (“ASC 360”), which addresses financial accounting and reporting in a period in which a component or group of components of an entity either has been disposed of or is classified as held for sale.

In accordance with ASC 360, at such time as a property is held for sale, such property is carried at the lower of: (1) its carrying amount, or (2) fair value less costs to sell. In addition, a property being held for sale ceases to be depreciated. We classify operating properties as properties held for sale in the period in which all of the following criteria are met:

- management, having the authority to approve the action, commits to a plan to sell the asset;
- the asset is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets;
- an active program to locate a buyer and other actions required to complete the plan to sell the asset has been initiated;
- the sale of the asset is probable and the transfer of the asset is expected to qualify for recognition as a completed sale within one year;
- the asset is being actively marketed for sale at a price that is reasonable in relation to its current fair value; and
- given the actions required to complete the plan to sell the asset, it is unlikely that significant changes to the plan would be made or that the plan would be withdrawn.

The results of operations of a component of an entity that either has been disposed of or is classified as held-for-sale under the requirements of ASC 360 shall be reported in discontinued operations in accordance with ASC 205, Presentation of Financial Statements (“ASC 205”) if such disposal or classification represents a strategic shift that has (or will have) a major effect on an entity’s operations and financial results.

There was one property classified as held for sale at March 31, 2019. As of June 30, 2019 the property no longer met the held for sale criteria. The change in classification did not affect the results of operations.

There were no properties classified as held for sale at June 30, 2019 or at December 31, 2018.

Construction in Progress

The Company capitalizes direct and certain indirect project costs incurred during the development period such as construction, insurance, architectural, legal, interest and other financing costs, and real estate taxes. At such time as the development is considered substantially complete, the capitalization of certain indirect costs such as real estate taxes and interest and financing costs cease and all project-related costs included in construction in process are reclassified to land and building and other improvements.

Construction in progress as of June 30, 2019 consists primarily of development and planning costs associated with the Glen Pond development in Eagan, Minnesota. The development consists of 114 units of multifamily property. Current expectations are that the project will be completed in the third or fourth quarter of calendar year 2020 and the current project budget approximates \$15,598,000.

Cash, Cash Equivalents and Restricted Deposits

We classify highly liquid investments with a maturity of three months or less when purchased as cash equivalents. Restricted deposits includes funds escrowed for tenant security deposits, real estate tax, insurance and mortgage escrow and escrow

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deposits required by lenders on certain properties to be used for future building renovations or tenant improvements and potential Internal Revenue Code Section 1031 tax deferred exchanges (1031 Exchange).

Investment in Unconsolidated Affiliates

We account for unconsolidated affiliates using the equity method of accounting per guidance established under ASC 323, Investments – Equity Method and Joint Ventures (“ASC 323”). The equity method of accounting requires the investment to be initially recorded at cost and subsequently adjusted for our share of equity in the affiliates’ earnings, contributions and distributions. We evaluate the carrying amount of the investments for impairment in accordance with ASC 323. Unconsolidated affiliates are reviewed for potential impairment if the carrying amount of the investment exceeds its fair value. An impairment charge is recorded when an impairment is deemed to be other-than-temporary. To determine whether impairment is other-than-temporary, we consider whether we have the ability and intent to hold the investment until the carrying amount is fully recovered. The evaluation of an investment in an affiliate for potential impairment can require our management to exercise significant judgments. No impairment losses were recorded related to the unconsolidated affiliates for the six months ended June 30, 2019 and 2018.

We use the equity method to account for investments that qualify as variable interest entities where we are not the primary beneficiary and entities that we do not control or where we do not own a majority of the economic interest but have the ability to exercise significant influence over the operations and financial policies of the investee. We will also use the equity method for investments that do not qualify as variable interest entities and do not meet the control requirements for consolidation, as defined in ASC 810. For a joint venture accounted for under the equity method, our share of net earnings and losses is reflected in income when earned and distributions are credited against our investment in the joint venture as received.

In determining whether an investment in a limited liability company or tenant in common is a variable interest entity, we consider: the form of our ownership interest and legal structure; the size of our investment; the financing structure of the entity, including the necessity of subordinated debt; estimates of future cash flows; our and our partner’s ability to participate in the decision making related to acquisitions, dispositions, budgeting and financing on the entity; and obligation to absorb losses and preferential returns. As of June 30, 2019, our tenant in common arrangements do not qualify as variable interest entities and do not meet the control requirements for consolidation, as defined in ASC 810.

As of June 30, 2019 and December 31, 2018, the unconsolidated affiliates held total assets of \$22,541 and \$22,954 and mortgage notes payable of \$16,894 and \$17,091, respectively.

The operating partnership is a 50% owner of a retail center as a tenant in common through 100% ownership in a limited liability company. The retail center has approximately 183,000 square feet of commercial space in Grand Forks, North Dakota. The property is encumbered by a non-recourse first mortgage with a balance at June 30, 2019 and December 31, 2018 of \$10,375 and \$10,483, respectively. The Company is jointly and severally liable for the full mortgage balance.

The operating partnership owns a 66.67% interest as tenant in common in an office building with approximately 75,000 square feet of commercial rental space in Fargo, North Dakota. The property is encumbered by a first mortgage with a balance at June 30, 2019 and December 31, 2018 of \$6,519 and \$6,608, respectively. The Company is jointly and severally liable for the full mortgage balance.

Receivables

Receivables consist primarily of amounts due for rent. Accounts receivable are carried at original amounts billed less an estimate made for doubtful accounts based on a review of outstanding amounts on a quarterly basis and reflect

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management's best estimate of the amounts that will not be collected. Accounts receivable are written off when collection efforts have been exhausted and they are deemed uncollectible. Recoveries, if any, of receivables previously written off are recorded when received. Accounts receivable are non-interest bearing and are unsecured. Notes receivable are issued periodically and are interest bearing and 100% secured by common stock. As of June 30, 2019 and December 31, 2018, management's estimate of uncollectible accounts receivable was \$778 and \$578, respectively. Receivables are included in "Other assets" in the accompanying consolidated balance sheets.

Financing and Lease Costs

Financing costs have been capitalized and are being amortized over the life of the financing (line of credit) using the effective interest method. Unamortized financing costs are written off when debt is retired before the maturity date and included in interest expense at that time.

Lease costs incurred in connection with new leases have been capitalized and are being amortized over the life of the lease using the straight-line method. We record the amortization of leasing costs in depreciation and amortization on the consolidated statements of operations and comprehensive income. If an applicable lease terminates prior to the expiration of its initial lease term, we write off the carrying amount of the costs to amortization expense.

Debt Issuance Costs

We amortize external debt issuance costs using the effective interest rate method, over the estimated life of the related debt. We record debt issuance costs related to notes and mortgage notes, net of amortization, on our consolidated balance sheets as an offset to their related debt. We record debt issuance costs related to revolving lines of credit on our consolidated balance sheets as financing fees, regardless of whether a balance on the line of credit is outstanding. We record the amortization of all debt issuance costs as interest expense.

Lease Intangible Assets

Lease intangibles are a purchase price allocation recorded on property acquisition. The lease intangibles represent the estimated value of in-place leases, tenant relationships and the value of leases with above or below market lease terms. Lease intangibles are amortized over the term of the related lease.

The carrying amount of intangible assets is regularly reviewed for indicators of impairments in value. Impairment is recognized only if the carrying amount of the intangible asset is considered to be unrecoverable from its undiscounted cash flows and is measured as the difference between the carrying amount and the estimated fair value of the asset. Based on the review, management determined no impairment charges were necessary at June 30, 2019 and December 31, 2018.

Noncontrolling Interest

A noncontrolling interest in a subsidiary (minority interest) is in most cases an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements and separate from the parent company's equity. In addition, consolidated net income is required to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest and the amount of consolidated net income attributable to the parent and the noncontrolling interest are required to be disclosed on the face of the consolidated statements of operations and comprehensive income.

Operating Partnership: Interests in the operating partnership held by limited partners are represented by operating partnership units. The operating partnership's income is allocated to holders of units based upon the ratio of their holdings

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to the total units outstanding during the period. Capital contributions, distributions, syndication costs, and profits and losses are allocated to noncontrolling interests in accordance with the terms of the operating partnership agreement.

Partially Owned Properties: The Company reflects noncontrolling interests in partially owned properties on the balance sheet for the portion of properties consolidated by the Company that are not wholly owned by the Company. The earnings or losses from those properties attributable to the noncontrolling interests are reflected as noncontrolling interests in partially owned properties in the consolidated statement of operations and comprehensive income.

Syndication Costs

Syndication costs consist of costs paid to attorneys, accountants, and selling agents, related to the raising of capital. Syndication costs are recorded as a reduction to beneficial and noncontrolling interest.

Federal Income Taxes

We have elected to be taxed as a REIT under the Internal Revenue Code, as amended. A REIT calculates taxable income similar to other domestic corporations, with the major difference being a REIT is entitled to a deduction for dividends paid. A REIT is generally required to distribute each year at least 90% of its taxable income. If it chooses to retain the remaining 10% of taxable income, it may do so, but it will be subject to a corporate tax on such income. REIT shareholders are taxed on REIT distributions of ordinary income in generally the same manner as they are taxed on other corporate distributions.

We intend to continue to qualify as a REIT and, provided we maintain such status, will not be taxed on the portion of the income that is distributed to shareholders. In addition, we intend to distribute all of our taxable income; therefore, no provisions or liabilities for income taxes have been recorded in the financial statements.

Sterling conducts its business activity as an Umbrella Partnership Real Estate Investment Trust ("UPREIT") through its Operating Partnership – Sterling Properties, LLLP. The Operating Partnership is organized as a limited liability limited partnership. Income or loss is allocated to the partners in accordance with the provisions of the Internal Revenue Code 704(b) and 704(c). UPREIT status allows non-recognition of gain by an owner of appreciated real estate if that owner contributes the real estate to a partnership in exchange for a partnership interest. The conversion of a partnership interest to shares of beneficial interest in the REIT will be a taxable event to the limited partner.

We follow ASC Topic 740, *Income Taxes*, to recognize, measure, present and disclose in our consolidated financial statements uncertain tax positions that we have taken or expect to take on a tax return. As of June 30, 2019 and December 31, 2018 we did not have any liabilities for uncertain tax positions that we believe should be recognized in our consolidated financial statements. We are no longer subject to Federal and State tax examinations by tax authorities for years before 2015.

The operating partnership has elected to record related interest and penalties, if any, as income tax expense on the consolidated statements of operations and other comprehensive income.

Revenue Recognition

We are the lessor for our residential and commercial leases and these leases will continue to be accounted for as operating leases under the new standard as described in Note 2. Therefore, the Company did not have significant changes in the accounting for its lease revenues.

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As of June 30, 2019, we derived 79% of our revenues from residential leases that are generally for terms of one year or less. The residential leases may include lease income related to such items as parking, storage and non-refundable deposits that we treat as a single lease component because the amenities cannot be leased on their own and the timing and pattern of revenue recognition are the same. The collection of lease payments at lease commencement is probable and therefore we subsequently recognize lease income over the lease term on a straight-line basis. Residential leases are renewable upon consent of both parties on an annual or monthly basis.

