MULTIFAMILY SECTOR OPPORTUNITY

Introduction

The multifamily rental segment that constitutes approximately 70% of the $5.4 trillion overall commercial real estate market in the US is an established, resilient, and viable investment strategy that has delivered superior risk adjusted returns to investors in the past and may continue to do so for the foreseeable future. This paper introduces broader advantages of commercial real estate investment in the US, subsequently focuses on the fundamentals of "multifamily" as a leading asset class, analyzes dominant trends and identifies potential opportunities in the mid-to-long term. It delivers a viewpoint from a direct real estate investing perspective rather than a sector-based analysis of real estate public equities whose valuations tend to fluctuate quarterly in rapid correlation with overall market moves.

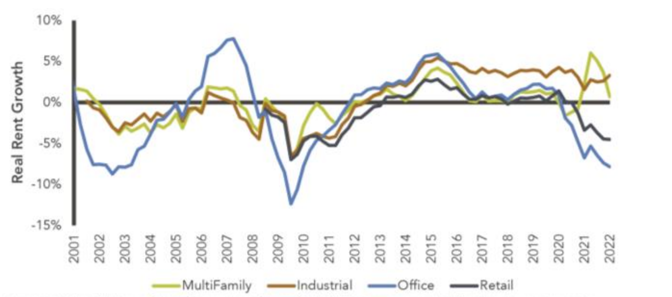
Commercial Real Estate ("CRE") Investment Overview

Despite its complexity and high barriers to entry in developed markets, select commercial real estate strategies provide a distinct array of benefits that outperform traditional financial assets.

- Diversification: Due to its longer-term investment horizon and steady cash flows, commercial real estate has become a significant tool for institutional investors in reducing exposure to the volatility of conventional portfolio structures comprised of stocks and bonds. Categorizing under alternative investment strategies, **institutional investors and global family offices have been increasing their real estate allocations over the past decade to as high as 15%[1] in some developed markets.**

- Tax Benefits: Due to favorable tax laws governing long term ownership, **commercial real estate investment in the US is one the most tax efficient investment strategies, for both domestic and foreign investors.** These strategies generally include leveraging depreciation allowances and various tax write-offs, taking advantage of lower, long-term capital gains tax rates and engaging in tax-deferred hold/exit strategies such as 1031 like-kind exchanges and qualified opportunity zone ("QOZ") investments.

- Inflation Hedge: Given its potential for long-term value appreciation and income growth, CRE investment may be considered an effective hedge against inflation whose importance is emphasized more than ever in today's economic conjuncture. Although some asset classes like office and retail (due to a confluence of other factors) have recorded negative real rent growth in recent years, **multifamily and industrial have outpaced inflation over the long term[2].**

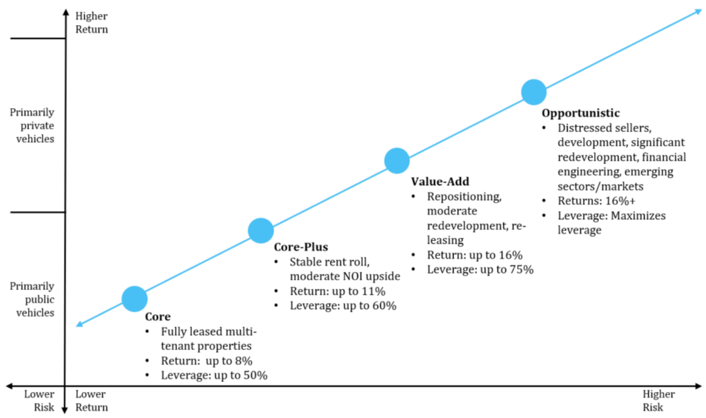


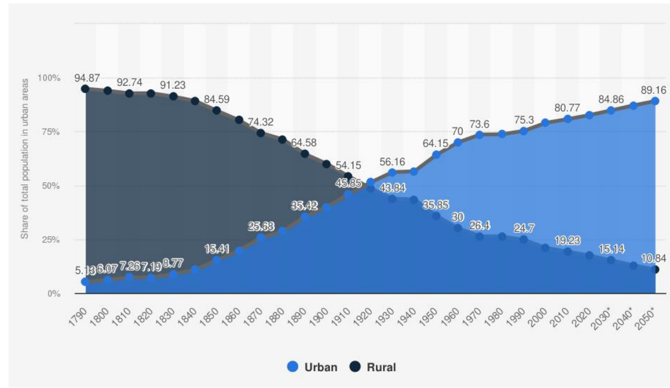
Sources: CoStar, JP Morgan Chase Research as of June 30, 2022. Real rent growth is defined as the year-over-year change in property rents less inflation.

