PILLARSTONE CAPITAL REIT
Form 10-Q
May 14, 2018

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

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2018

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 001-15409
PILLARSTONE CAPITAL REIT
(Exact name of registrant as specified in its charter)

Maryland	39-6594066
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

2600 South Gessner, Suite 555
Houston, Texas 77063
(Address of principal executive offices)

(832) 810-0100
(Registrant’s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes [ ] No [X]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or 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 [ ] Accelerated filer [ ]
Non-accelerated filer [ ] Smaller reporting company [X]
Emerging growth company [ ]

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

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

The Registrant had 405,169 common shares outstanding as of March 31, 2018.

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PART I. Financial Information

Part II. Other Information

PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
Pillarstone Capital REIT and Subsidiaries
CONSOLIDATED BALANCE SHEETS

	March 31, 2018 (unaudited)	December 31, 2017
ASSETS		
Cash and cash equivalents	$ 174,814	$ 179,385
Marketable securities	100	100
Other assets	7,000	9,679
Fixed assets	2,831	3,398
Total assets	$ 184,745	$ 192,562
LIABILITIES AND EQUITY (DEFICIT)		
Liabilities:		
Accounts payable and accrued expenses	$ 68,363	$ 92,105
Accounts payable - related party	316,103	316,103
Convertible notes payable - related parties	197,780	197,780
Accrued interest payable - related parties	46,763	41,832
Negative equity investment in Pillarstone Capital REIT Operating Partnership LP	82,256	88,880
Total liabilities	711,265	736,700
Commitments and contingencies	—	—
Shareholders' Equity (Deficit):		
Preferred A Shares - $0.01 par value, 1,518,000 authorized: 256,636 Class A cumulative convertible shares issued and outstanding at March 31, 2018 and December 31, 2017, $10.00 per share liquidation preference	2,567	2,567
Preferred C Shares - $0.01 par value, 300,000 authorized: 244,444 Class C cumulative convertible shares issued and outstanding at March 31, 2018 and December 31, 2017, $10.00 per share liquidation preference	2,444	2,444
Common Shares - $0.01 par value, 400,000,000 authorized: 443,299 shares issued and 405,169 outstanding at March 31, 2018 and December 31, 2017	4,052	4,052
Additional paid-in capital	28,146,986	28,146,986
Accumulated deficit	(27,881,834)	(27,899,452)
Treasury shares, at cost, 38,130 shares	(800,735)	(800,735)
Total Pillarstone Capital REIT shareholders' deficit	(526,520)	(544,138)
Total liabilities and equity (deficit)	$ 184,745	$ 192,562

The accompanying notes are an integral part of the condensed consolidated financial statements.

Pillarstone Capital REIT and Subsidiaries
CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended March 31, 2018	2017
Revenues		
Interest and dividend income	$—	$—
Total revenues	—	—
Expenses		
General and administrative	98,664	147,821
Depreciation	566	—
Interest	4,931	4,876
Total expenses	104,161	152,697
Loss from operations	(104,161)	(152,697)
Equity in income of Pillarstone Capital REIT Operating Partnership LP	121,779	64,249
Net income (loss) attributable to common shareholders	$17,618	$(88,448)
Earnings (Loss) Per Share:		
Basic income (loss) per common share:		
Net income (loss) available to common shareholders	$0.04	$(0.22)
Diluted income (loss) per common share:		
Net income (loss) available to common shareholders	$0.01	$(0.22)
Weighted average number of common shares outstanding:		
Basic	405,169	405,169
Diluted	2,903,219	405,169

The accompanying notes are an integral part of the condensed consolidated financial statements.

Pillarstone Capital REIT and Subsidiaries
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Three Months Ended March 31,	
	2018	2017
Cash flows from operating activities:		
Net income (loss)	$ 17,618	$ (88,448)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation	566	—
Equity in income of Pillarstone Capital REIT Operating Partnership LP	(121,779)	(23,165)
Distributions received from Pillarstone Capital REIT Operating Partnership LP	115,155	—
Changes in operating assets and liabilities:		
Distribution receivable	—	(41,084)
Other assets	2,680	8,926
Accounts payable and accrued expenses	(18,811)	139,460
Net cash used in operations	(4,571)	(4,311)
Cash flows from investing activities:		
Net cash provided by investing activities	—	—
Cash flows from financing activities:		
Net cash provided by financing activities	—	—
Net decrease in cash and cash equivalents	(4,571)	(4,311)

Cash and cash equivalents at beginning of year	179,385		7,445	
Cash and cash equivalents at end of year	$	174,814	$	3,134

The accompanying notes are an integral part of the condensed consolidated financial statements.