As of June 30, 2019, we derived 21% of our revenues from commercial leases primarily under long-term lease agreements. We elected to apply the package of practical expedients for the commercial leases and these leases will continue to be accounted for as operating leases as of January 1, 2019. Substantially all commercial leases contain fixed escalations or, in some instances, changes based on the Consumer Price Index, which occur at specified times during the term of the lease. In certain commercial leases, variable lease income, such as percentage rent, is recognized when rents are earned. We recognize rental income and rental abatements from our commercial leases when earned on a straight-line basis over the lease term. Recognition of rental income commences when control of the leased space has been transferred to the tenant.

We recognize variable income from pass-through expenses on an accrual basis over the periods in which the expenses were incurred. Pass-through expenses are comprised of real estate taxes, operating expenses and common area maintenance costs which are reimbursed by tenants in accordance with specific allowable costs per tenant lease agreements. When we pay pass-through expenses, subject to reimbursement by the tenant, they are included within "Operating expenses, excluding real estate taxes" and "Real estate taxes," and reimbursements are included within "Real estate rental income" along with the associated base rent in the accompanying consolidated financial statements.

We record base rents on a straight-line basis. The monthly base rent income according to the terms of our leases is adjusted so that an average monthly rent is recorded for each tenant over the term of its lease. The straight-line rent adjustment decreased revenue by \$48 and increased revenue by \$19 for the three months ended June 30, 2019 and 2018, respectively. The straight-line rent adjustment increased revenue by \$55 and \$70 the six months ended June 30, 2019 and 2018, respectively. The straight-line receivable balance included in receivables on the consolidated balance sheets as of June 30, 2019 and December 31, 2018 was \$3,430 and \$3,374, respectively. We receive payments for expense reimbursements from substantially all our multi-tenant commercial tenants throughout the year based on estimates. Differences between estimated recoveries and the final billed amounts, which generally are immaterial, are recognized in the subsequent year.

Upon adoption of ASU 2016-02 on January 1, 2019, we elected not to bifurcate lease contracts into lease and non-lease components, since the timing and pattern of revenue is not materially different and the non-lease component is not the primary component of the lease. Accordingly, both lease and non-lease components are presented in "Real estate rental income" beginning January 1, 2019 in our consolidated financial statements. We elected to reclass bad debt expense to real estate rental income for the three and six months ended June 30, 2018. The effect on the three and six months ended June 30, 2018 was \$642 and \$791, respectively. The adoption of ASU 2016-02 did not result in a material change to our recognition of real estate rental income.

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Lease income related to the Company's operating leases is comprised of the following:

As of June 30, 2019	Six months ended June 30, 2019		
	Residential	Commercial	Total
	(in thousands)		
Lease income related to fixed lease payments	\$ 45,874	\$ 9,706	\$ 55,580
Lease income related to variable lease payments	—	3,038	3,038
Other (a)	(405)	81	(324)
Lease Income (b)	\$ 45,469	\$ 12,825	\$ 58,294

- (a) For the six months ended June 30, 2019, "Other" is comprised of revenue adjustments related to changes in collectibility and amortization of above and below market lease intangibles and lease inducements.
(b) Excludes other rental income for the six months ended June 30, 2019 of \$1,808, which is accounted for under the revenue recognition standard.

As of June 30, 2019	Three months ended June 30, 2019		
	Residential	Commercial	Total
	(in thousands)		
Lease income related to fixed lease payments	\$ 23,077	\$ 4,929	\$ 28,006
Lease income related to variable lease payments	—	1,551	1,551
Other (a)	(188)	(35)	(223)
Lease Income (b)	\$ 22,889	\$ 6,445	\$ 29,334

- (a) For the three months ended June 30, 2019, "Other" is comprised of revenue adjustments related to changes in collectibility and amortization of above and below market lease intangibles and lease inducements.
(b) Excludes other rental income for the three months ended June 30, 2019 of \$936, which is accounted for under the revenue recognition standard.

As of June 30, 2019, non-cancelable commercial operating leases provide for future minimum rental income as follows (in thousands). Apartment leases are not included as the terms are generally for one year or less.

Years ending December 31,	Amount
	(in thousands)
2019 (July 1, 2019 to December 31, 2019)	\$ 9,183
2020	17,353
2021	14,171
2022	10,800
2023	9,087
Thereafter	51,610
	\$ 112,204

Earnings per Common Share

Basic earnings per common share is computed by dividing net income available to common shareholders (the "numerator") by the weighted average number of common shares outstanding (the "denominator") during the period. Sterling had no dilutive potential common shares as of June 30, 2019 and 2018, and therefore, basic earnings per common share was equal to diluted earnings per common share for both periods.

For the three months ended June 30, 2019 and 2018, Sterling's denominators for the basic and diluted earnings per common share were approximately 9,209,000 and 8,720,000, respectively. For the six months ended June 30, 2019 and 2018,

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Sterling's denominators for the basic and diluted earnings per common share were approximately 9,151,000 and 8,674,000, respectively.

Reclassifications

Certain reclassifications considered necessary for a fair presentation have been made to the prior period financial statements in order to conform to the current year presentation. These reclassifications have not changed the results of operations or equity.

Recent Accounting Pronouncements

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*, which superseded FASB ASC Topic 840. The standard for operating leases as lessor is largely unchanged under ASU 2016-02. However, the standard requires lessees to recognize lease assets and lease liabilities for leases classified as operating and finance leases on the balance sheet. Lessees will recognize in the statement of financial position a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it will recognize lease expense for such leases generally on a straight-line basis over the lease term.

The new standard was effective for the Company effective January 1, 2019. The new standard was adopted using the optional transition method to apply the standard as of the effective date. The Company elected to apply the package of practical expedients for the leases as lessor for its residential and commercial leases and these leases will continue to be accounted for as operating leases as of the effective date. Further, the Company elected the practical expedient to combine lease and nonlease components for leases as lessor. Finally, the Company evaluated taxes collected from lessees, lessor costs paid directly by lessees, and initial direct costs and determined that the guidance was consistent with existing practice. Based on these evaluations, the Company determined that for leases as lessor, as of January 1, 2019, there was no impact on lease revenue or related expenses.

Management does not believe that any other recently issued, but not yet effective accounting pronouncements, if adopted, would have a material effect on the accompanying Consolidated Financial Statements.

NOTE 3 – SEGMENT REPORTING

We report our results in two reportable segments: residential and commercial properties. Our residential properties include multifamily properties. Our commercial properties include retail, office, industrial, restaurant and medical properties. We assess and measure operating results based on net operating income ("NOI"), which we define as total real estate segment revenues less real estate expenses (which consist of real estate taxes, property management fees, utilities, repairs and maintenance, insurance and direct administrative costs). We believe NOI is an important measure of operating performance even though it should not be considered an alternative to net income or cash flow from operating activities. NOI is unaffected by financing, depreciation, amortization and certain general and administrative expenses. The accounting policies of each segment are consistent with those described in Note 2 of this report.

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Segment Revenues and Net Operating Income

The revenues and net operating income for the reportable segments (residential and commercial) are summarized as follows for the three and six months ended June 30, 2019 and 2018, along with reconciliations to the consolidated financial statements. Segment assets are also reconciled to Total Assets as reported in the consolidated financial statements.

	Three months ended June 30, 2019			Three months ended June 30, 2018		
	Residential	Commercial	Total	Residential	Commercial	Total
	(in thousands)			(in thousands)		
Income from rental operations	\$ 23,822	\$ 6,448	\$ 30,270	\$ 22,014	\$ 6,632	\$ 28,646
Expenses from rental operations	12,995	1,856	14,851	12,756	1,851	14,607
Net operating income	\$ 10,827	\$ 4,592	\$ 15,419	\$ 9,258	\$ 4,781	\$ 14,039
Depreciation and amortization			5,353			5,283
Interest			4,582			4,576
Administration of REIT			971			1,089
Other (income)/expense			(308)			(1,886)
Net income			\$ 4,821			\$ 4,977

	Six months ended June 30, 2019			Six months ended June 30, 2018		
	Residential	Commercial	Total	Residential	Commercial	Total
	(in thousands)			(in thousands)		
Income from rental operations	\$ 47,258	\$ 12,844	\$ 60,102	\$ 44,244	\$ 13,503	\$ 57,747
Expenses from rental operations	26,384	3,675	30,059	24,845	3,609	28,454
Net operating income	\$ 20,874	\$ 9,169	\$ 30,043	\$ 19,399	\$ 9,894	\$ 29,293
Depreciation and amortization			10,891			10,633
Interest			9,298			9,076
Administration of REIT			2,082			2,243
Other (income)/expense			(839)			(2,895)
Net income			\$ 8,611			\$ 10,236

Segment Assets and Accumulated Depreciation

As of June 30, 2019	Residential	Commercial	Total
	(in thousands)		
Real estate investments	\$ 598,060	\$ 194,866	\$ 792,926
Accumulated depreciation	(97,321)	(39,976)	(137,297)
	\$ 500,739	\$ 154,890	655,629
Cash and cash equivalents			16,617
Restricted deposits and funded reserves			7,932
Investment in unconsolidated affiliates			2,641
Other assets			8,248
Intangible assets, less accumulated amortization			10,022
Total Assets			\$ 701,089

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As of December 31, 2018	Residential	Commercial	Total
		(in thousands)	
Real estate investments	\$ 595,006	\$ 195,690	\$ 790,696
Accumulated depreciation	(90,143)	(37,969)	(128,112)
	<u>\$ 504,863</u>	<u>\$ 157,721</u>	<u>662,584</u>
Cash and cash equivalents			21,212
Restricted deposits and funded reserves			8,853
Investment in unconsolidated affiliates			2,691
Other assets			8,151
Intangible assets, less accumulated amortization			10,976
Total Assets			\$ 714,467

NOTE 4 - LEASE INTANGIBLES

The following table summarizes the net value of other intangible assets and liabilities and the accumulated amortization for each class of intangible:

As of June 30, 2019	Lease Intangibles	Accumulated Amortization	Lease Intangibles, net
		(in thousands)	
Lease Intangible Assets			
In-place leases	\$ 21,480	\$ (13,269)	\$ 8,211
Above-market leases	3,211	(1,400)	1,811
	<u>\$ 24,691</u>	<u>\$ (14,669)</u>	<u>\$ 10,022</u>
Lease Intangible Liabilities			
Below-market leases	\$ (3,089)	\$ 1,754	\$ (1,335)
As of December 31, 2018	Lease Intangibles	Accumulated Amortization	Lease Intangibles, net
		(in thousands)	
Lease Intangible Assets			
In-place leases	\$ 21,480	\$ (12,422)	\$ 9,058
Above-market leases	3,211	(1,293)	1,918
	<u>\$ 24,691</u>	<u>\$ (13,715)</u>	<u>\$ 10,976</u>
Lease Intangible Liabilities			
Below-market leases	\$ (3,089)	\$ 1,621	\$ (1,468)

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The estimated aggregate amortization expense for each of the five succeeding fiscal years and thereafter is as follows:

Years ending December 31,	Intangible Assets	Intangible Liabilities
	(in thousands)	
2019 (July 1, 2019 to December 31, 2019)	\$ 889	\$ 128
2020	1,456	213
2021	1,163	184
2022	1,028	164
2023	891	151
Thereafter	4,595	495
	<u>\$ 10,022</u>	<u>\$ 1,335</u>

The weighted average amortization period for the intangible assets, in-place leases, above-market leases, and below-market leases acquired as of June 30, 2019 was 6.7 years.