- Risk Adjusted Returns: Whether invested in through professional fund managers or acquired directly by the investor, real estate investment results in both income and realized gains / losses flowing directly to the investor.[3]

  Given the passthrough nature of its net cash flows, professional investment managers grade risk tolerance (vs. targeted return) in real estate investment ranging from conservative to aggressive. **Accordingly, CRE investment strategies typically fall into four categories, Core, Core Plus, Value-Add and Opportunistic, with Core being the lowest risk / return category.** This categorization is an effective way for real estate private equity firms to set clear expectations for investor returns as well as a business plan for each investment. Returns typically range from single digits to 16%+ on an annualized basis over the term of the investment. [4]

1 https://www.msci.com/real-estate-investors
2 https://www.marquetteassociates.com/to-inflation-and-beyond/
3 https://www.preqin.com/academy/lesson-4-asset-class-101s/real-estate
4 https://www.wallstreetprep.com/knowledge/real-estate-private-equity-career-guide/





Multifamily Fundamentals

As the biggest asset class of commercial real estate, the $3.8 trillion[5] "multifamily" segment stands out for its inherent stability, consistent cash flow potential, adaptability to evolving market dynamics, and recent performance.

- Demand: The biggest demand driver for multifamily rental properties has been and will continue to be modern society's transition into developed, denser city centers, commonly referred to as "urbanization." According to a United Nations report, 83% of the U.S. population lived in urban areas in 2018, which is 64% more than in 1950. This trend is expected to persist in the following decades (estimated to reach 89% by 2050), driven by two fundamental demographic trends. Firstly, the aging population (biggest cohort is baby boomers who become downsizing empty nesters) gravitates towards urban centers or adjacent suburbs for better access to hospitals and other services. Secondly, immigration contributes significantly to the U.S. population growth, and cities offer better employment, leisure, and educational opportunities for new immigrants to start their lives. According to the National Multifamily Housing Council, 73% of immigrants who have been living in the US for less than five years rent[6]. Consequently, both developers and residents are inclined towards more effective land utilization, such as multifamily housing, to accommodate the rapidly growing urban population.

Expanding on the efficiency of multifamily within the context of urbanization, it is important to note that **multifamily buildings in denser urban centers possess attributes which lead to a lower carbon footprint.** Some of these attributes [in comparison to larger detached homes in sprawling suburbs] are smaller apartment size per family, collective use of resources, centralized development services, heat islands lowering heating costs and expensive heat insulation methods applied in today's construction.[7] Adding electrified public transportation and shorter distances to reach lifestyle amenities, urban multifamily helps US's commitment to lower carbon emissions.

- Supply: Despite seemingly unlimited demand, housing supply has struggled to keep pace with the population growth over the past decade. Since 2006, home construction has fallen by 55%[8]. According to Jeffrey Hayward, EVP of the Federal National Mortgage Association, fewer homes were built in the 10 years following the GFC than in any decade since the 1960's.[9] **As a result, housing shortage in the US was estimated to be 3.8 million units in 2019.** Labor and material cost escalation due to the pandemic, global political upheavals, supply chain problems, as well as domestic bureaucracy hurdles, have only exacerbated the problem. **The result is a demand / supply imbalance in favor of demand that is likely to put upward pressure on multifamily rents for the foreseeable future.**

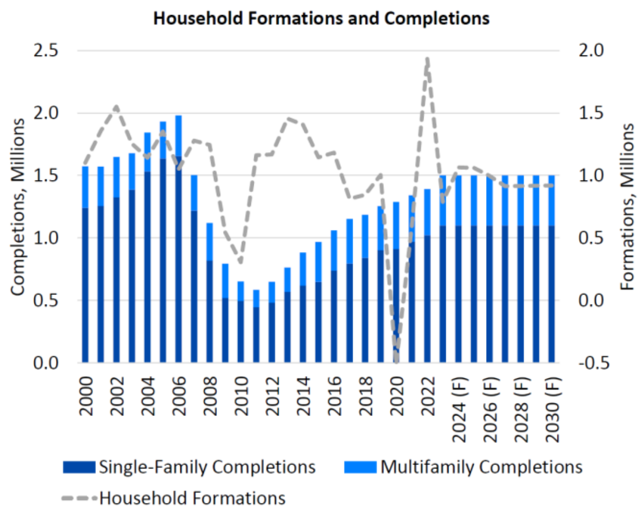
[5] https://www.reit.com/news/blog/market-commentary/estimating-size-commercial-real-estate-market