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Pillarstone Capital REIT
Notes to Condensed Consolidated Financial Statements
(unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Introduction. The use of the words "we," "us," "our," "Company" or "Pillarstone" refers to Pillarstone Capital REIT and our consolidated subsidiaries, except where the context otherwise requires.

Business. Pillarstone Capital REIT is a Maryland real estate investment trust ("REIT") engaged in investing in, owning and operating commercial properties. We serve as the general partner of Pillarstone Capital REIT Operating Partnership LP ("Pillarstone OP"), which was formed on September 23, 2016 as a Delaware limited partnership. We currently conduct substantially all operations and activities through Pillarstone OP. As the general partner of Pillarstone OP, we have responsibility and discretion in the management of Pillarstone OP, subject to certain customary exceptions. Future real estate investments may include (i) acquisition and development of retail, office, office warehouse, industrial, multifamily, hotel, and other commercial properties, (ii) acquisition of or merger with a REIT or a real estate operating company, and (iii) joint venture investments.

Basis of Presentation. The consolidated financial statements included in this report are unaudited; however, amounts presented in the consolidated balance sheet as of December 31, 2017 are derived from our audited consolidated financial statements as of that date. The unaudited financial statements as of and for the periods ended March 31, 2018 and 2017 have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information on a basis consistent with the annual audited consolidated financial statements and with the instructions to Form 10-Q. Certain information and footnote disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). However, we believe that the included disclosures are adequate to make the information presented not misleading. The consolidated financial statements presented herein reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position of Pillarstone and our subsidiary as of March 31, 2018 and the results of operations and cash flows for the three months ended March 31, 2018 and 2017. All of these adjustments are of a normal recurring nature. The results of operations for the interim periods are not necessarily indicative of the results expected for a full year. The statements should be read in conjunction with the audited consolidated financial statements and the notes thereto which are included in our Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC on March 29, 2018 (the “2017 Form 10-K”).

Basis of consolidation. The Company presents its financial statements on a consolidated basis because it combines its accounts with a wholly-owned subsidiary that ceased operations in 2002. All significant intercompany transactions are eliminated in consolidation.

Going concern. The financial statements have been prepared assuming the Company will continue as a going concern, which contemplates continued operations as a public company and paying liabilities in the normal course of business. The Company, through Pillarstone OP, acquired 14 real estate assets in December 2016, and its receipt of cash distributions from Pillarstone OP are expected to be sufficient for the Company to continue as a going concern.

Cash flow statement classification of equity method investment. The Company follows the guidance the Financial Accounting Standards Board issued in August 2016 on the classification of certain cash receipts and payments in the statement of cash flows, including distributions received from equity method investments. We have adopted this guidance for all periods presented and have chosen to classify distributions received from Pillarstone OP using the cumulative earnings approach. Under this approach, any distributions received up to the cumulative equity earnings are considered a return on investment and are classified as operating activities. Any excess distributions are considered a return of investment and are classified as investing activities.

2. MARKETABLE SECURITIES

As of March 31, 2018, our marketable securities had a fair market value of $100. This value was determined using Level 1 inputs and is based on the amount of cash in an insured deposit account at the brokerage firm. During the three months ended March 31, 2018, there were no transfers to the operating account from the brokerage firm, and there was no interest income earned in the account at the brokerage firm.