NOTE 5 – LINES OF CREDIT

We have a \$18,300 variable rate (1-month LIBOR plus 2.25%) line of credit agreement with Wells Fargo Bank, which expires in June 2021; a \$6,315 variable rate (prime rate less 0.5%) line of credit agreement with Bremer Bank, which expires in November 2019; a \$5,000 variable rate (floating LIBOR plus 2.00%) line of credit agreement with Bremer Bank, which expires June 2022; and a \$3,200 variable rate (LIBOR plus 2.04%) line of credit agreement with Bank of the West, which expires November 2020. The lines of credit are secured by properties in Duluth, Edina, Moorhead and St. Cloud, Minnesota; and Bismarck, Dickinson, Grand Forks and Fargo, North Dakota. At June 30, 2019, there was no balance outstanding on the lines of credit, leaving \$32,815 available and unused under the agreements.

Certain line of credit agreements includes covenants that, in part, impose maintenance of certain debt service coverage and debt to net worth ratios on an annual and semi-annual basis. As of December 31, 2018, three residential properties were out of compliance with Bremer's debt service coverage ratio requirement on an individual property basis. As of June 30, 2019 and December 31, 2018, the pooled property debt yield was out of compliance with Wells Fargo's requirement. Annual and semi-annual waivers were received from the lenders.

NOTE 6 - MORTGAGE NOTES PAYABLE

The following table summarizes the Company's mortgage notes payable.

	Principal Balance At	
	June 30, 2019	December 31, 2018
	(in thousands)	
Fixed rate mortgage notes payable (a)	\$ 398,179	\$ 408,339
Less unamortized debt issuance costs	2,050	2,322
	<u>\$ 396,129</u>	<u>\$ 406,017</u>

(a) Includes \$840 and \$865 of variable rate mortgage debt that was swapped to a fixed rate at June 30, 2019 and December 31, 2018, respectively.

As of June 30, 2019, we had 124 mortgage loans with effective interest rates ranging from 3.54% to 7.25% per annum and a weighted average effective interest rate of 4.40% per annum.

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As of December 31, 2018, we had 127 mortgage loans with effective interest rates ranging from 3.44% to 7.25% per annum, and a weighted average effective interest rate of 4.42% per annum.

The majority of the Company's mortgages payable require monthly payments of principal and interest. Certain mortgages require reserves for real estate taxes and certain other costs. Mortgages are secured by the respective properties, assignment of rents, business assets, deeds to secure debt, deeds of trust and/or cash deposits.

Certain mortgage note agreements include covenants that, in part, impose maintenance of certain debt service coverage and debt to net worth ratios. As of December 31, 2018, nine loans on residential properties were out of compliance with annual loan covenants due to various unit renovation and parking lot repair and maintenance costs and increased vacancies in the North Dakota markets. The loans were secured by properties located in Bismarck, Fargo and Grand Forks, North Dakota with a total outstanding balance of \$13,128 at December 31, 2018. Annual waivers have been received from the lenders.

We are required to make the following principal payments on our outstanding mortgage notes payable for each of the five succeeding fiscal years and thereafter as follows:

Years ending December 31,	Amount
	(in thousands)
2019 (July 1, 2019 to December 31, 2019)	\$ 14,838
2020	28,616
2021	46,541
2022	31,788
2023	48,046
Thereafter	228,350
Total payments	\$ 398,179

NOTE 7 – HEDGING ACTIVITIES

As part of our interest rate risk management strategy, we have used derivative instruments to minimize significant unanticipated earnings fluctuations that may arise from rising variable interest rate costs associated with existing borrowings. To meet these objectives, we entered into an interest rate swap in the notional amount of \$1,294 to provide a fixed rate of 7.25% that matures in April 2020. The swap was issued at approximate market terms and thus no fair value adjustment was recorded at inception.

The carrying amount of the swap has been adjusted to its fair value at the end of the quarter, which because of changes in forecasted levels of LIBOR, resulted in reporting a liability for the fair value of the future net payments forecasted under the swaps. The interest rate swap is accounted for as an effective hedge in accordance with ASC 815-20 whereby it is recorded at fair value and changes in fair value are recorded to accumulated comprehensive income. As of June 30, 2019 and December 31, 2018, we recorded a liability and other accumulated comprehensive loss of \$23 and \$30, respectively.

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NOTE 8 - FAIR VALUE MEASUREMENT

The following table presents the carrying value and estimated fair value of the Company's financial instruments:

	June 30, 2019		December 31, 2018	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	(in thousands)			
Financial liabilities:				
Mortgage notes payable, net	\$ 396,129	\$ 407,370	\$ 406,017	\$ 400,192
Fair value of interest rate swaps	\$ 23	\$ 23	\$ 30	\$ 30

The carrying values shown in the table are included in the consolidated balance sheets under the indicated captions.

ASC 820-10 established a three-level valuation hierarchy for fair value measurement. Management uses these valuation techniques to establish the fair value of the assets at the measurement date. These valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect management's assumptions.

These two types of inputs create the following fair value hierarchy:

- Level 1 – Quoted prices for identical instruments in active markets;
- 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 whose significant inputs are observable;
- Level 3 – Instruments whose significant inputs are unobservable.

The guidance requires the use of observable market data, when available, in making fair value measurements. When inputs used to measure fair value fall within different levels of the hierarchy, the level within which the fair value measurement is categorized is based on the lowest level input that is significant to the fair value measurement.

Recurring Fair Value Measurements

The following table presents the Company's financial instruments, which are measured at fair value on a recurring basis, by the level in the fair value hierarchy within which those measurements fall. Methods and assumptions used to estimate the fair value of these instruments are described after the table.

	Level 1	Level 2	Level 3	Total
	(in thousands)			
June 30, 2019				
Fair value of interest rate swaps	\$ —	\$ 23	\$ —	\$ 23
December 31, 2018				
Fair value of interest rate swaps	\$ —	\$ 30	\$ —	\$ 30

Fair value of interest rate swaps: The fair value of interest rate swaps is determined using a discounted cash flow analysis on the expected future cash flows of the derivative. This analysis utilizes observable market data including forward yield curves and implied volatilities to determine the market's expectation of the future cash flows of the variable component. The fixed and variable components of the derivative are then discounted using calculated discount factors developed based on the LIBOR swap rate and are aggregated to arrive at a single valuation for the period. The Company also incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements.

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Although the Company has determined that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by itself and its counterparties. However, as of June 30, 2019 and December 31, 2018, the Company has assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and has determined that the credit valuation adjustments are not significant to the overall valuation. As a result, the Company has determined that its derivative valuations in their entirety are classified within Level 2 of the fair value hierarchy. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, the Company has considered any applicable credit enhancements. The Company's derivative instruments are further described in Note 7.

Fair Value Disclosures

The following table presents the Company's financial assets and liabilities, which are measured at fair value for disclosure purposes, by the level in the fair value hierarchy within which they fall. Methods and assumptions used to estimate the fair value of these instruments are described after the table.

	Level 1	Level 2	Level 3	Total
	(in thousands)			
June 30, 2019				
Mortgage notes payable, net	\$ —	\$ —	\$ 407,370	\$ 407,370
December 31, 2018				
Mortgage notes payable, net	\$ —	\$ —	\$ 400,192	\$ 400,192

Mortgage notes payable: The Company estimates the fair value of its mortgage notes payable by discounting the future cash flows of each instrument at rates currently offered to the Company for similar debt instruments of comparable maturities by the Company's lenders. Judgment is used in determining the appropriate rate for each of the Company's individual mortgages and notes payable based upon the specific terms of the agreement, including the term to maturity, the quality and nature of the underlying property and its leverage ratio. The rates used range from 4.00% to 4.10% and from 4.82% to 4.83% at June 30, 2019 and December 31, 2018, respectively. The fair value of the Company's matured mortgage notes payable were determined to be equal to the carrying value of the properties because there is no market for similar debt instruments and the properties' carrying value was determined to be the best estimate of fair value as of June 30, 2019 and December 31, 2018. The Company's mortgage notes payable are further described in Note 6.

NOTE 9 – NONCONTROLLING INTEREST OF UNITHOLDERS IN OPERATING PARTNERSHIP

As of June 30, 2019 and December 31, 2018, outstanding limited partnership units totaled 17,826,000 and 17,876,000 respectively. For the three months ended June 30, 2019 and 2018, the operating partnership declared distributions of \$4,657 and \$4,465 respectively, to limited partners which were paid on July 15, 2019 and July 16, 2018, respectively. Distributions per unit were \$0.52250 and \$0.508750 during the six months ended June 30, 2019 and 2018, respectively.

During the six months ended June 30, 2019 and 2018 there were no limited partnership units exchanged for common shares pursuant to redemption requests.

At the sole and absolute discretion of the limited partnership, and so long as our redemption plans exist, and applicable holding periods are met, Limited Partners may request the operating partnership redeem their limited partnership units. The operating partnership may choose to offer the Limited Partner: (i) cash for the redemption or, at the request of the Limited Partner, (2) offer shares in lieu of cash for the redemption on a basis of one limited partnership unit for one Sterling common share (the "Exchange Request"). The Exchange Request shall be exercised pursuant to a Notice of Exchange. If

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the issuance of Sterling common shares pursuant to an Exchange Request will cause the shareholder to exceed the ownership limitations, among other reasons, payment will be made to the Limited Partner in cash. No Limited Partner may exercise an Exchange Request more than twice during any calendar year, and Exchange Requests may not be made for less than 1,000 limited partnership units. If a Limited Partner owns fewer than 1,000 limited partnership units, all of the limited partnership units held by the Limited Partner must be exchanged pursuant to the Exchange Request.

NOTE 10 – REDEMPTION PLANS

Our Board of Trustees has approved redemption plans that enable our shareholders to sell their common shares and the partners of our operating partnership to sell their limited partnership units to us, after they have held the securities for at least one year and subject to other conditions and limitations described in the plans. Our redemption plans currently provide that the maximum amount that can be redeemed under the plan is \$35,000 worth of securities. Currently, the fixed redemption price is \$18.00 per share or unit under the plans, which price became effective January 1, 2019.

We may redeem securities under the plans provided that the aggregate total has not been exceeded and we have sufficient funds to do so. The plans will terminate in the event the shares become listed on any national securities exchange, the subject of bona fide quotes on any inter-dealer quotation system or electronic communications network or are the subject of bona fide quotes in the pink sheets. Additionally, the Board, in its sole discretion, may terminate, amend or suspend the redemption plans, either or both of them, if it determines to do so in its sole discretion.