[6] https://www.nmhc.org/contentassets/ede5d2c75b614ea686edd963dabf93bc/immigration-reform-fact-sheet-2015-02.pdf

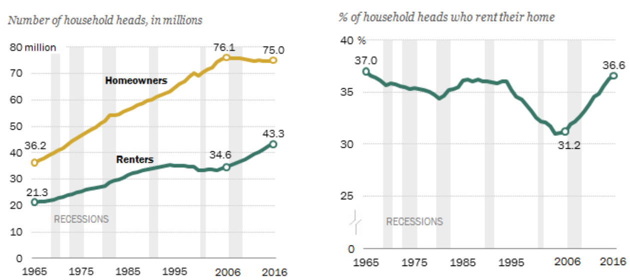
[7] https://www.nmhc.org/contentassets/bd412df7b54b4ebc8f4c85c4344990c5/obrinsky-and-walter-energy-efficiency-in-multifamily.pdf

[8] https://usafacts.org/articles/population-growth-has-outpaced-home-construction-for-20-years/

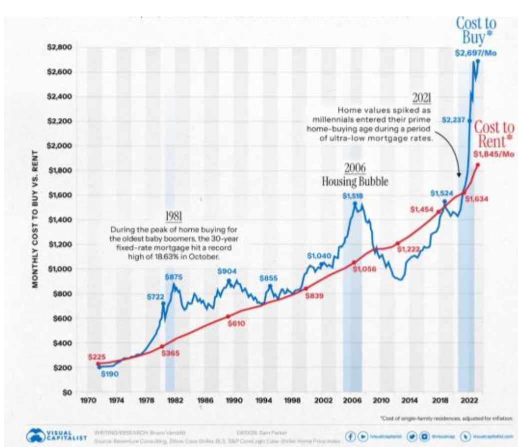
[9] https://www.fanniemae.com/research-and-insights/perspectives/us-housing-shortage



- Housing Trends: According to the Pew Research Center[10], following the housing market turmoil post GFC, the number of renting U.S. households has surged to 43.3 million, reaching its highest point since 1965. Remarkably, % of households renting their home rose from 31.2% in 2006 to 36.6% in 2016.



Adding the cost of homeownership vs. renting to the equation, this growing preference for renting directly translates into a stable and reliable tenant base, as well as a continuous positive trend for multifamily.



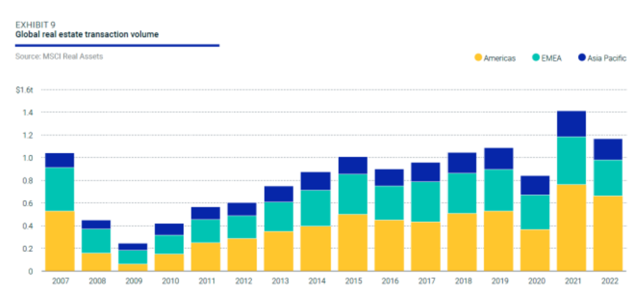
- Resiliency: Multifamily lease duration, typically reset every 12 months, positions the asset class as the most efficient inflation hedge among all CRE asset classes while protecting its downside. Due to its annual turnover, multifamily avoids the volatility and seasonality of a hotel, while staying flexible enough to adjust pricing instead of being locked into long term leases like office, retail and industrial. Additionally, larger multifamily complexes are more resilient than office or industrial properties as individual vacancies cause a comparatively lesser impact on the overall rent roll and bottom-line revenue stream. A study by NMHC quantifies the risk adjusted return of all property types using standard deviation, showing that multifamily exhibits the lowest levels of volatility in its return performance. [11] [12]

	10-year Holding Period			15-year Holding Period		
Property Type	Mean	S.D.	Sharpe Ratio	Mean	S.D.	Sharpe Ratio
All	8.39%	2.47%	0.89	8.71%	1.33%	1.24
Apartment	**9.35%**	**1.98%**	**1.59**	**9.62%**	**1.04%**	**2.45**
Industrial	8.83%	2.44%	1.08	9.13%	1.22%	1.71
Office	7.72%	3.20%	0.48	8.01%	1.91%	0.50
Retail	9.02%	2.64%	1.07	9.46%	1.46%	1.65

