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Rethinking Real Estate Investing in the New Interest Rate World

Peakhill Equity Partners
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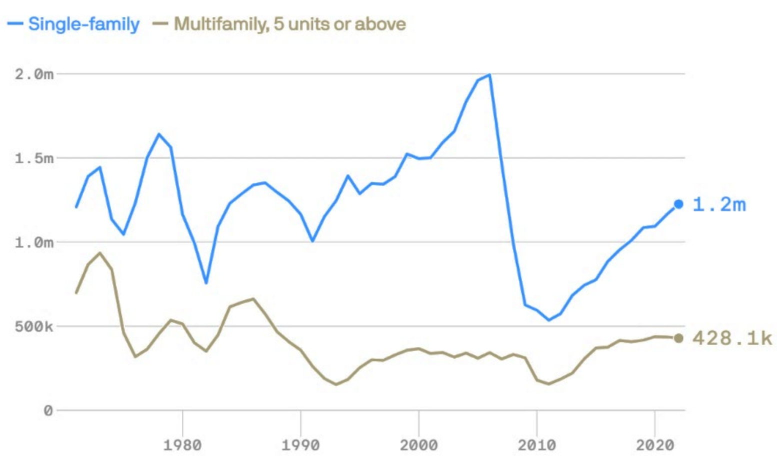
In a world replete with inflation, monetary tightening, negative leverage, energy supply issues and geopolitical turmoil, it can be challenging to formulate a strategy around investing in real assets. However, we see the current dislocation in financial markets and the start of a new investment cycle as perfect conditions to pursue opportunistic investment decisions. We believe that this approach should include a real estate investment strategy that involves "Co-GP" (Co-General Partnership), preferred equity, and distressed asset/sponsor opportunities. This paper will provide a clear rationale for including Co-GP and preferred equity investments as part of a real estate portfolio today, while briefly touching on an opportunity to acquire distressed assets that may materialize as cycle conditions unfold.

CURRENT STATE OF THE MARKET

An Underserved Housing Market

While the current state of capital markets has changed dramatically, the macroeconomic outlook for rental housing and other select real estate sectors remains on solid footing. Housing in the U.S. continues to be well undersupplied, with a projected housing supply deficit of 2.3 million homes as of the end of 2022[1]. The main driver of the housing shortage has been household formations outpacing housing starts. However, rising land costs and construction material costs, regulatory restrictions including archaic zoning laws, and the high cost of debt have all exacerbated this deficit and will likely cause the trend to continue.

U.S. Homes Constructed Annually (1971-2022)[1]

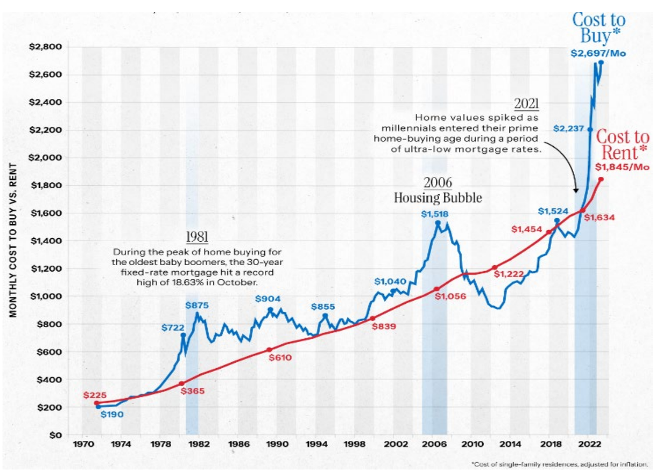


High Cost of Ownership

From the demand side, mortgage rates in both the U.S. and Canada have risen dramatically since March 2022. New U.S. 30-year fixed-rate mortgages carry rates around 8%, putting home ownership increasingly out of reach.

In the U.S., this has created the largest gap in the last 50 years between the monthly cost of owning a home compared to renting. Single-family and multi-family rental housing have therefore become attractive not only to end-users, but to developers and investors as well.

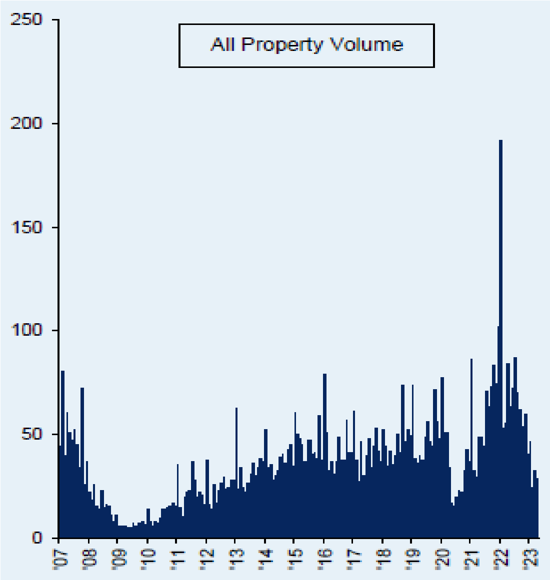
Monthly Cost of Buying vs. Renting in the U.S.[2]