During the six months ended June 30, 2019 and 2018, the Company redeemed 20,000 and 49,000 common shares valued at \$351 and \$858. In addition, during the six months ended June 30, 2019 and 2018, the Company redeemed 50,000 and 46,000 units valued at \$902 and \$805.

NOTE 11 – BENEFICIAL INTEREST

We are authorized to issue 100,000,000 common shares of beneficial interest with \$0.01 par value and 50,000,000 preferred shares with \$0.01 par value, which collectively represent the entire beneficial interest of Sterling. As of June 30, 2019 and December 31, 2018, there were 9,206,000 and 8,967,000 common shares outstanding, respectively. We had no preferred shares outstanding as of either date.

Dividends paid to holders of common shares were \$0.52250 per share and \$0.508750 per share for the six months ended June 30, 2019 and 2018, respectively.

NOTE 12 – DIVIDEND REINVESTMENT PLAN

Our Board of Trustees approved a dividend reinvestment plan to provide existing holders of our common shares with a convenient method to purchase additional common shares without payment of brokerage commissions, fees or service charges. On July 20, 2012, we registered with the Securities Exchange Commission 2,000,000 common shares to be issued under the plan on Form S-3D, which automatically became effective on July 20, 2012. On July 11, 2017, we registered with the Securities Exchange Commission an additional 2,000,000 common shares to be issued under the plan on Form S-3D, which automatically became effective on July 11, 2017.

Under this plan, eligible shareholders may elect to have all or a portion (but not less than 25%) of the cash dividends they receive automatically reinvested in our common shares. If an eligible shareholder elects to reinvest cash dividends under the plan, the shareholder may also make additional optional cash purchases of our common shares, not to exceed \$10 per fiscal quarter without our prior approval. The purchase price per common share under the plan equals 95% of the estimated value per common share for dividend reinvestments and equals 100% of the estimated value per common share for

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additional optional cash purchases, as determined by our Board of Trustees. In addition, eligible shareholders may not in any calendar year purchase or receive via transfer more than \$40 additional optional cash purchases of Common Shares.

The estimated value per common share was \$19.00 and \$18.50 at June 30, 2019 and December 31, 2018, respectively. See discussion of determination of estimated value in Note 16.

Therefore, the purchase price per common share for dividend reinvestments was \$18.05 and \$17.58 and for additional optional cash purchases was \$19.00 and \$18.50 at June 30, 2019 and December 31, 2018, respectively. The Board, in its sole discretion, may amend, suspend or terminate the plan at any time, without the consent of shareholders, upon a ten-day notice to participants.

In the six months ended June 30, 2019, 168,000 shares were issued pursuant to dividend reinvestments and 91,000 shares were issued pursuant to additional optional cash purchases under the plan. In the six months ended June 30, 2018, 159,000 shares were issued pursuant to dividend reinvestments and 117,000 shares were issued pursuant to additional optional cash purchases under the plan.

NOTE 13 – RELATED PARTY TRANSACTIONS

Property Management Fees

During the six months ended June 30, 2019 and 2018, we paid property management fees to GOLDMARK Property Management in an amount equal to 5% of rents of the properties managed by GOLDMARK. GOLDMARK Property Management is owned in part by Kenneth Regan, James Wieland and Joel Thomsen. For the six months ended June 30, 2019 and 2018, we paid management fees of \$6,313 and \$6,409, respectively, to GOLDMARK Property Management. In addition, during the six months ended June 30, 2019 and 2018, we paid repair and maintenance related payroll and payroll related expenses to GOLDMARK Property Management totaling \$3,118 and \$2,581, respectively.

Board of Trustee Fees

We incurred Trustee fees of \$29 and \$34 during the six months ended June 30, 2019 and 2018, respectively. As of June 30, 2019, and December 31, 2018 we owed our Trustees \$63 and \$34 for unpaid board of trustee fees, respectively. There is no cash retainer paid to Trustees. Instead, we pay Trustees specific amounts for meetings attended.

The plan provides:

Board Chairman – Board Meeting	105 shares/meeting
Trustee – Board Meeting	75 shares/meeting
Committee Chair – Committee Meeting	30 shares/meeting
Trustee – Committee Meeting	30 shares/meeting

Common shares earned in accordance with the plan are calculated on an annual basis. Shares earned pursuant to the Trustee Compensation Plan are issued on or about July 15 for Trustees' prior year of service. Non-independent Trustees are not compensated for their service on the Board or Committees.

Advisory Agreement

We are an externally managed trust and as such, although we have a Board of Trustees and executive officers responsible for our management, we have no paid employees. The following is a brief description of the current fees and compensation

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that may be received by the Advisor under the Advisory Agreement, which must be renewed on an annual basis and approved by a majority of the independent trustees. The Advisory Agreement was approved by the Board of Trustees (including all the independent Trustees) on March 28, 2019, effective until March 31, 2020.

Management Fee : 0.35% of our total assets (before depreciation and amortization), annually. Total assets are our gross assets (before depreciation and amortization) as reflected on our consolidated financial statements, taken as of the end of the fiscal quarter last preceding the date of computation. The management fee will be payable monthly in cash or our common shares, at the option of the Advisor, not to exceed one-twelfth of 0.35% of the total assets as of the last day of the immediately preceding month. The management fee calculation is subject to quarterly and annual reconciliations. The management fee may be deferred at the option of the Advisor, without interest.

During the six months ended June 30, 2019 and 2018, we incurred advisory management fees of \$1,496 and \$1,440 with Sterling Management, LLC, our Advisor. As of June 30, 2019 and December 31, 2018, we owed our Advisor \$498 and \$242, respectively, for unpaid advisory management fees. These fees cover the office facilities, equipment, supplies, and staff required to manage our day-to-day operations. During the six months ended June 30, 2019 and 2018, we reimbursed the Advisor for operating costs totaling \$22 and \$15, respectively. There were no unpaid reimbursable operating costs owed to our Advisor as of June 30, 2019 or December 31, 2018.

Acquisition Fee : For its services in investigating and negotiating acquisitions of investments for us, the Advisor receives an acquisition fee of 2.5% of the purchase price of each property acquired, capped at \$375 per acquisition. The total of all acquisition fees and acquisition expenses cannot exceed 6% of the purchase price of the investment, unless approved by a majority of the trustees, including a majority of the independent trustees, if they determine the transaction to be commercially competitive, fair and reasonable to us.

During the six months ended June 30, 2019 there were no acquisition fees incurred with our Advisor. During the six months ended June 30, 2018 we incurred acquisition fees of \$114 with our Advisor. There were no acquisition fees owed to our Advisor as of June 30, 2019. As of December 31, 2018, we owed our Advisor \$32 for unpaid acquisition fees.

Disposition Fee : For its services in the effort to sell any investment for us, the Advisor receives a disposition fee of 2.5% of the sales price of each property disposition, capped at \$375 per disposition.

During the six months ended June 30, 2019 there were no disposition fees incurred with our Advisor. During the six months ended June 30, 2018, we incurred \$130 in disposition fees with our Advisor. See Note 15. There were no disposition fees owed to our Advisor as of June 30, 2019 or December 31, 2018.

Financing Fee : 0.25% of all amounts made available to us pursuant to any loan, refinance (excluding rate and/or term modifications of an existing loan with the same lender), line of credit or other credit facility. The finance fee shall be capped at \$38 per loan, refinance, line of credit or other credit facility.

During the six months ended June 30, 2019 there were no financing fees incurred with our Advisor for loan financing and refinancing activities. During the six months ended June 30, 2018, we incurred financing fees of \$25 with our Advisor. There were no financing fees owed to our Advisor as of June 30, 2019. As of December 31, 2018, we owed our Advisor \$8 for unpaid financing fees.

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Development Fee : Based on regressive sliding scale (starting at 5% and declining to 3%) of total project costs, excluding cost of land, for development services requested by us.

Total Cost	Fee	Range of Fee	Formula
0 – 10M	5.0 %	0 – .5M	$0M - 5.0\% \times (TC - 0M)$
10M - 20M	4.5 %	.5 M – .95M	$.50M - 4.5\% \times (TC - 10M)$
20M – 30M	4.0 %	.95 M – 1.35M	$.95M - 4.0\% \times (TC - 20M)$
30M – 40M	3.5 %	1.35 M – 1.70M	$1.35M - 3.5\% \times (TC - 30M)$
40M – 50M	3.0 %	1.70 M – 2.00M	$1.70M - 3.0\% \times (TC - 40M)$

TC = Total Project Cost

During the six months ended June 30, 2019 and 2018, there were no development fees incurred with our Advisor. As of both June 30, 2019, and December 31, 2018, we owed our Advisor a total of \$104 for unpaid development fees, of which the entire amount was for unpaid development fees as part of a 10% hold back with respect to the Stonefield development project, respectively.

Operating Partnership Units Issued in Connection with Acquisitions

During the six months ended June 30, 2019, there were no operating partnership units issued directly or indirectly, to affiliated entities.

During the six months ended June 30, 2018, we issued directly or indirectly 42,000 operating partnership units to entities affiliated with Messrs. Regan and Wieland, two of our trustees, in connection with the acquisition of various properties. The aggregate value of these units was \$773.

Rental Income

During the six months ended June 30, 2019 and 2018, we received rental income of \$25 and \$25, respectively, under an operating lease agreement with our Advisor.

During the six months ended June 30, 2019 and 2018, we received rental income of \$28 and \$27, respectively, under an operating lease agreement with GOLDMARK Commercial Real Estate Services, Inc.

During the six months ended June 30, 2019 and 2018, we received rental income of \$115 and \$115, respectively, under operating lease agreements with GOLDMARK Property Management.

NOTE 14 - COMMITMENTS AND CONTINGENCIES

Environmental Matters

Federal law (and the laws of some states in which we own or may acquire properties) imposes liability on a landowner for the presence on the premises of hazardous substances or wastes (as defined by present and future federal and state laws and regulations). This liability is without regard to fault or knowledge of the presence of such substances and may be imposed jointly and severally upon all succeeding landowners. If such hazardous substance is discovered on a property acquired by us, we could incur liability for the removal of the substances and the cleanup of the property.

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There can be no assurance that we would have effective remedies against prior owners of the property. In addition, we may be liable to tenants and may find it difficult or impossible to sell the property either prior to or following such a cleanup.

Risk of Uninsured Property Losses

We maintain property damage, fire loss, and liability insurance. However, there are certain types of losses (generally of a catastrophic nature) which may be either uninsurable or not economically insurable. Such excluded risks may include war, earthquakes, tornados, certain environmental hazards, and floods. Should such events occur, (i) we might suffer a loss of capital invested, (ii) tenants may suffer losses and may be unable to pay rent for the spaces, and (iii) we may suffer a loss of profits which might be anticipated from one or more properties.

Litigation

The Company is subject, from time to time, to various legal proceedings and claims that arise in the ordinary course of business. While the resolution of such matters cannot be predicted with certainty, management believes, based on currently available information, that the final outcome of such matters will not have a material effect on the financial statements of the Company.