Data Source: National Council of Real Estate Investment Fiduciaries (NCREIF)

Current Market Conditions

Three years after the start of the pandemic, global economies are struggling to grow with most central banks having adopted quantitative tightening policies to combat persistently high inflation. Conversely, US economy, seemingly resilient, is benefiting from big infrastructure spending, onshoring policies and innovation led technology growth. Despite its strong currency, US seems to continue being a "safe haven" investment for the rest of world that is plagued with varying levels of political tumult. However, the high interest rate environment leading to dramatically more restrictive lending conditions is dampening commercial real estate investment activity and hurting valuations. According to MSCI, global acquisitions of investment properties fell by nearly 20% relative to 2021[13].



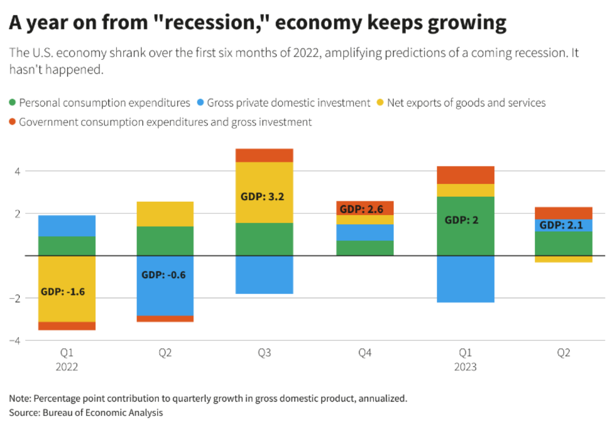
[10] https://www.pewresearch.org/short-reads/2017/07/19/more-u-s-households-are-renting-than-at-any-point-in-50-years/

[11] https://www.nmhc.org/contentassets/98b98e79c61c48f5ab981ffbc7713a9b/explaining-high-apartment-returns.pdf

[12] *Mean is returns – higher is better, S.D is standard deviation - lower is better*

[13] https://www.commercialsearch.com/news/us-real-estate-is-actually-holding-up-well/

Contrary to the sentiment in late 2022, when according to Reuters [14] 65% of economist polled opined that the US economy would go into a recession, current sentiment indicates that the FED is possibly one last hike away from ending its tightening policy and US is poised go through a mild recession in 2024 followed by a recovery. An important factor in the revision of the broader outlook was the staying power of the US consumer, impacting the GDP growth in a positive manner.



Multifamily Market Post Pandemic

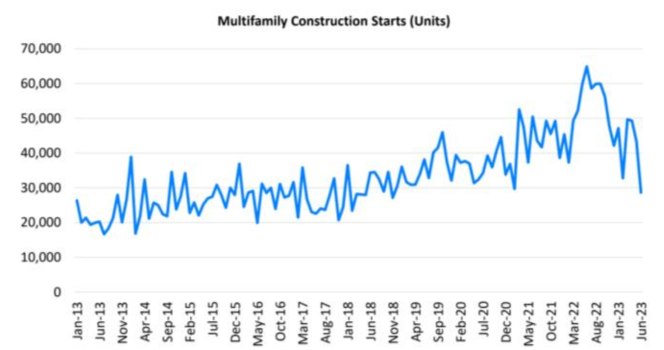
Following the initial shock of the pandemic, US implemented unprecedented measures to stabilize and stimulate the economy. Among the various methods used as part of fiscal and monetary policies, the Fed’s quantitative easing policy and lowering of interest rates to inject liquidity into the system propelled real estate valuations. Multifamily enjoyed record valuations due to cheap financing and sunbelt markets witnessed record rent growth and interstate migration.

Even in the post pandemic, high interest rate era and despite a decelerating rent growth, US multifamily sector appears resilient. Fundamentally, it has benefited from consistent demand, driven by stronger-than-anticipated economic growth as GDP reached 2.1% and unemployment remained at a historically low level of 3.8%. Coupled with supply constraints in major cities, the average asking rent reached its all-time high and vacancy rate has been relatively stable at around 5%. Some markets like South Florida which received record migration from the Northeast performed exceptionally well achieving YoY rent growth as high as 32% in 2021 while supply constrained gateway markets such as New York are currently witnessing occupancy rates over 200 basis points above the national average.