Pillarstone Capital REIT
Notes to Condensed Consolidated Financial Statements
(unaudited)

3. EQUITY METHOD INVESTMENT

On December 8, 2016, Pillarstone and Pillarstone OP, entered into a Contribution Agreement (the “Contribution Agreement”) with Whitestone REIT Operating Partnership, L.P. (“Whitestone OP”), a subsidiary and the operating partnership of Whitestone REIT (“Whitestone”), both of which are related parties to Pillarstone and Pillarstone OP, pursuant to which Whitestone OP contributed to Pillarstone OP all of the equity interests in four of its wholly-owned subsidiaries: Whitestone CP Woodland Ph. 2, LLC, a Delaware limited liability company (“CP Woodland”); Whitestone Industrial-Office, LLC, a Texas limited liability company (“Industrial-Office”); Whitestone Offices, LLC, a Texas limited liability company (“Whitestone Offices”); and Whitestone Uptown Tower, LLC, a Delaware limited liability company (“Uptown Tower” and together with CP Woodland, Industrial-Office and Whitestone Offices, the “Entities”) that together own 14 real estate assets (the “Real Estate Assets” and, together with the Entities, the “Property”) for aggregate consideration of approximately $84 million, consisting of (i) approximately $18.1 million of Class A units representing limited partnership interests in Pillarstone OP (“OP Units”), issued at a price of $1.331 per OP Unit; and (ii) the assumption of approximately $65.9 million of liabilities by Pillarstone OP. Pillarstone is the general partner of Pillarstone OP and, as a result of the Contribution Agreement, has equity ownership interest in Pillarstone OP totaling approximately 18.6% valued at $4,121,312 as of the date of the agreement.

In connection with the Contribution Agreement, on December 8, 2016, Pillarstone, as the general partner of Pillarstone OP, entered into an Amended and Restated Agreement of Limited Partnership of Pillarstone OP (as amended and restated, the “Limited Partnership Agreement”). Pursuant to the Limited Partnership Agreement, subject to certain protective rights of the limited partners described below, the general partner has responsibility and discretion in the management and control of Pillarstone OP, including the ability to cause Pillarstone OP to enter into certain major transactions including a merger of Pillarstone OP or a sale of substantially all of the assets of Pillarstone OP. The limited partners have no power to remove the general partner without the general partner's consent. In addition, pursuant to the Limited Partnership Agreement, the general partner may not conduct any business other than in connection with the ownership, acquisition and disposition of Pillarstone OP's interest and management of its business without the consent of a majority of the limited partners other than in connection with certain actions described therein. As such, the Company is deemed to exercise significant influence but not complete control over Pillarstone OP. Additionally, we determined that we are not the primary beneficiary under the variable interest entity rules prescribed by GAAP, and thus the investment in Pillarstone OP qualifies for usage of the equity method of accounting.

The equity method of accounting requires our investment in Pillarstone OP be shown on our Balance Sheets as a single amount. Pillarstone's investment in Pillarstone OP amounted to an 18.6% ownership interest and carrying values of $(82,256) and $(88,880) as of March 31, 2018 and December 31, 2017, respectively. As of March 31, 2018, the $(82,256) carrying value of our equity investment exceeded our equity in the underlying net assets of Pillarstone OP by approximately $70,257. This difference arose due to the $4,121,312 in-kind distribution we received during December 2016, and the difference between the carrying value attributed to the assets and liabilities transferred to Pillarstone OP under common control accounting rules and their fair values. We are amortizing the difference over 25 years based on the estimate of the remaining useful lives of the properties acquired. Amortization of the difference is $393 and $0 for the three month periods ending March 31, 2018 and March 31, 2017, respectively. Pillarstone's investment in Pillarstone OP is negative as of March 31, 2018 due to the reductions in the balance from distributions received from Pillarstone OP and amortization offset by increases in the balance from equity in earnings from Pillarstone OP. Equity in earnings for the three month periods ending March 31, 2018 and 2017 were $121,779 and $64,249, respectively, and distributions declared for the three month periods ending March 31, 2018 and 2017 were $115,155 and $41,084, respectively.