NOTE 15 – DISPOSITIONS

During the six months ended June 30, 2019, the operating partnership did not dispose of any properties. During the six months ended June 30, 2018, the operating partnership sold one property. We sold an industrial property located in Redwood Falls, Minnesota for \$5,200 and recognized a gain of \$1,084 in April 2018.

NOTE 16 – ACQUISITIONS

The Company had no acquisitions during the six months ended June 30, 2019. The Company closed on the following acquisitions during the six months ended June 30, 2018:

Date	Property Name	Location	Property Type	Units/ Square Footage/ Acres	Acquisition Price
3/1/18	Thunder Creek Apartments	Fargo, ND	Apartment complex	57 units	\$ 4,460 (a)

(a) Acquisition price does not include capitalized costs and adjustments of \$119.

Total consideration given for acquisitions through June 30, 2018 was completed through issuing approximately 84,000 limited partnership units of the operating partnership valued at \$18.50 per unit for an aggregate consideration of approximately \$1,546, assumed liabilities of \$54 and cash of \$2,979. The value of units issued in exchange for property is determined through a value established annually by our Board of Trustees, and reflects the fair value at the time of issuance.

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The following table summarizes the acquisition date fair values, before prorations, the Company recorded in conjunction with the acquisitions discussed above:

	Six Months Ended June 30,	
	2019	2018
Land, building, tenant improvements and FF&E	\$ -	\$ 4,579
Other liabilities	-	(54)
Net assets acquired	-	4,525
Equity/limited partnership unit consideration	-	(1,546)
Net cash consideration (a)	\$ -	\$ 2,979

Estimated Value of Units/Shares

The Board of Trustees determined an estimate of fair value for the trust shares in the first six months of 2019 and 2018. In addition, the Board of Trustees, acting as general partner for the operating partnership, determined an estimate of fair value for the limited partnership units in the first six months of 2019 and 2018. In determining this value, the Board relied upon their experience with, and knowledge about, the Trust's real estate portfolio and debt obligations. The Board typically determines the share price on an annual basis. The trustees determine the price in their discretion and use data points to guide their determination which is typically based on a consensus of opinion. In addition, the Board considers how the price chosen will affect existing share and unit values, redemption prices, dividend coverage ratios, yield percentages, dividend reinvestment factors, and future UPREIT transactions, among other considerations and information.

The Board determined the fair value of the shares and limited partnership units to be \$18.50 per share/unit effective January 1, 2018. The Board determined the fair value of the shares and limited partnership units to be \$19.00 per share/unit effective January 1, 2019.

Determination of price is a matter within the Board's sole discretion. The Trust does not determine price based on any rote formula or specific factors. At this time, no shares are held in street name accounts and the Trust is not subject to FINRA's specific pricing requirements set out in Rule 2340 or otherwise. Thus, the Trust does not employ any specific valuation methodology or formula. Rather, the Board looks to available data and information, which is often adjusted and weighted to comport more closely with the assets held by the Trust at the time of valuation. The principal valuation methodology utilized is the NAV calculation/direct capitalization method. The information made available to the Board is assembled by the Trust's Advisor.

As with any valuation methodology, the methodologies utilized by the Board in reaching an estimate of the value of the shares and limited partnership units are based upon a number of estimates, assumptions, judgments or opinions that may, or may not, prove to be correct. The use of different estimates, assumptions, judgments, or opinions would likely have resulted in significantly different estimates of the value of the shares and limited partnership units. In addition, the Board's estimate of share and limited partnership unit value is not based on the book values of our real estate, as determined by GAAP, as our book value for most real estate is based on the amortized cost of the property, subject to certain adjustments.

Furthermore, in reaching an estimate of the value of the shares and limited partnership units, the Board applied a liquidity discount to one valuation scenario in order to reflect the fact that the shares and limited partnership units are not currently traded on a national securities exchange and did not consider: a discount for debt that may include a prepayment obligation or a provision precluding assumption of the debt by a third party or the costs that are likely to be incurred in connection with an appropriate exit strategy, whether that strategy might be a listing of the limited partnership units or common shares on a national securities exchange or a merger or sale of our portfolio.

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NOTE 17 - SUBSEQUENT EVENTS

On July 15, 2019, we paid a dividend or distribution of \$0.26125 per share on our common shares of beneficial interest or limited partnership units, respectively, to common shareholders and limited partnership unit holders of record on June 28, 2019.

Pending acquisitions and dispositions are subject to numerous conditions and contingencies and there are no assurances that the transactions will be completed.

We have evaluated subsequent events through the date of this filing. We are not aware of any other subsequent events which would require recognition or disclosure in the consolidated financial statements.

All dollar amounts in this Form 10-Q in Part I Items 2. through 4 and Part II Items 2. are stated in thousands with the exception of share and per share amounts, unless otherwise indicated.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995

Certain statements contained in this section and elsewhere in this Form 10-Q constitute “*forward-looking statements*” within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve a number of known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include but are not limited to: (i) trends affecting our financial condition or results of operations; (ii) our business and growth strategies; (iii) the real estate industry; (iv) our financing plans; and (v) other risks detailed in the Company’s periodic reports filed with the Securities and Exchange Commission. The words “*believe*”, “*expect*”, “*anticipate*”, “*may*”, “*plan*”, “*should*”, and similar expressions identify forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date the statements were made and are not guarantees of future performance.

Overview

Sterling Real Estate Trust (“Sterling”, “the Trust” or “the Company”) is a registered, but unincorporated business trust organized in North Dakota in December 2002. Sterling has elected to be taxed as a Real Estate Investment Trust (“REIT”) under Sections 856-860 of the Internal Revenue Code, which requires that 75% of the assets of a REIT must consist of real estate assets and that 75% of its gross income must be derived from real estate. The net income of the REIT is allocated in accordance with the stock ownership in the same fashion as a regular corporation. Our real estate portfolio consisted of 173 properties containing 9,852 apartment units and approximately 1,662,000 square feet of leasable commercial space as of June 30, 2019.

We operate as an Umbrella Partnership Real Estate Investment Trust (UPREIT), which is a REIT that holds all or substantially all of its assets through a partnership which the REIT controls as general partner. Therefore, we hold all or substantially all of our assets through our operating partnership. We control the operating partnership as the sole general partner and own approximately 34.06% of the operating partnership as of June 30, 2019. For purposes of satisfying the asset and income tests for qualification as a REIT for tax purposes, our proportionate shares of the assets and income of our operating partnership are deemed to be assets and income of the trust.

We use this UPREIT structure to facilitate acquisitions of real estate properties. A sale of property directly to a REIT is generally a taxable transaction to the property seller. However, in an UPREIT structure, if a property seller exchanges the property with one of its operating partnerships in exchange for limited partnership units, the seller may defer taxation of gain in such exchange until the seller resells its limited partnership units or exchanges its limited partnership units for the REIT’s common stock. By offering the ability to defer taxation, we may gain a competitive advantage in acquiring desired properties over other buyers who cannot offer this benefit. In addition, investing in our operating partnership, rather than directly in Sterling, may be more attractive to certain institutional or other investors due to their business or tax structure. If an investor is interested in making a substantial investment in our operating partnership, our structure provides us the flexibility to accommodate different terms for each investment, while applicable tax laws generally restrict a REIT from charging different fee rates among its shareholders. Finally, if our shares become publicly traded, the former property seller may be able to achieve liquidity for the investment in order to pay taxes.

Operating Partnership

Our operating partnership, Sterling Properties, LLLP, was formed as a North Dakota limited liability limited partnership April 2003 to acquire, own and operate properties on our behalf. The operating partnership holds a diversified portfolio of multifamily and commercial properties located principally in the upper and central Midwest United States.

As of June 30, 2019, approximately 73.2% of our properties were apartment communities located primarily in North Dakota with others located in Minnesota, Missouri and Nebraska. Most multifamily properties are leased to a variety of tenants under short-term leases.

As of June 30, 2019, approximately 26.8% of our properties were comprised of office, retail, industrial, restaurant and medical commercial property located primarily in North Dakota with others located in Arkansas, Colorado, Iowa, Louisiana, Michigan, Minnesota, Mississippi, Nebraska and Wisconsin. We have both single and multi-tenant properties in the commercial portfolio, most of which are under long-term leases.

Our real estate portfolio consisted of 173 properties containing 9,852 apartment units and approximately 1,662,000 square feet of leasable commercial space as of June 30, 2019. The portfolio has a net book value of real estate investments (cost less accumulated depreciation) of approximately \$655,629, which includes construction in progress. Sterling's current acquisition strategy and focus is on multifamily apartment properties.

Our Board of Trustees and Executive Officers

We operate under the direction of our Board of Trustees, the members of which are accountable to us and our shareholders. Our trustees are elected annually by our shareholders. In addition, the Board has a duty to supervise our relationship with the Advisor and evaluates the performance of and fees paid to the Advisor on an annual basis. The Advisory Agreement was approved by the Board of Trustees (including all the independent trustees) on March 28, 2019, effective April 1, 2019 until March 31, 2020. Our Board of Trustees has provided investment guidance for the Advisor to follow, and must approve each investment recommended by the Advisor. Currently, we have nine members on our board, seven of whom are independent.

Our Advisor

Our external Advisor is Sterling Management, LLC, a North Dakota limited liability company formed in November 2002. Our Advisor, with an office in Fargo, North Dakota, is responsible for managing our day-to-day affairs and for identifying, acquiring and disposing investments on our behalf.

Critical Accounting Estimates

Preparation of our financial statements requires estimates and judgments to be made that affect the amounts of assets, liabilities, revenues and expenses reported. Such decisions include the selection of the appropriate accounting principles to be applied and the assumptions on which to base accounting estimates. We evaluate these estimates based on assumptions we believe to be reasonable under the circumstances.

There have been no material changes in our Critical Accounting Policies as disclosed in Note 2 to our financial statements for the six months ended June 30, 2019 included elsewhere in this report.

Specific Achievements

- Increased revenues from rental operations by \$2,355 or 4.1% for the six months ended June 30, 2019, compared to same six month period in 2018.
- Declared and paid dividends aggregating \$0.52250 per common share for the six months ended June 30, 2019.

Results of Operations for the Three Months Ended June 30, 2019 and 2018

	Three months ended June 30, 2019			Three months ended June 30, 2018		
	Residential	Commercial (unaudited) (in thousands)	Total	Residential	Commercial (unaudited) (in thousands)	Total
Real Estate Revenues	\$ 23,822	\$ 6,448	\$ 30,270	\$ 22,014	\$ 6,632	\$ 28,646
Real Estate Expenses						
Real Estate Taxes	2,308	711	3,019	2,194	704	2,898
Property Management	3,171	286	3,457	3,058	198	3,256
Utilities	1,978	261	2,239	1,859	351	2,210
Repairs and Maintenance	4,989	578	5,567	5,083	574	5,657
Insurance	549	20	569	562	24	586
Total Real Estate Expenses	12,995	1,856	14,851	12,756	1,851	14,607
Net Operating Income	\$ 10,827	\$ 4,592	\$ 15,419	\$ 9,258	\$ 4,781	\$ 14,039
Interest			4,582			4,576
Depreciation and amortization			5,353			5,283
Administration of REIT			971			1,089
Other (income)/expense			(308)			(1,886)
Net Income			\$ 4,821			\$ 4,977
Net Income Attributed to:						
Noncontrolling Interest			\$ 3,174			\$ 3,302
Sterling Real Estate Trust			\$ 1,647			\$ 1,675
Dividends per share ⁽¹⁾			\$ 0.2613			\$ 0.2544
Earnings per share			\$ 0.18			\$ 0.19
Weighted average number of common shares			9,209			8,720

(1) Does not take into consideration the amounts distributed by the operating partnership to limited partners.