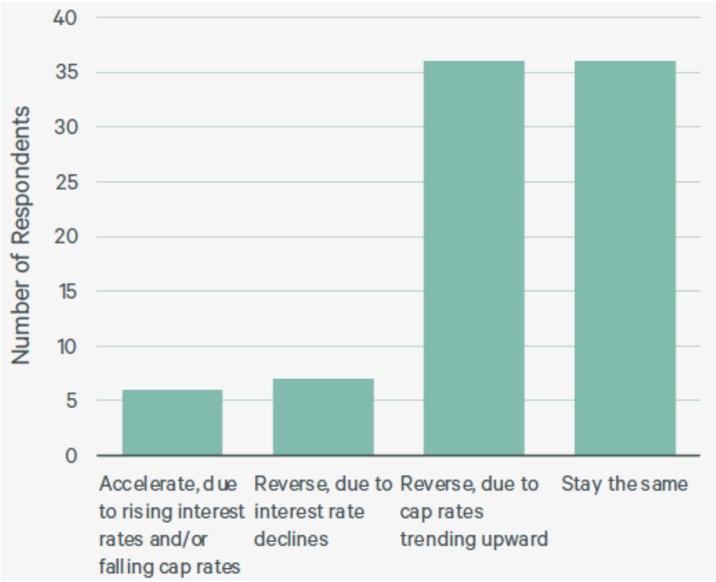
New Interest Rate Environment

Real estate investors' recent experience of achieving outsized returns from inflationary rent growth and falling rates has become much more challenging in the new high interest rate environment that began in Q1 2022. Since March 2022, the U.S. Fed Funds target rate has increased 11 times to 5.25-5.50%. These recent rate hikes have given rise to a phenomenon known as negative leverage, where the cost of borrowing exceeds the unlevered return on an asset's cash flow, amplifying the negative impact to property returns and cash flow to owners. A survey recently conducted by real estate firm CBRE showed that many respondents expect the current negative leverage trend to continue.

Monthly U.S. Real Estate Sales Volumes ($ in Billions)[3]

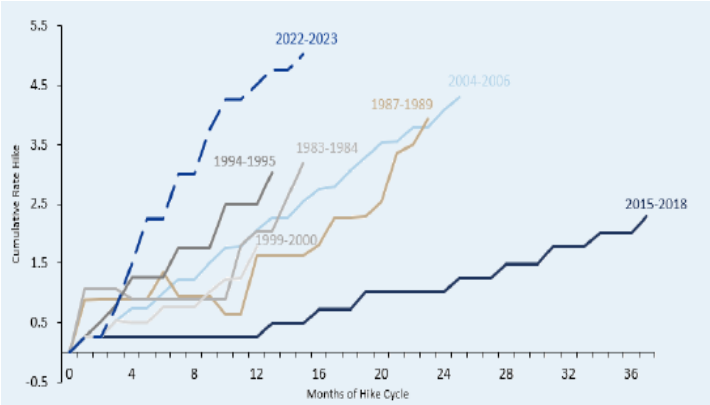


Will the Negative Leverage Trend Continue?[4]