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Pillarstone Capital REIT
Notes to Condensed Consolidated Financial Statements
(unaudited)

The combined results of operations and financial position of Pillarstone OP are summarized below (in thousands):

Condensed income statement information:	Three Months Ended March 31, 2018	2017
Property revenues	$4,268	$4,020
Property expenses	1,883	2,068
Other expenses	1,708	1,575
Provision for income taxes	19	25
Loss on sale or disposal of assets	—	6
Net income	$658	$346
Pillarstone's equity in earnings of Pillarstone OP	$122	$64

Condensed balance sheet information:	March 31, 2018	December 31, 2017
Real estate assets, net of accumulated depreciation	$59,005	$ 59,166
Other assets	8,297	9,954
Total assets	$67,302	$ 69,120
Notes payable	$64,013	$ 64,313
Other liabilities	4,091	5,690
Total liabilities	68,104	70,003
Total deficit	(802)	(883)
Total liabilities and deficit	$67,302	$ 69,120

4. CONVERTIBLE NOTES PAYABLE - RELATED PARTIES

On November 20, 2015, five trustees on our board of trustees loaned $197,780 to the Company in exchange for convertible notes payable. The convertible notes payable accrue interest at 10% per annum, mature on November 20, 2018 and can be converted by the noteholders into common shares at the rate of $1.331 per common share at any time. After six months, the Company can convert the notes payable and accrued interest into common shares and as of March 31, 2018, the Company did not intend to convert the notes payable and accrued interest into common shares. At maturity or when the Company chooses to convert the notes payable and accrued interest into common shares, the noteholders have the option to receive cash plus accrued interest or convert the notes and accrued interest into common shares.

Pillarstone Capital REIT
Notes to Condensed Consolidated Financial Statements
(unaudited)

5. EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share is determined by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding during the period. Dilutive earnings (loss) per share reflects the potential dilution that could occur if Class A Cumulative Convertible Preferred Shares (the “Preferred Class A Shares”), Class C Cumulative Convertible Preferred Shares (the “Preferred Class C Shares”), and convertible notes payable were converted into common shares. We had 2,498,050 potentially convertible securities based on Preferred Class A Shares and Preferred Class C Shares that were included in the calculation of dilutive earnings (loss) per share for the three month period ended March 31, 2018. We had 183,729 potentially convertible securities based on convertible notes payable and accrued interest that were excluded from the calculation of dilutive earnings per share for the three month period ended March 31, 2018, and 2,666,919 potentially convertible securities based on Preferred Class A Shares, Preferred Class C Shares and convertible notes payable and accrued interest that were excluded from the calculation of dilutive earnings loss per share for the three month period ended March 31, 2017, as they were anti-dilutive. Options for 667 common shares have been excluded from the calculation of dilutive earnings per share due to the exercise price being significantly higher than the market price of the common shares.

	Three Months Ended March 31,	
	2018	2017
Numerator:		
Net income (loss) available to common shareholders	$17,618	$(88,448)
Denominator:		
Weighted average number of common shares - basic	405,169	405,169
Effect of dilutive securities:		
Assumed conversion of Preferred A Shares	53,610	—
Assumed conversion of Preferred C Shares	2,444,440	—
Assumed conversion of convertible notes payable and accrued interest	—	—
Weighted average number of common shares - dilutive	2,903,219	405,169
Earnings (Loss) Per Share:		
Basic income (loss) per common share:		
Net income (loss) available to common shareholders	$0.04	$(0.22)
Diluted income (loss) per common share:		
Net income (loss) available to common shareholders	$0.01	$(0.22)

6. 2016 EQUITY PLAN

At the 2016 Annual Meeting of Shareholders, our shareholders approved the 2016 Equity Plan (“2016 Plan”).

The 2016 Plan provides that awards may be made in common shares of the Company or in OP Units, which may be converted into common shares. Subject to adjustment as provided by the terms of the 2016 Plan, the maximum aggregate number of common shares with respect to which awards may be granted under the 2016 Plan will be increased based on future issuances of common shares of the Company and OP Units of Pillarstone OP, including issuances pursuant to the 2016 Plan, so that at any time the maximum number of shares that may be issued under the 2016 Plan shall equal 12.5% of the aggregate number of common shares of the Company and OP Units issued and outstanding (other than treasury shares or units issued to or held by the Company).