Revenues

Property revenues of \$30,270 for the three months ended June 30, 2019 increased \$1,624 or 5.7% in comparison to the same period in 2018. Residential property revenues increased \$1,808 and commercial property revenues decreased \$184.

The following table illustrates changes in occupancy for the three month periods indicated:

	June 30, 2019	June 30, 2018
Residential occupancy	94.1 %	94.0 %
Commercial occupancy	88.4 %	92.1 %

Residential revenues for the three months ended June 30, 2019 increased \$1,808 in comparison to the same period for 2018. Residential properties acquired since January 1, 2018 contributed approximately \$747 to the increase in total residential revenues in the three months ended June 30, 2019. Rental income from residential properties owned for more than one year increased approximately \$432 in comparison to the three months ended June 30, 2018. Residential revenues comprised 78.7% of total revenues for the three months ended June 30, 2019 compared to 76.8% of total revenues for the three months ended June 30, 2018. The residential occupancy rates for the three months ended June 30, 2019 increased 0.1% primarily due to marketing strategies to increase unit rentals, as well as acquisitions occurring in late 2018.

For the three months ended June 30, 2019 total commercial revenues decreased \$184 in comparison to the same period for 2018. The decrease was attributed to the sales of an industrial property in Redwood Falls, Minnesota and a retail property in Austin, Texas, as well as recognizing rental incentives on an office property located in Fargo, North Dakota. Commercial revenues comprised 21.3% of the total revenues for the three months ended June 30, 2019 compared to 23.2%

of total revenues for the three months ended June 30, 2018. The commercial occupancy rates for the three months ended June 30, 2019 decreased 3.7% primarily due to vacant office buildings located in both Waite Park, Minnesota and Fargo, North Dakota.

Expenses

Residential expenses from operations of \$12,995 during the three months ended June 30, 2019 increased \$239 or 1.9% in comparison to the same period in 2018. The increase was attributed to an increase in utilities expense of \$119 or 6.4%, as well as increased real estate tax expense. Real estate taxes increased \$114 or 5.2% due to acquisitions of properties occurring in late 2018. Actual property management fees remain unchanged and continue to approximate 5% of net collected rents; however, other property management related expenses have increased due to increased competition for labor.

Commercial expenses from operations of \$1,856 during the three months ended June 30, 2019 increased \$5 or 0.3% in comparison to the same period in 2018. The expenses remain consistent with the prior period.

Interest expense of \$4,582 during the three months ended June 30, 2019 increased \$6 in comparison to the same period in 2018. Interest expense was approximately 15.1% and 16.0% of rental income for the three months ended June 30, 2019 and 2018, respectively.

Depreciation and amortization expense increased 1.3% from \$5,283 for the three months ended June 30, 2018 to \$5,353 for the three months ended June 30, 2019. The increase is primarily due to normal increases in monthly amortization expense. Amortization expense will continue to decrease as lease intangibles become fully amortized but will increase upon acquisitions of intangible assets.

REIT administration expenses decreased from \$1,089 for the three months ended June 30, 2018 to \$971 for the three months ended June 30, 2019 due to disposition fees recorded in 2018. As of December 31, 2018, all disposition fees are netted with gain or loss on sale of real estate investments.

Net Operating Income

We measure the performance of our segments based on net operating income ("NOI"), which we define as total revenue from rental operations less expenses from rental operations and real estate taxes (excluding depreciation and amortization related to real estate investments and impairment of real estate investments). We believe that NOI is an important supplemental measure of operating performance for a REIT because it provides a measure of core operations unaffected by depreciation, amortization, financing, and administration expense. NOI does not represent cash generated by operating activities in accordance with GAAP and should not be considered an alternative to net income, net income available for non-controlling interests and shareholders of the Trust or cash flow from operating activities as a measure of financial performance. See Note 3 for NOI performance by segment.

Net Income

Net income for the three months ended June 30, 2019 was \$4,821 compared to \$4,977 for the three months ended June 30, 2018. The decrease noted in Net Income is primarily attributed to the one-time activity in the prior period that did not occur in the current period. During the Q2 2018, we recognized a gain on involuntary conversion of \$1,886 compared to \$308 in Q2 2019. Q2 2019 has seen increased income from operations of \$1,422 which has offset the one time activity from Q2 2018.

Results of Operations for the Six Months Ended June 30, 2019

	Six months ended June 30, 2019			Six months ended June 30, 2018		
	Residential	Commercial (unaudited) (in thousands)	Total	Residential	Commercial (unaudited) (in thousands)	Total
Real Estate Revenues	\$ 47,258	\$ 12,844	\$ 60,102	\$ 44,244	\$ 13,503	\$ 57,747
Real Estate Expenses						
Real Estate Taxes	4,658	1,390	6,048	4,374	1,370	5,744
Property Management	6,286	496	6,782	5,973	436	6,409
Utilities	4,538	587	5,125	4,268	736	5,004
Repairs and Maintenance	9,761	1,162	10,923	9,172	1,022	10,194
Insurance	1,141	40	1,181	1,058	45	1,103
Total Real Estate Expenses	26,384	3,675	30,059	24,845	3,609	28,454
Net Operating Income	\$ 20,874	\$ 9,169	30,043	\$ 19,399	\$ 9,894	29,293
Interest			9,298			9,076
Depreciation and amortization			10,891			10,633
Administration of REIT			2,082			2,243
Other (income)/expense			(839)			(2,895)
Net Income			\$ 8,611			\$ 10,236
Net Income Attributed to:						
Noncontrolling Interest			\$ 5,676			\$ 6,819
Sterling Real Estate Trust			\$ 2,935			\$ 3,417
Dividends per share ⁽¹⁾			\$ 0.5225			\$ 0.5088
Earnings per share			\$ 0.3200			\$ 0.3900
Weighted average number of common shares			9,151			8,674

(1) Does not take into consideration the amounts distributed by the operating partnership to limited partners.

Revenues

Property revenues of \$60,102 for the six months ended June 30, 2019 increased \$2,355 or 4.1% in comparison to the same period in 2018. Residential property revenues increased \$3,014 and commercial property revenues decreased \$659.

The following table illustrates changes in occupancy for the six month periods indicated:

	June 30, 2019	June 30, 2018
Residential occupancy	93.8 %	94.1 %
Commercial occupancy	88.4 %	92.1 %

Residential revenues for the six months ended June 30, 2019 increased \$3,014 in comparison to the same period for 2018. Residential properties acquired since January 1, 2018 contributed approximately \$1,568 to the increase in total residential revenues in the six months ended June 30, 2019. The remaining increase is due to improved collection efforts in regards to outstanding receivables, decreasing bad debt expense and increase collections on balances written off. Income related to Ratio Utility Billing System (RUBS) income in our Minneapolis market also contributed to the overall residential income increase. Residential revenues comprised 78.6% of total revenues for the six months ended June 30, 2019 compared to 76.6% of total revenues for the six months ended June 30, 2018. Residential occupancy year-over-year has decreased 0.31% due to increased competition from development of new properties in a mature real estate market.

For the six months ended June 30, 2019, total commercial revenues decreased \$659 in comparison to the same period for 2018. The decrease was primarily attributable to the sale of three commercial properties in 2018, as well as rental incentives recorded in 2019 for an office building in Fargo, North Dakota. Commercial revenues comprised 21.4%

of the total revenues for the six months ended June 30, 2019 compared to 23.4% of total revenues for the six months ended June 30, 2018. Commercial occupancy year-over-year decreased 3.7% primarily due to vacant office buildings located in both Waite Park, Minnesota and Fargo, North Dakota.

Expenses

Residential expenses from operations of \$26,384 during the six months ended June 30, 2019 increased \$1,539 or 6.2% in comparison to the same period in 2018. The increase was primarily due to increased real estate taxes of \$284 or 6.4% due to increased real estate tax estimates in 2019 as well as acquisitions occurring in late 2018. Utilities and repairs and maintenance expense increases also contributed to the increase due to utility rate increases and performing upgrades to residential units prior to re-leasing. In addition, we experienced increases in property management fees of \$99 or 4.5%. Actual property management fees remain unchanged and continue to approximate 5% of net collected rents; however, other property management related expenses have increased due to increased competition for labor.

Commercial expenses from operations of \$3,675 during the six months ended June 30, 2019 increased \$66 or 1.8% in comparison to the same period in 2018. The increase in commercial expenses related to demolition work incurred on an office property in Fargo, North Dakota as the result of a roof collapse.

Interest expense of \$9,298 during the six months ended June 30, 2019 increased \$222 in comparison to the same period in 2018 due to an increase in interest expense related to mortgage interest incurred on our acquired properties in the third and fourth quarters of 2018. Interest expense was approximately 15.5% and 15.7% of rental income for the six months ended June 30, 2019 and 2018, respectively.

Depreciation and amortization expense increased 2.4% from \$10,633 for the six months ended June 30, 2018 to \$10,891 for the six months ended June 30, 2019. The \$258 increase was primarily a result of increases in depreciation and amortization expenses attributed to acquisitions in the third and fourth quarters of 2018. Amortization expense will generally continue to decrease as lease intangibles become fully amortized except when acquisitions occur. Depreciation and amortization expense as a percentage of rental income for the six months ended June 30, 2019 and 2018 was relatively consistent at 18.1% and 18.4%, respectively.

Other income decreased 71.0% from \$2,895 for the six months ended June 30, 2018 to \$839 for the six months ended June 30, 2019. The decrease was primarily attributed to one-time activity in the prior period that did not occur in the current period. During the six months ended June 30, 2018 we recognized a gain on involuntary conversion of \$1,370 and a gain on sale of real estate investments of \$1,084.

REIT administration expenses decreased from \$2,243 for the six months ended June 30, 2018 to \$2,082 for the six months ended June 30, 2019 due to disposition fees recognized during the six month period ending June 30, 2018 of \$148.

Net Operating Income

We measure the performance of our segments based on net operating income ("NOI"), which we define as total revenue from rental operations less expenses from rental operations and real estate taxes (excluding depreciation and amortization related to real estate investments and impairment of real estate investments). We believe that NOI is an important supplemental measure of operating performance for a REIT because it provides a measure of core operations unaffected by depreciation, amortization, financing, and administration expense. NOI does not represent cash generated by operating activities in accordance with GAAP and should not be considered an alternative to net income, net income available for non-controlling interests and shareholders of the Trust or cash flow from operating activities as a measure of financial performance. See Note 3 for NOI performance by segment.