Multifamily Outlook

Despite benefiting from the post pandemic growth, it is still a widely shared consensus that multifamily may be impacted by a potential recession in Q4 2023 or Q1 2024. However, the persistent supply-demand dynamic, coupled with a favorable trajectory of cap rates and declining property values, 2024 may present notable investment opportunities, particularly for investors poised to act upon potential distress arising from refinancing pressures.

- Housing Shortage Remains Unsolved: The scarcity of available starter homes and the resulting surge in prices have led to a growing number of individuals opting to rent, and this trend appears unlikely to reverse in the foreseeable future. On the supply side, multifamily construction starts have been decreasing since Q3 2022 to less than 50% of its all-time high in June 2023 (around 29,000 units) due to the slowdown in capital availability and high cost of borrowing. Such pattern is likely to further push rents up in the short-to-mid-term.[15]



- Long-Term Rental Demand Persists: According to a housing study by Harvard University[16], rental housing serves a large and diverse population of nearly 44 million households. **Most renters are working professionals seeking lower cost of living. Commonly defined as “renter-by-necessity”**, this population occupies over 70% of rental housing or 31 million units nationally, and it is expected to expand notably in the near future due to factors such as immigration, elevated mortgage rates, the high cost of living, and property taxes. At the other end of the spectrum, **recent data has revealed a significant rise in high-income households within the rental market referred to as “renters-by-choice”.** It is

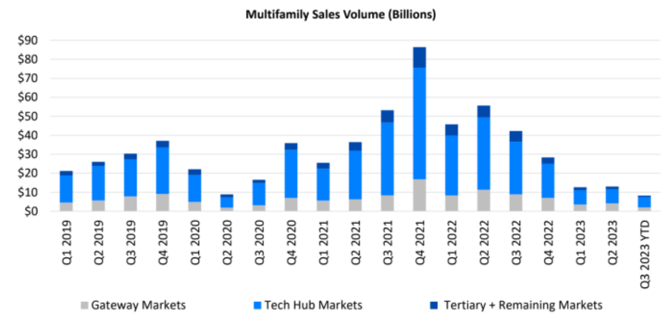
[14] https://www.reuters.com/markets/us/with-gallic-shrug-fed-bids-adieu-recession-that-wasnt-2023-08-16/

[15] https://www.yardimatrix.com/News-Events/Webinars/Webinar/self-storage-national-outlook-fall-2023--48

[16] https://www.jchs.harvard.edu/sites/default/files/ahr2011-3-demographics.pdf

estimated that about 14 million renters are in the top half of the income distribution, and 5.2 million are in the top quartile. For this population, choosing to rent upscale apartments in smaller, more affordable cities enables them to access the luxury amenities they desire in their homes, which might otherwise be financially out of reach. This trend was further intensified as work-from-home significantly changed people's lifestyles in 2020.

- Treasury Yields and Cap Rates: In July, the Federal Reserve raised interest rates for the 11th consecutive time to combat inflation, taking the benchmark rates from nearly 0% to a range of 5.25% to 5.50% in a short 18 months. Consequently, a tremendous tightening in liquidity and overall lending has dominated the market causing a near halt in investment sales activity.



While it is reasonable to expect that rising interest rates may impact cap rates[17], cap rate expansion has been slowly running its course even though some markets have been more immune to it. If spread between 10- year treasury yields and cap rates is a commonly accepted measure of risk premium for multifamily investments, then it is interesting to note that we may be entering a period of increasing spread as cap rates rise and yields decline.[18]

Opportunities in Multifamily

While the current dislocation in capital markets creates a strong argument for private debt / rescue capital opportunities that may offer equity like returns, a lot of **investors and family offices from around the world prefer equity investments and staying close to the asset level real estate. For those, multifamily presents a good opportunity for mid-to-long term value creation with a solid downside protection.**

Assuming a higher interest rate environment for longer and adding "mounting refinancing pressure" to the equation, next 12-18 months may lead to a more pronounced market wide, cap rate expansion. However as indicated on the above chart, cap rates don't fluctuate as much as treasury yields, they usually lag market moves by a few quarters and have a longer-term declining pattern. **Hence, we may be approaching a limited window of opportunity to purchase good multifamily assets at a reasonable basis before cap rates stabilize again.**

As Caldera's research established, long term trends point to strong fundamentals for multifamily but short-term headwinds such as capital markets disruption, imminent wave of commercial loan maturities ($2.75 trillion of loans set to mature by 2027), decelerating rent growth and new supply coming into the market in 2023 / 24 may create opportunities to get into multifamily.