The Management, Organization and Compensation Committee (the “Committee”) administers the 2016 Plan, except with respect to awards to non-employee trustees, for which the 2016 Plan is administered by the board of trustees. Subject to the terms of the 2016 Plan, the Committee is authorized to select participants, determine the type and number of awards to be granted, determine and later amend (subject to certain limitations) the terms and conditions of any award, interpret and specify the rules and regulations relating to the 2016 Plan, and make all other determinations which may be necessary or desirable for the administration of the 2016 Plan. The 2016 Plan includes the types of awards for grants and the types of financial performance measures.

As of March 31, 2018, the maximum number of common shares of the Company or OP Units available to be granted based on 2,903,219 potentially converted common shares, exclusive of 183,729 potentially converted common shares from convertible notes payable, and 13,591,764 potentially converted OP Units is 2,356,426, and no grants have been issued under the 2016 Plan.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

The use of the words "we," "us," "our," "Company" or "Pillarstone" refers to Pillarstone Capital REIT and our consolidated subsidiaries, except where the context otherwise requires.

FORWARD LOOKING INFORMATION

This Quarterly Report on Form 10-Q contains historical information, as well as forward-looking statements within the meaning of the federal securities laws, including discussion and analysis of our financial condition, anticipated capital expenditures required to complete projects, amounts of anticipated cash distributions to our shareholders in the future and other matters. These forward-looking statements are not historical facts but are the intent, belief or current expectations of our management based on its knowledge and understanding of our business and industry. Forward-looking statements are typically identified by the use of terms such as “may,” “will,” “should,” “potential,” “predicts,” “anticipates,” “expects,” “intends,” “plans,” “believes,” “seeks,” “estimates” or the negative of such terms and variations of the words and similar expressions, although not all forward-looking statements include these words. These statements are not guarantees of future performance and are subject to risks, uncertainties and other factors, some of which are beyond our control, are difficult to predict and could cause actual results to differ materially from those expressed or forecasted in the forward-looking statements.

Forward-looking statements that were true at the time made may ultimately prove to be incorrect or false. You are cautioned not to place undue reliance on forward-looking statements, which reflect our management’s view only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes to future operating results. Factors that could cause actual results to differ materially from any forward-looking statements made in this Quarterly Report on Form 10-Q include:

- uncertainties related to the national economy, the real estate industry in general and in our specific markets;
- legislative or regulatory changes;
- adverse economic conditions in Texas;
- adverse changes in governmental rules and fiscal policies;
- increases in interest rates and operating costs;
- availability and terms of capital and financing, both to fund our operations and to refinance our indebtedness as it matures;
- decreases in rental rates or increases in vacancy rates;
- litigation risks;
- lease-up risks, including leasing risks arising from exclusivity and consent provisions in leases with significant tenants;
- our inability to renew tenants or obtain new tenants upon the expiration of existing leases; and
- our inability to generate sufficient cash flows due to market conditions, competition, uninsured losses, changes in tax or other applicable laws.

In addition, an investment in the Company involves numerous risks that potential investors should consider carefully, including, without limitation:

- our cash resources are limited;
- we have a history of losses;
- we have not raised funds through a public equity offering;
- our trustees control a significant percentage of our voting shares;
- shareholders could experience possible future dilution through the issuance of additional equity;

- we are dependent on a small number of key senior professionals who are part-time employees; and
- we currently do not plan to distribute dividends to the holders of our shares.

The forward-looking statements should be read in light of these factors and the factors identified in the “Risk Factors” section of the 2017 Form 10-K.

OVERVIEW

Pillarstone Capital REIT was formed on March 15, 1994 as a Maryland real estate investment trust ("REIT"). The Company operated as a traditional real estate investment trust by buying, selling, owning and operating commercial and residential properties through December 31, 1999. In 2000, the Company purchased a software technology company, resulting in the Company not meeting the qualifications to be a REIT under the Internal Revenue Code of 1986, as amended (the "Code"). In 2002, the Company discontinued the operations of the technology segment, and from 2003 through 2006, pursued a value-added business plan primarily focused on acquiring well located, under-performing multi-family residential properties, including affordable housing communities, and repositioning them through renovation, leasing, improved management and branding.