Net Income

Net income for the six months ended June 30, 2019 was \$8,611 compared to \$10,236 for the six months ended June 30, 2018. During the six months ended June 30, 2018, the Company recognized one-time gains in other income totaling \$2,454, as discussed above, which resulted in higher net income in the prior period than the current period.

Property Acquisitions and Dispositions

See Notes 15 and 16 to the Consolidated Financial Statements included above for more information regarding our acquisitions and dispositions during the six months ended June 30, 2019 and 2018.

Funds From Operations (FFO)

Funds From Operations (FFO) applicable to common shares and limited partnership units means net income (computed in accordance with GAAP), excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures will be calculated to reflect funds from operations on the same basis.

Historical cost accounting for real estate assets implicitly assumes 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 have considered presentations of operating results for real estate companies that use historical cost accounting to be insufficient by themselves. The term Funds From Operations (FFO) was created to address this problem. It was intended to be a standard supplemental measure of REIT operating performance that excluded historical cost depreciation from — or “added back” to — GAAP net income.

Our management believes this non-GAAP measure is useful to investors because it provides supplemental information that facilitates comparisons to prior periods and for the evaluation of financial results. Management uses this non-GAAP measure to evaluate our financial results, develop budgets and manage expenditures. The method used to produce non-GAAP results is not computed according to GAAP, is likely to differ from the methods used by other companies and should not be regarded as a replacement for corresponding GAAP measures. Management encourages the review of the reconciliation of this non-GAAP financial measure to the comparable GAAP results.

Since the introduction of the definition of FFO, the term has come to be widely used by REITs. In the view of National Association of Real Estate Investment Trusts (“NAREIT”), the use of the definition of FFO (combined with the primary GAAP presentations required by the Securities and Exchange Commission) has been fundamentally beneficial, improving the understanding of operating results of REITs among the investing public and making it easier to compare the results of one REIT with another.

While FFO applicable to common shares and limited partnership units are widely used by REITs as performance metrics, all REITs do not use the same definition of FFO or calculate FFO in the same way. The FFO reconciliation presented here is not necessarily comparable to FFO presented by other real estate investment trusts. FFO should also not be considered as an alternative to net income as determined in accordance with GAAP as a measure of a real estate investment trust’s performance, but rather should be considered as an additional, supplemental measure, and should be viewed in conjunction with net income as presented in the consolidated financial statements included in this report. FFO applicable to common shares and limited partnership units does not represent cash generated from operating activities in accordance with GAAP and is not necessarily indicative of sufficient cash flow to fund a real estate investment trust’s needs or its ability to service indebtedness or to pay dividends to shareholders.

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The following tables include calculations of FFO, and the reconciliations to net income, for the three and six months ended June 30, 2019 and 2018, respectively. We believe these calculations are the most comparable GAAP financial measure (in thousands):

Reconciliation of Net Income Attributable to Sterling to FFO Applicable to Common Shares and Limited Partnership Units

	Three months ended June 30, 2019			Three months ended June 30, 2018		
	Amount	Weighted Avg Shares and Units(1)	Per Share and Unit (2)	Amount	Weighted Avg Shares and Units(1)	Per Share and Unit (2)
	(unaudited)					
	(in thousands, except per share data)					
Net Income attributable to Sterling Real Estate Trust	\$ 1,647	9,209	\$ 0.18	\$ 1,675	8,720	\$ 0.19
Add back:						
Noncontrolling Interest - OPU	3,191	17,830		3,376	17,567	
Depreciation & Amortization from continuing operations	5,353			5,283		
Pro rata share of unconsolidated affiliate depreciation & amortization	95			94		
Subtract:						
Gain on sales of land, depreciable real estate, investment in equity method investee, and change in control of real estate investments	—			(1,084)		
Funds from operations applicable to common shares and limited partnership units (FFO)	\$ 10,286	27,039	\$ 0.38	\$ 9,344	26,287	\$ 0.36

- (1) Please see Note 9 and Note 11 to the consolidated financial statements included above for more information.
(2) Net Income is calculated on a per share basis. FFO are calculated on a per share and unit basis.

	Six months ended June 30, 2019			Six months ended June 30, 2018		
	Amount	Weighted Avg Shares and Units(1)	Per Share and Unit (2)	Amount	Weighted Avg Shares and Units(1)	Per Share and Unit (2)
	(unaudited)					
	(in thousands, except per share data)					
Net Income attributable to Sterling Real Estate Trust	\$ 2,935	9,151	\$ 0.32	\$ 3,417	8,674	\$ 0.39
Add back:						
Noncontrolling Interest - OPU	5,723	17,845		6,912	17,550	
Depreciation & Amortization from continuing operations	10,891			10,633		
Pro rata share of unconsolidated affiliate depreciation & amortization	189			188		
Subtract:						
Gain on sale of land, depreciable real estate, investment in equity method investee, and change in control of real estate investments	—			(1,084)		
Funds from operations applicable to common shares and limited partnership units (FFO)	\$ 19,738	26,996	\$ 0.73	\$ 20,066	26,224	\$ 0.77

- (1) Please see Note 9 and Note 11 to the consolidated financial statements included above for more information.
(2) Net Income is calculated on a per share basis. FFO are calculated on a per share and unit basis.

FFO was impacted by the gain on involuntary conversion during the six months ended June 30, 2019 and 2018. The impact on FFO was \$0.0122 and \$0.0521 per share, respectively. FFO was impacted by the gain on involuntary conversion during the three months ended June 30, 2018, the impact on FFO was \$0.0236 per share. FFO was not impacted by gain on involuntary conversion during the three months ended June 30, 2019.

Liquidity and Capital Resources

Our principal demands for funds will be for the (i) acquisition of real estate and real estate-related investments, (ii) payment of acquisition related expenses and operating expenses, (iii) payment of dividends/distributions (iv) payment of principal and interest on current and any future outstanding indebtedness, and (v) redemptions of our securities under

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our redemption plans. Additionally, demands for funds over the next 6 fiscal quarters, will be for the development and planning costs associated with the 114 unit development at the Glen Pond property located in Eagan, Minnesota. Total projected costs for the development is \$15,598,000. Generally, we expect to meet cash needs for the payment of operating expenses and interest on outstanding indebtedness from cash flow from operations. We expect to pay dividends/distributions and any repurchase requests to our shareholders and the unit holders of our operating partnership from cash flow from operations; however, we may use other sources to fund dividends/distributions and repurchases, as necessary. We expect to meet cash needs for acquisitions and other real-estate investments from cash flow from operations, net proceeds of share offerings and debt proceeds.

Evaluation of Liquidity

We continually evaluate our liquidity and ability to fund future operations, debt obligations and any repurchase requests. As part of our analysis, we consider among other items, credit quality of tenants and lease expirations.

Credit Quality of Tenants

We are exposed to credit risk within our tenant portfolio, which can reduce our results of operations and cash flow from operations if our tenants are unable to pay their rent. Tenants experiencing financial difficulties may become delinquent on their rent or default on their leases and, if they file for bankruptcy protection, may reject our lease in bankruptcy court, resulting in reduced cash flow. This may negatively impact net asset values and require us to incur impairment charges. Even if a default has not occurred and a tenant is continuing to make the required lease payments, we may restructure or renew leases on less favorable terms, or the tenant's credit profile may deteriorate, which could affect the value of the leased asset and could in turn require us to incur impairment charges.

To mitigate credit risk on commercial properties, we have historically looked to invest in assets that we believe are critically important to our tenant's operations and have attempted to diversify our portfolio by tenant, tenant industry and geography. We also monitor all of our properties performance through review of rent delinquencies as a precursor to a potential default, meetings with tenant management and review of tenants' financial statements and compliance with financial covenants. When necessary, our asset management process includes restructuring transactions to meet the evolving needs of tenants, refinancing debt and selling properties, as well as protecting our rights when tenants default or enter into bankruptcy.

Lease Expirations and Occupancy

No significant leases are scheduled to expire or renew in the next twelve months. The Advisor, with the assistance of our commercial property managers, actively manages our real estate portfolio and begins discussing options with tenants in advance of scheduled lease expirations. In certain cases, we may obtain lease renewals from our tenants; however, tenants may elect to move out at the end of their term. In the cases where commercial tenants elect not to renew, we may seek replacement tenants or try to sell the property.

Cash Flow Analysis

Our objectives are to generate sufficient cash flow over time to provide shareholders with increasing dividends and to seek investments with potential for strong returns and capital appreciation throughout varying economic cycles. We have funded 100% of the dividends from operating cash flows. In setting a dividend rate, we focus primarily on expected returns from investments we have already made to assess the sustainability of a particular dividend rate over time.

	Six Months Ended June 30,	
	2019	2018
	(in thousands)	
Net cash flows provided by operating activities	\$ 19,136	\$ 17,018
Net cash flows used in investing activities	\$ (3,896)	\$ (1,873)
Net cash flows used in financing activities	\$ (20,756)	\$ (11,382)

Operating Activities

Our real estate properties generate cash flow in the form of rental revenues, which is reduced by interest payments, direct lease costs and property-level operating expenses. Property-level operating expenses consist primarily of property management fees including salaries and wages of property management personnel, utilities, cleaning, repairs, insurance, security and building maintenance cost, and real estate taxes. Additionally, we incur general and administrative expenses, advisory fees, acquisition and disposition expenses and financing fees.

Net cash provided by operating activities was \$19,136 and \$17,018 for the six months ended June 30, 2019 and 2018, respectively, which consists primarily of net income from property operations adjusted for non-cash depreciation and amortization. The funds generated for the six months ended June 30, 2019 and 2018 were primarily from property operations of our real estate portfolio.

Investing Activities

Our investing activities generally consist of real estate-related transactions (purchases and sales of properties) and payments of capitalized property-related costs such as intangible assets.

Net cash used in investing activities was \$3,896 and \$1,873 for the six months ended June 30, 2019 and 2018, respectively (this does not include the value of UPREIT units issued in connection with investing activities). For the six months ended June 30, 2019 and 2018, cash flows used in investing activities related primarily to the acquisition of properties and capital expenditures was \$4,005 and \$7,527, respectively. In addition, during the six months ended June 30, 2019, a \$1,300 revolving line of credit was made to an unrelated third party, which loan bears an interest rate of 7.5% on the outstanding balance. In addition, during the six months ended June 30, 2019 and 2018, proceeds of \$1,065 and \$330 were received from involuntary conversions. During the six months ended June 30, 2018, proceeds of \$5,200 were generated from the sale of one commercial property.

Financing Activities

Our financing activities generally consist of funding property purchases by raising proceeds and securing mortgage notes payable as well as paying dividends, paying syndication costs and making principal payments on mortgage notes payable.

Net cash used in financing activities was \$20,756 and \$11,382 for the six months ended June 30, 2019 and 2018, respectively. During the six months ended June 30, 2019, we paid \$10,828 in dividends and distributions, redeemed \$1,253 of shares and units, received no proceeds from new mortgage notes payable, and made mortgage principal payments of \$10,160. For the six months ended June 30, 2018, we paid \$10,301 in dividends and distributions, redeemed \$1,663 of shares and units, received proceeds from new mortgage notes payable of \$7,064, and made mortgage principal payments of \$8,223.

