JANUARY 2023

Despite Recent Volatility, U.S. Multifamily Remains On Track

KEY TAKEAWAYS

- The long-term outlook for U.S. multifamily investments remains strong due to ample dry powder, a structural supply-demand imbalance, and favorable employment, income, and demographic trends
- Market conditions are expected to improve in 2023 and beyond as interest rates and supply pipelines level off

After thriving in the immediate aftermath of the COVID-19 pandemic, largely as a result of soaring demand and record low interest rates, U.S. multifamily real estate metrics have returned to levels more in line with long-term industry averages. The disruption and ambiguity caused by stubbornly high inflation, and the Federal Reserve's ongoing strategic rate hikes designed to tame it, have caused the industry to pump the brakes on what until recently had been an unprecedented surge of rent growth and transactional activity. Jaw-dropping stats abound for 2021, when asking rents rose 13.5% nationally, 8% higher than in the previous peak year of 2015[1], and sales volume hit $335.8 billion to eclipse the previous high set in 2019 by 74%.

U.S. APARTMENT SALES IN 2021 SHATTER PREVIOUS HIGH BY 74%

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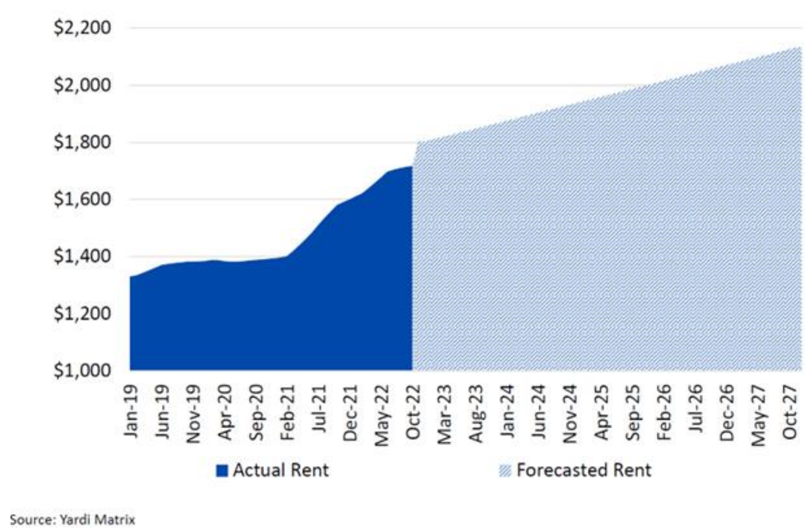
Following in the footsteps of these unsustainable heights was always going to be a daunting task, especially as investors and renters alike grew comfortable in an ultra-low interest rate environment that was likely propping up large segments of the U.S. economy. Some pullback in performance in 2022 was to be expected – and was already occurring naturally after a stellar first few months of the year – before the chilling impact of rapidly rising interest rates took effect. Tipping the scales at 9.1% year-over-year in June, uncharacteristically stubborn inflation led the Federal Reserve to take the dramatic step of raising rates 2.25% over a 96-day period in the summer of 2022, followed by additional increases in November and December. Facing an onslaught of pessimistic economic headlines, consumer sentiment cooled, inspiring more would-be renters to find roommates or continue living with their parents. This led to muted demand and slower rent growth during the fall and brought back a measure of "seasonality" for the first time since the days before the pandemic.

Meanwhile, many of the big-name institutional players who often shape the tenor of the multifamily industry viewed the shifting dynamics of the market as a good excuse to hit the pause button until conditions settled. As a result, the vast majority of owners, already enjoying strong operating performance, opted not to explore the sales market, causing transaction volume to drop substantially during the final third of 2022, with most recent sales taking place only under what brokers are calling "special circumstances," often involving distressed sellers approaching either loan maturities or fund expiration dates that compel them to accept valuations that in some cases are 20%+ lower than they would have been at the peak of the market. While these circumstances might sound disappointing, there are numerous reasons for optimism in the years to come.

> Looking past some of the headlines and digging deeper into both the history and the overall fundamentals of the multifamily asset class, it is our view that what the market is experiencing now is nothing more than a momentary hiatus before an inevitable return to normalcy.