Pillarstone is currently engaged in investing in, owning and operating commercial properties. Substantially all of our business is conducted through our operating partnership Pillarstone Capital REIT Operating Partnership, a Delaware limited partnership formed on September 23, 2016 ("Pillarstone OP"). We are the sole general partner of Pillarstone OP. As of March 31, 2018, we owned approximately 18.6% of the outstanding equity in Pillarstone OP, and Whitestone OP owned approximately 81.4% of the outstanding equity in Pillarstone OP. We account for Pillarstone OP on our financial statements using the equity method. Future real estate investments may include (i) acquisition and development of retail, office, office warehouse, industrial, multifamily, hotel and other commercial properties, (ii) acquisition of or merger with a REIT or a real estate operating company, and (iii) joint venture investments.

As of March 31, 2018, the Company is a smaller reporting company current in its quarterly and annual financial statement filings with the SEC that may make future real estate investments. There can be no assurance that we will be able to close additional transactions. Even if our management is successful in closing additional transactions, investors may not value the transactions or the Company in the same manner as we do, and investors may not value the transactions as they would value other transactions or alternatives. Failure to obtain additional sources of capital will materially and adversely affect the Company's ability to continue operations, as well as its liquidity and financial results.

EXECUTIVE OVERVIEW

On December 8, 2016, Pillarstone and Pillarstone OP, entered into a Contribution Agreement (the "Contribution Agreement") with Whitestone REIT Operating Partnership, L.P. ("Whitestone OP"), a subsidiary and the operating partnership of Whitestone REIT ("Whitestone"), both of which are related parties to Pillarstone and Pillarstone OP, pursuant to which Whitestone OP contributed to Pillarstone OP all of the equity interests in four of its wholly-owned subsidiaries: Whitestone CP Woodland Ph. 2, LLC, a Delaware limited liability company ("CP Woodland"); Whitestone Industrial-Office, LLC, a Texas limited liability company ("Industrial-Office"); Whitestone Offices, LLC, a Texas limited liability company ("Whitestone Offices"); and Whitestone Uptown Tower, LLC, a Delaware limited liability company ("Uptown Tower" and, together with CP Woodland, Industrial-Office and Whitestone Offices, the "Entities") that own 14 real estate assets (the "Real Estate Assets" and, together with the Entities, the "Property") for aggregate consideration of approximately $84 million, consisting of (i) approximately $18.1 million of Class A units representing limited partnership interests in Pillarstone OP ("OP Units"), issued at a price of $1.331 per OP Unit; and (ii) the assumption of approximately $65.9 million of liabilities by Pillarstone OP (collectively, the "Acquisition"). Pillarstone is the general partner of Pillarstone OP and, as a result of the Contribution Agreement, has an equity ownership interest in Pillarstone OP totaling approximately 18.6% valued at $4,121,312 as of the date of the agreement.

RESULTS OF OPERATIONS

The following is a discussion of our results of operations for the three month periods ended March 31, 2018 and 2017 and our financial condition, including:

- Explanation of changes in the results of operations in the Consolidated Statements of Operations for the three month period ended March 31, 2018 compared to the three month period ended March 31, 2017.

- Our critical accounting policies and estimates that require our subjective judgment and are important to the presentation of our financial condition and results of operations.

- Our primary sources and uses of cash for the three month periods ended March 31, 2018 and 2017, and how we intend to generate cash for long-term capital needs.

- Our current income tax status.

The following discussion and analysis should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere herein.

Comparison of the Three Month Periods Ended March 31, 2018 and 2017

Revenues from Operations

There was no revenue for the three month periods ended March 31, 2018 and 2017. This was the result of no operations or temporary investments in marketable securities.

Expenses from Operations

Total expenses, comprised of general and administrative expenses, decreased $49,157 from $147,821 for the three month period ended March 31, 2017 to $98,664 for the three month period ended March 31, 2018. This decrease is primarily the result of decreases in acquisition expenses of $19,717, legal fees of $10,691, SEC filing charges and transfer agent fees of $7,954 and other expenses of $10,795. Depreciation increased $566 and interest expense increased $55 for the three month period ended March 31, 2018 as compared to three month period ended March 31, 2017.

Loss from Operations

As a result of the above, the loss from operations decreased $48,536 from $152,697 for the three month period ended March 31, 2017 to $104,161 for the three month period ended March 31, 2018.