Dividends

Common Stock

We declared cash dividends to our shareholders during the period from January 1, 2019 to June 30, 2019 totaling \$4,779 or \$0.52250 per share, including amounts reinvested through the dividend reinvestment plan. During the six months ended June 30, 2019, we paid cash dividends of \$1,665 and dividends of \$3,114 were reinvested under the dividend reinvestment plan. The cash dividends were paid with the \$19,136 from our cash flows from operations and \$50 provided by distributions from unconsolidated affiliates.

We declared cash dividends to our shareholders during the period from January 1, 2018 to June 30, 2018 totaling \$4,407 or \$0.508750 per share, including amounts reinvested through the dividend reinvestment plan. During the six months ended June 30, 2018, we paid cash dividends of \$1,524 and dividends of \$2,883 were reinvested under the dividend reinvestment plan. The cash dividends were paid with the \$17,018 from our cash flows from operations and \$124 provided by distributions from unconsolidated affiliates.

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We continue to provide cash dividends to our shareholders from cash generated by our operations. The following chart summarizes the sources of our cash used to pay dividends. Our primary source of cash is cash flow provided by operating activities from our investments as presented in our cash flow statement. We also include distributions from unconsolidated affiliates to the extent that the underlying real estate operations in these entities generate cash flow and the gain on sale of properties relates to net profits from the sale of certain properties. Our presentation is not intended to be an alternative to our consolidated statement of cash flows and does not present all sources and uses of our cash.

The following table presents certain information regarding our dividend coverage:

	Six Months Ended June 30,	
	2019	2018
	(in thousands)	
Cash flows provided by operations (includes net income of \$8,611 and \$10,236, respectively)	\$ 19,136	\$ 17,018
Distributions in excess of earnings received from unconsolidated affiliates	50	124
Gain (Loss) on sales of real estate and non-real estate investments	—	1,084
Dividends declared	(4,779)	(4,407)
Excess	\$ 14,407	\$ 13,819

Limited Partnership Units

The operating partnership agreement provides that our operating partnership will distribute to the partners (subject to certain limitations) cash from operations on a quarterly basis (or more frequently, if we so elect) in accordance with the percentage interests of the partners. We determine the amounts of such distributions in our sole discretion.

For the six months ended June 30, 2019, we declared quarterly distributions totaling \$9,318 to holders of limited partnership units in our operating partnership, which we paid on April 15 and July 15, 2019. Distributions were paid at a rate of \$0.261250 per unit per quarter, which is equal to the per share distribution rate paid to the common shareholders.

For the six months ended June 30, 2018, we declared quarterly distributions totaling \$8,938 to holders of limited partnership units in our operating partnership, which we paid on April 16 and July 16, 2018. Distributions were paid at a rate of \$0.254375 per unit per quarter, which is equal to the per share distribution rate paid to the common shareholders.

Sources of Dividends

For the six months ended June 30, 2019, we declared aggregate dividends of \$4,779, which were paid with cash flows provided by operating activities and distributions from unconsolidated affiliates. Our funds from operations, or FFO, was \$19,738; therefore, our management believes our distribution policy is sustainable over time. For the six months ended June 30, 2018, we declared aggregate dividends of \$4,407 which were paid with cash flows provided by operating activities and distributions from unconsolidated affiliates. Our FFO was \$20,066 as of the six months ended June 30, 2018. For a further discussion of FFO, including a reconciliation of FFO to net income, see “Funds from Operations” above.

Cash Resources

At June 30, 2019, our cash resources consisted of cash and cash equivalents totaling approximately \$16,617. Our cash reserves can be used for working capital needs and other commitments. In addition, we had unencumbered properties with a gross book value of \$43,335, which could potentially be used as collateral to secure additional financing in future periods.

At June 30, 2019, there was no balance outstanding on our lines of credit, leaving \$32,815 available and unused under the agreements. See Note 5 to the accompanying consolidated financial statements for additional details regarding our line of credit agreements.

The sale of our securities and issuance of limited partnership units of the operating partnership in exchange for property acquisitions and sale of additional common or preferred shares is also expected to be a source of long-term capital for us. During the six months ended June 30, 2019, we did not sell any common shares in a private placement. During the

six months ended June 30, 2019, we issued 168,000 and 91,000 common shares under the dividend reinvestment plan, through dividends reinvested and the optional share purchases, respectively, and raised gross proceeds of \$4,757. During the six months ended June 30, 2018, we did not sell any common shares in a private placement. During the six months ended June 30, 2018, we issued 159,000 and 117,000 common shares under the dividend reinvestment plan, through dividends reinvested and the optional share repurchases, respectively, and raised gross proceeds of \$4,957.

During the six months ended June 30, 2019, no partnership units were issued in relation to property acquisitions.

During the six months ended June 30, 2018, we issued limited partnership units valued at approximately \$1,546 in connection with the acquisition of one property.

Off-Balance Sheet Arrangements

As of June 30, 2019 and December 31, 2018, we had no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Inflation

Substantially all of our multifamily property leases are for a term of one year or less. In an inflationary environment, this may allow us to realize increased rents upon renewal of existing leases or the beginning of new leases. Short-term leases generally will minimize our risk from the adverse effects of inflation, although these leases generally permit residents to leave at the end of the lease term and therefore will expose us to the effect of a decline in market rents. In a deflationary rent environment, we may be exposed to declining rents more quickly under these shorter term leases.

As of June 30, 2019, most of our commercial leases require tenants to pay directly or reimburse us for a share of our operating expenses. As a result, we are able to pass on much of any increases to our property operating expenses that might occur due to inflation by correspondingly increasing our expense reimbursement revenues. During the six months ended June 30, 2019, inflation did not have a material impact on our revenues or net income.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The principal material financial market risk to which we are exposed is interest-rate risk. Our exposure to market risk for changes in interest rates relates primarily to refinancing long-term fixed rate obligations, the opportunity cost of fixed rate obligations in a falling interest rate environment and our variable rate lines of credit.

As virtually all of our outstanding debt is long-term, fixed rate debt, our interest rate risk has not changed significantly from what was disclosed in our Annual Report on Form 10-K for the year ended December 31, 2018 filed with the Securities and Exchange Commission on March 15, 2019.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of June 30, 2019, such disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and is accumulated and communicated to management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Controls over Financial Reporting

There were no changes in our internal controls over financial reporting that occurred during the second fiscal quarter of 2019 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

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

Sale of Securities

Neither Sterling nor the operating partnership issued any unregistered securities during the three months ended June 30, 2019.

Other Sales

During the three months ended June 30, 2019, we did not issue any common shares in exchange for limited partnership units of the operating partnership on a one-for-one basis pursuant to redemption requests made by accredited investors pursuant to Section 4(2) and Rule 506 of Regulation D.

Redemptions of Securities

Set forth below is information regarding common shares and limited partnership units redeemed during the three months ended June 30, 2019:

Period	Total Number of Common Shares Redeemed	Total Number of Limited Partner Units Redeemed	Average Price Paid per Common Share/Unit	Total Number of Shares Redeemed as Part of Publicly Announced Plans or Programs	Total Number of Units Redeemed as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares (or Units) that May Yet Be Redeemed Under Publicly Announced Plans or Programs
April 1-30, 2019	3,000	5,000	\$ 18.00	1,201,000	809,000	\$ 6,905
May 1-31, 2019	2,000	8,000	\$ 18.00	1,203,000	817,000	\$ 6,728
June 1-30, 2019	3,000	3,000	\$ 18.00	1,206,000	820,000	\$ 6,632
Total	8,000	16,000				

For the three months ended June 30, 2019, we redeemed all shares or units for which we received redemption requests. In addition, for the three months ended June 30, 2019, all common shares and units redeemed were redeemed as part of the publicly announced plans.

The Amended and Restated Share Redemption Plan permits us to repurchase common shares held by our shareholders and limited partnership units held by partners of our operating partnership, up to a maximum amount of \$35,000 worth of shares and units, upon request by the holders after they have held them for at least one year and subject to other conditions and limitations described in the plan. The redemption price for such shares and units redeemed under the plan was fixed at \$17.50 per share or unit, which was increased to \$18.00 effective January 1, 2019. The redemption plan will terminate in the event the shares become listed on any national securities exchange, the subject of bona fide quotes on any inter-dealer quotation system or electronic communications network or are the subject of bona fide quotes in the pink sheets. Additionally, the Board, in its sole discretion, may terminate, amend or suspend the redemption plan at any time if it determines to do so is in our best interest.

Item 6. Exhibits.

<u>Exhibit Number</u>	<u>Title of Document</u>
31.1	<u>Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
31.2	<u>Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
32.1	<u>Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the of the Sarbanes-Oxley Act of 2002.</u>
101	The following materials from Sterling Real Estate Trust's Quarterly Report on Form 10-Q for the quarter ended June 30, 2019, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets at June 30, 2019 and December 31, 2018; (ii) Consolidated Statements of Operations and Other Comprehensive Income for the three and six months ended June 30, 2019 and 2018; (iii) Consolidated Statements of Shareholders' Equity for the three and six months ended June 30, 2019; (iv) Consolidated Statements of Cash Flows for the six months ended June 30, 2019 and 2018, and; (v) Notes to Consolidated Financial Statements.

SIGNATURES

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

Dated: August 8, 2019

STERLING REAL ESTATE TRUST

By: /s/ Kenneth P. Regan
Kenneth P. Regan
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Erica J. Chaffee
Erica J. Chaffee
Chief Financial Officer
(Principal Financial and Accounting Officer)

**OFFICER'S CERTIFICATE
PURSUANT TO SECTION 302**

I, Kenneth P. Regan, certify that:

1. I have reviewed this quarterly report on Form 10-Q for Sterling Real Estate Trust.
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. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-5(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 my supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to me 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 my 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 my 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. I have disclosed, based on my most recent evaluation of internal control over financial reporting, to the registrant's auditors and 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.

Dated: August 8, 2019

By: /s/ Kenneth P. Regan
Chief Executive Officer

**OFFICER'S CERTIFICATE
PURSUANT TO SECTION 302**

I, Erica J. Chaffee, certify that:

1. I have reviewed this quarterly report on Form 10-Q for Sterling Real Estate Trust.
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. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-5(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 my supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to me 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 my 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 my 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. I have disclosed, based on my most recent evaluation of internal control over financial reporting, to the registrant's auditors and 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.

Dated: August 8, 2019

By: /s/ Erica J. Chaffee
Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Sterling Real Estate Trust (the "Company") on Form 10-Q for the period ended June 30, 2019 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, in the capacities and on the dates indicated below, hereby certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operation of the Company.

Dated: August 8, 2019

By: /s/ Kenneth P. Regan
Chief Executive Officer

By: /s/ Erica J. Chaffee
Chief Financial Officer

A signed original of this written statement required by Section 906 has been provided to Sterling Real Estate Trust and will be retained by Sterling Real Estate Trust and furnished to the Securities and Exchange Commission or its staff upon request.