Given its data driven approach and active external CIO assignments in several markets, Caldera identifies some of the following multifamily investment strategies:

1. Quality, core / core+, mid-market opportunities ($40M-70M purchase price) for mid-size family offices or quality core / core+ larger deals for institutional money / large family offices ($70M-$200M purchase price) with slightly higher than normal cap rates. Investors with extra dry powder may choose to purchase these assets all cash or with low leverage, endure negative leverage if needed that may be off-set with cash flow shortfall reserves set aside and refinance in a potentially better market in 2-4 years.

2. Properties that have been foreclosed on by debt funds / non-traditional lenders [due to refinancing problems]. These foreclosure properties are likely to end up being owned by the originating lender's debt fund that is not equipped to own / operate property. Hence, they may be more inclined to sell to investors who can manage their assets.

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[17] *Capitalization rate is net operating income divided by asset value / price*

[18] https://multifamily.fanniemae.com/news-insights/multifamily-market-commentary/2023-multifamily-market-outlook-turbulence-ahead

3. Deals with assumable financing with 4-6 years remaining term that could deliver double digit cash on cash returns. This is especially valuable for long-term owners / family offices. Investors should still be cautious of refinancing underwriting as today's assumable loans inherently are high leverage loans due to currently lower valuations. Investors also must be diligent about loan terms such as interest only term vs amortization, prepayment penalties, defeasance, and yield maintenance clauses as well as exit / extension fees.

4. Value-add opportunities that have lower valuations due to expensive financing, where rent growth can be achieved with hands-on value add strategies such unit renovations, addition of new building amenities such as health clubs, work from home / coworking components, shorter term / furnished rentals, unit reconfigurations and tenant services programming. Investors are advised to partner up with experienced operators or management companies for these types of "heavy lift" projects.

5. Recapitalization opportunities where investors have a chance to own partial interests in quality properties by purchasing an existing partner's share in the investment. Investors should be wary about control / decision making rights, entry valuation and operator fees charged to the joint venture / property level cash flows.

6. Adaptive re-use opportunities such as office to residential or hotel to residential conversions. These investments require specialized expertise in due diligence, zoning, design, and construction. Among many considerations, the feasibility of the project is directly tied to the building's existing footprint, load bearing structure and zoning / building code restrictions.

7. Similar assets to multifamily such as senior housing and student housing which also have strong fundamentals and positive outlook. Investors should consider partnering up with experienced operators / managers as senior housing has various sub-segments depending on age restrictions and healthcare services offered.

In conclusion, Caldera Real Estate Ventures ("Caldera") believes that there is a strong case for investing in and owning multifamily rental properties in the near future. The investment thesis is supported by long term macro trends, strong fundamentals of the asset class and opportunities that are likely to emerge due to the dislocation in capital markets. However, the future success of multifamily investment truly depends on several factors: i) profound understanding of the underlying asset and investment horizon, ii) thorough due diligence / financial analysis for ultimate risk assessment, iii) independent vetting of the sponsor / manager and iv) creation of asset / portfolio specific business strategies. **Family offices and investors, especially the ones who do not have the right in-house team to diligently assess risks, are advised to work with external CIO advisors like Caldera that have a direct, asset level real estate investment track record.**

Author Information

*Can Tavsanoglu is the Founder of Caldera Real Estate Ventures, an External Chief Investment Officer ("**CIO on Demand**"), **strategic, independent advisory** business for commercial real estate. Caldera partners with US & Non-US based family offices, institutional investors and (U)HNW individuals who want to invest / or have already invested in US Commercial Real Estate but have not hired a full time CIO and/or an asset management team.*

Caldera is founded on Mr. Tavsanoglu's track record of 14 years of successful principal side investment experience totaling $2 billion in transactions, developments, and financings. Caldera has an advisory board that consists of the former head of Ernst & Young's global real estate advisory, Executive Chair of Herrick Feinstein, a legal firm with 140 attorneys and global presence, and the head of northeast construction financing at Santander Bank.

Caldera offers a comprehensive set of services including Strategy & Growth, Acquisitions, Due Diligence, Finance, Structuring, Dispositions, Development and Asset Management including ESG compliance & institutional reporting.