For one, the seasonality that has crept back into the rental realm in recent months is something that was both typical and accepted prior to 2020. Demand for apartments generally slows and rental rates often hold firm or retreat during the average Q4/Q1 cycle. This process started slightly earlier than normal in 2022, with the third quarter having lower absorption numbers than expected due to the reduced household formation and diminished consumer sentiment mentioned above, but it is still nothing too far out of the ordinary. Furthermore, national rent growth is expected to surpass 5.5% in 2022[2] when final numbers are tallied and is projected by many trusted sources, including RealPage[3], Yardi Matrix, and Newmark[4], to sit at a healthy 3-4% annually for years to come.

HISTORICAL & FORECASTED NATIONAL RENTS

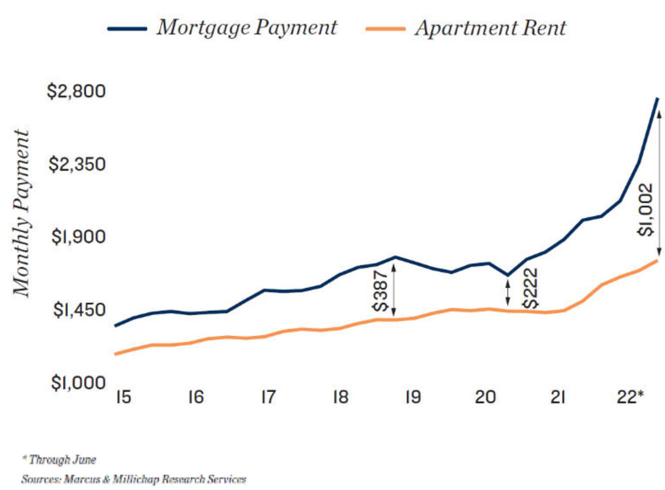


Source: Yardi Matrix

Even the transaction market is something that should be taken with a grain of salt due to the unique nature of most recent sales. Indeed, valuations are down and cap rates have crept up by 50 basis points in some markets on the small number of transactions that are still moving forward, but rents and net operating incomes remain well above where they were anticipated to be when most owners initially underwrote their investments years ago; and many of these same owners are content to simply sit on cash-flowing assets with favorable long-term debt that was locked in prior to the summer of 2022. Moreover, sale pricing is expected to strengthen once buyers return to the market en-masse, which many industry experts predict will occur at some point during the second half of 2023, when the Federal Reserve is expected to finally signal that inflation is under control and rate increases have ceased or will even head in the opposite direction, something for which historical precedent exists.

As detailed in a research paper published by Crow Holdings in June 2022, since the early 1980s, Fed rates have fallen by an average of 2% within 12 months of their peaks after significant hikes.[5] The same paper also has some interesting data on the correlation between cap rates and treasury yields, showing that cap rates tend to be lower than the 10-Year Treasury yield during times of higher inflation. As such, it does not feel like too large of a leap to say that brighter days are ahead, potentially not that far down the road, especially given that the 10-Year Treasury hovered around 3.5% as of mid-January 2023.

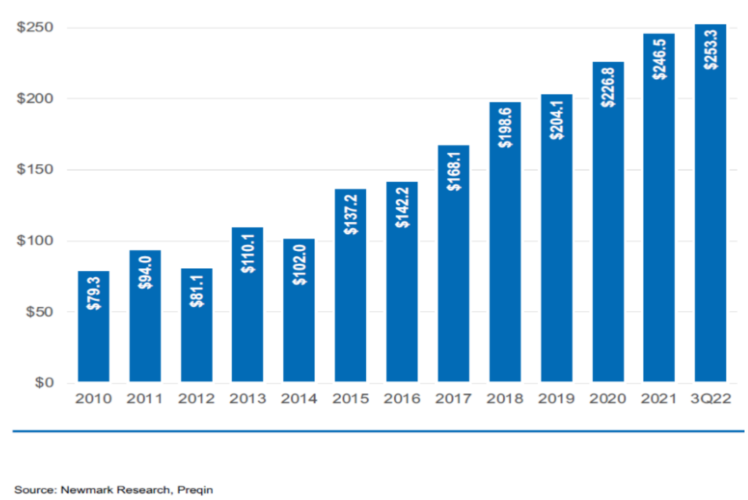
HOME MORTGAGE PAYMENT VS. RENT



For those who remain skeptical, we encourage you to examine why multifamily, long known as a hedge against inflation, has become something of an investment darling over the past decade. There is a strong argument to be made that many of the reasons for the enduring appeal of the asset class remain intact within the current environment. For starters, the supply-demand story continues to be a compelling one, largely due to favorable employment, income, and demographic trends nationwide. Current estimates show a housing shortage of approximately 1.7 million units as of Q2 2022, with a total forecasted need of 4.3 million new units by 2035.[6] Additionally, of the single-family homes that are available, average prices were up nearly 40% over the past two years through August 2022; and escalating interest rates have pushed the gap between the average rent payment and the average mortgage payment to above $1,000 per month.[7] These realities alone should continue to catapult numerous would-be homebuyers into the renter pool for the foreseeable future, further bolstering apartment demand.