Equity in income of Pillarstone OP

The equity in income of Pillarstone OP increased $57,530 from $64,249 for the three month period ended March 31, 2017 to $121,779 for the three month period ended March 31, 2018. Pillarstone accounts for its interest as an equity method investment. Pillarstone recognizes a portion of Pillarstone OP's income in its financial statements.

Net income (loss) attributable to common shareholders

Due to the above, the Company generated net income attributable to common shareholders of $17,618 during the three months ended March 31, 2018 compared to a net loss attributable to common shareholders of $88,448 for the three months ended March 31, 2017.

Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with GAAP, which requires us to make certain estimates and assumptions. A summary of our significant accounting policies is provided in Note 3 to our audited consolidated financial statements included in the 2017 Form 10-K. The following section is a summary of certain aspects of those accounting policies that both require our most subjective judgment and are most important to the presentation of our financial condition and results of operations. It is possible that the use of different estimates or assumptions in making these judgments could result in materially different amounts being reported in our consolidated financial statements.

Valuation Allowance of Deferred Tax Asset

We account for income taxes using the liability method under which deferred tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities using enacted tax rates in effect for the period in which the differences are expected to affect taxable income. At March 31, 2018, we had net operating loss carryforwards totaling $2,460,000.

While these losses created a deferred tax asset of $567,000, a valuation allowance of $567,000 was applied against this asset because of the uncertainty of whether we will be able to use these loss carryforwards, which will expire in varying amounts through the year 2036. Pursuant to current Code regulations, we will be limited to using $1,881,000 of the prior net operating losses of $11,196,000, and these same regulations also limit the amount of loss used in any one year. Additionally, use of our net operating loss carryforwards will be limited in the event of a change in ownership of the Company.

Liquidity and Capital Resources

Cash provided by operations, equity transactions, and borrowings from affiliates and lending institutions have generally provided the primary sources of liquidity to the Company. Historically, the Company has used these sources to fund operating expenses, satisfy its debt service obligations and fund distributions to shareholders. During most of 2016, we were dependent on cash provided by loans in 2015 of $197,780 from five trustees on our board of trustees in exchange for convertible notes payable (see Note 4 of our unaudited consolidated financial statements). The funds were utilized for due diligence costs incurred in connection with the negotiation and execution of the Acquisition and related transaction documents as well as maintaining the Company's status as a smaller reporting company current in its periodic filings with the SEC. We have kept the public entity available for value-added real estate opportunities, including (i) acquisition and development of retail, office, office warehouse, industrial, multifamily, hotel, and other commercial properties, (ii) acquisition of or merger with a REIT or real estate operating company, and (iii) joint venture investments. During 2017 and 2018 we have been dependent on cash distributions from Pillarstone OP generated through Pillarstone OP's ownership of real estate assets acquired in the Acquisition. Excess funds can be invested in cash equivalents depending on market conditions.

Cash Flows

As of March 31, 2018, our unrestricted cash resources were $174,814. We are dependent on cash distributions from Pillarstone OP generated through Pillarstone OP's ownership of the Real Estate Assets acquired in the Acquisition to meet our liquidity needs and have received distributions of $115,155 for the three months ended March 31, 2018.

We had cash and cash equivalents of $174,814 as of March 31, 2018, as compared to $179,385 on December 31, 2017. The decrease of $4,571 was the result of cash used in operations. During the three months ended March 31, 2018, we had no investing or financing activities.

Cash used for continuing operations included general and administrative costs, primarily for keeping Pillarstone current in its SEC filings so that we may make or enter into additional real estate transactions or acquire or combine with another real estate company.

Future Obligations

The Company does not directly participate in any revenue generating activities, and as such, we currently have no cash from operations and have reduced our day-to-day overhead expenses and material future obligations. However, during December 2016, the Company, through the Contribution Agreement and its resulting 18.6% equity investment in Pillarstone OP, became a party to income generating activities. Until the time that this investment results in significant cash distributions to the Company, we intend to maintain reduced overhead expenses by issuing common shares for our trustee fees, retaining the employees on a part-time unpaid basis, and not replacing employees who have left. We have also reduced the use of outside consultants and negotiated discounts on or eliminated other expenses wherever possible.