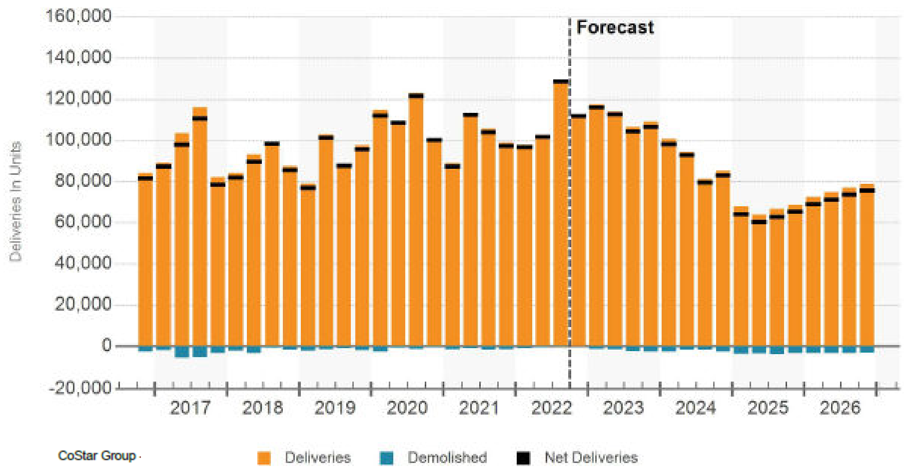
Another notable statistic that supports the continued solidity of U.S. multifamily investments is the sheer amount of capital, or dry powder, that was raised specifically for investment in multifamily and is waiting to be deployed, which was estimated to stand at approximately $250 billion at the end of Q3 2022. Again, the general industry sentiment is that this considerable war chest will be unleashed once investors are able to comfortably predict when interest rate increases will end, rewarding those sellers who are not under pressure to take their assets to market beforehand.

DRY POWDER (ALL PROPERTY TYPES, NORTH AMERICA)



Lastly, on the supply side of the equation, after what will generally be high unit delivery totals in 2023 and 2024, the development pipeline is expected to substantially decline[8], as many construction starts planned for 2022/2023 have been delayed or cancelled due to a lack of available financing and/or skittish equity partners. This should put further upward pressure on rent and occupancy rates in the future.

DELIVERIES & DEMOLITIONS



For the many reasons listed above, along with a host of other data points, CP Capital remains optimistic about the long-term prospects of multifamily real estate. Since 1989, we have invested in development and value-add projects across various economic cycles, primarily in the suburbs of growth markets throughout the country, with some of our strongest results originating under conditions like these, which, if not entirely recessionary, can at least be considered recession-adjacent. Alongside our trusted developer partners, who we consider to be best-in-class, we intend to develop through the current market volatility and deliver high-quality multifamily properties for years to come as the economy improves and the overall market strengthens. By maintaining a healthy, long-term perspective – one that avoids recency bias and focuses on positive underlying fundamentals and historical trends – we plan, just as we have for the past 33 years, to build now in the hopes of thriving later.

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[1] Yardi Matrix, December 2021 Report
[2] Yardi Matrix, November 2022 Report
[3] RealPage, Q3 2022 Webinar
[4] Newmark, Q3 2022 U.S. Multifamily Capital Markets Report
[5] "How Will Real Estate Cap Rates Respond to the Rise in the Fed Fund Rate," by Mark G. Roberts, June 2022
[6] National Multifamily Housing Council (NMHC), July 2022
[7] Marcus and Millichap Housing Affordability Special Report, Q2 2022
[8] CoStar, Q3 2022 U.S. Market Narrative

ABOUT CP CAPITAL

CP Capital is a highly disciplined U.S. real estate investment manager focused on the multifamily sector. Founded in 1989, the firm has invested in more than $15 billion of U.S. real estate on behalf of global institutions, family offices and ultra-high net worth individuals. CP Capital's primary investment strategy focuses on opportunistic and value-add rental apartment investments with best-in-class joint venture partners in select high growth markets.

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