Long Term Liquidity and Operating Strategies

Historically, we have financed our long term capital needs, including acquisitions, as follows:

- borrowings from new loans;
- additional equity issuances of our common and preferred shares; and
- proceeds from the sales of our marketable securities.

From 2006 until December 2016, the Company continued its existence as a corporate shell filing its current quarterly and annual reports with the SEC so that it could be used for future real estate transactions or sold to another company. During this time, the Company was funded by its trustees who contributed $500,000 in exchange for 125,000 Class C Convertible Preferred Shares and $197,780 in exchange for convertible notes payable.

Subsequent to the Acquisition through which Pillarstone OP acquired the Real Estate Assets, Pillarstone intends to develop strategies for the Properties in order to create value for the enterprise and our shareholders. As part of the Acquisition, Pillarstone OP and Whitestone OP have agreed that Pillarstone OP may require Whitestone OP to purchase up to an aggregate of $3.0 million of additional OP Units from Pillarstone OP at $1.331 per unit over a two year period. To implement the strategy to create value with the Real Estate Assets, additional capital will need to be raised.

Current Tax Status

At March 31, 2018, we have net operating loss carryforwards of $2,460,000. While these losses created a deferred tax asset, a valuation allowance was applied against the asset because of the uncertainty as to whether we will be able to use these loss carryforwards, which will expire in varying amounts through the year 2036. In the event of a change of ownership of the Company, our ability (or the ability of any company that acquires or merges with us) to use our net operating loss carryforwards will be limited by federal tax regulations.

We and our subsidiary are also subject to certain state and local income, excise and franchise taxes. The provision for state and local taxes has been reflected in general and administrative expense in the consolidated statements of operations and has not been separately stated due to its insignificance.

Interest Rates and Inflation

The Company was not significantly affected by inflation during the periods presented in this report due primarily to the relative low nationwide inflation rates and the Company having minimal operations with an equity investment in Pillarstone OP.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements that have, or are likely to have, a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

ITEM 4. CONTROLS AND PROCEDURES

James C. Mastandrea, our Chairman of the Board, Chief Executive Officer and President, and John J. Dee, our Chief Financial Officer and Senior Vice President, have evaluated the effectiveness of the Company's disclosure controls and procedures as defined in Rule 13a – 15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act") as of March 31, 2018. Based on this evaluation, Mr. Mastandrea and Mr. Dee each concluded that, as of March 31, 2018, our disclosure controls and procedures were effective to ensure that information that is required to be disclosed by us in the reports we file or submit under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms; and (ii) accumulated and communicated to our management, as appropriate, to allow timely decisions regarding required disclosure.

There was no change during the three months ended March 31, 2018 in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We may from time to time become a party to legal proceedings and claims that arise in the ordinary course of our business. These matters are generally covered by insurance. While the frequency and resolutions of any such matters cannot be predicted with certainty, we believe that occurrence and outcomes of these matters will not have a material effect on our financial position, results of operations or cash flows.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES.

Not applicable

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

Exhibit Number	Exhibit Description
31.1	Section 302 Certification pursuant to the Sarbanes-Oxley Act of 2002 - Chief Executive Officer
31.2	Section 302 Certification pursuant to the Sarbanes-Oxley Act of 2002 - Chief Financial Officer
32.1	CEO/CFO Certification under Section 906 of Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document

* The following financial information of the Registrant for the quarter ended March 31, 2018, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets (unaudited), (ii) Condensed Consolidated Statements of Operations and Comprehensive Income (unaudited), (iii) Condensed Consolidated Statements of Cash Flows (unaudited), and (iv) Notes to Condensed Consolidated Financial Statements (unaudited).

SIGNATURES

In accordance with the requirements of the Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	PILLARSTONE CAPITAL REIT
	By: /s/ James C. Mastandrea
	James C. Mastandrea
Date: May 14, 2018	Chief Executive Officer
	(Principal executive officer)
	PILLARSTONE CAPITAL REIT
	By: /s/ John J. Dee
	John J. Dee
Date: May 14, 2018	Chief Financial Officer
	(Principal financial and accounting officer)

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