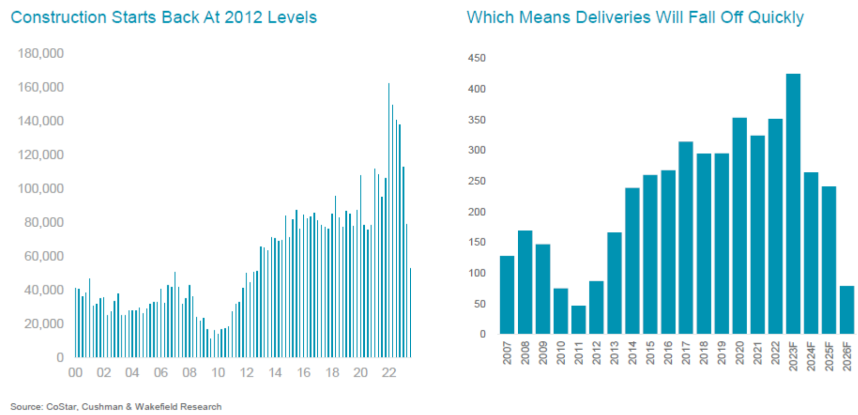


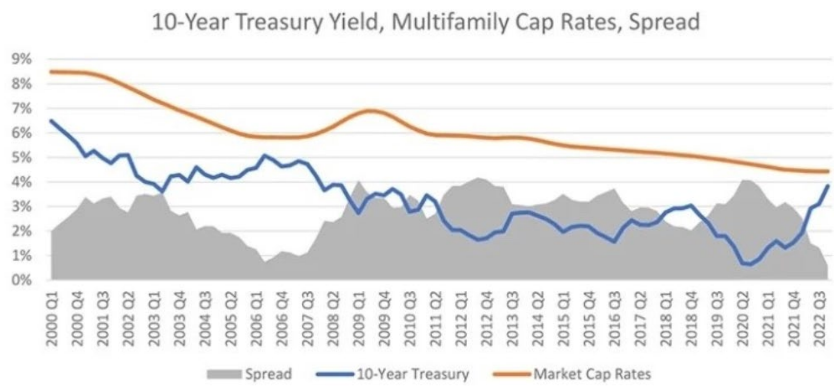
Following an extended period of inflation and Fed tightening, the economy is now moving into a "new normal", where we are witnessing moderating inflation and downward pressure on prices, including the input costs of development and an easing of materials and labour supply constraints. Coupled with persistently high interest rates and investor uncertainty, new multi-family construction starts have retreated back to 2012 levels. This trend of input costs moderating and falling future supply provides a unique backdrop for making structured equity investment opportunities in real estate – namely in strategies including Co-GP equity, preferred equity, and distressed investments, which capitalize on a market environment with lower costs and competition today but potential for substantial upside once conditions normalize.

Historical Federal Reserve Interest Rate Hike Cycles[5]



Construction Starts and Deliveries - Slowing Starts Point to a Major Slowdown in Deliveries[6]





THE CASE FOR CO-GP EQUITY

Peakhill Equity Partners believes there is a substantial opportunity to create tangible value through its Co-GP investment strategy. This platform allows Peakhill an opportunity to achieve outsized returns by investing at the Sponsor/General Partner-level to earn "GP-level" carried interest. While economic terms vary on a deal-specific basis, Co-GP Investors typically receive enhanced economics in exchange for bringing value to a project (whether in the form of development expertise, capital, and/or balance sheet support). A GP/LP joint venture commonly utilizes an incentive mechanism known as a disproportionate sharing of profits (promote or carried interest). By investing directly in the GP entity, Peakhill is able to earn a percentage of the promote, or "Alpha", on top of standard LP profit share.

There are several reasons why now is the right time to invest in a Co-GP investment strategy. The current interest rate environment has made it more difficult for developers to finance land acquisitions which they can carry through the entitlement and predevelopment process. Having the combined efforts of a capital provider with in-house development expertise can create the necessary conditions to effectuate a transaction in an otherwise challenged environment.

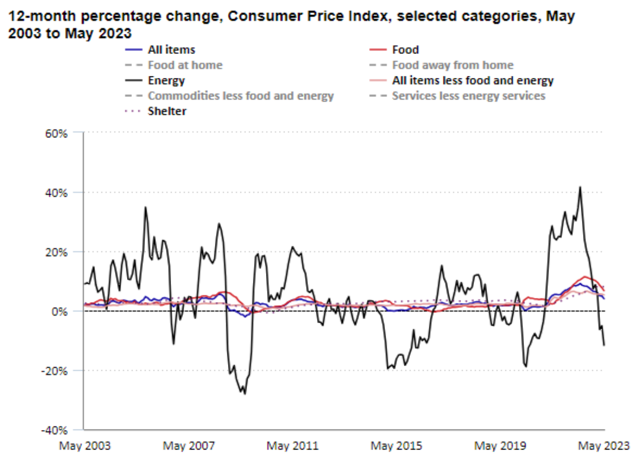
Secondly, national lenders have either reduced their balance sheet allocations to real estate in general or taken more conservative financing positions, creating a natural capital shortfall to complete acquisitions or develop/redevelop properties. Further exacerbating the issue, smaller U.S. regional lenders have pulled back their real estate lending activities to reduce their exposures in the markets. In the U.S., nearly 70% of loans are held by regional banks. This has had a significant negative impact on borrowers who are seeking financing for their real estate projects as lending standards were tightened. A recent survey conducted by PwC and the Urban Land Institute shows that debt underwriting standards in the U.S. are expected to be significantly more conservative due to the current low leverage environment. Developers are likely to require additional equity capital to complete projects as well as to carry those newly acquired properties through longer predevelopment timelines.

Debt Underwriting Standards Forecasts for the U.S.[7]

Source: *Emerging Trends in Real Estate* surveys.
Note: Based on U.S. respondents only.

Capital invested through a Co-GP structure can enable developers to pursue multiple opportunities rather than committing capital to a single project and to position their businesses to scale as the real estate cycle turns. The benefit can extend beyond access to capital, by providing credit support to owners/developers at a time where lenders are imposing more stringent covenant requirements. A Co-GP partner can provide its balance sheet to secure more favorable debt terms through loan guarantees.

U.S. Inflation Rates, % Changes over 12-month Periods[8]



Following an extended period of inflation, we are now seeing downward pressure on the input costs of development and an easing on supply constraints associated with materials and labour. As of October 2023, the year-over-year change in the Consumer Price Index was 3.2%, down significantly from the 9.1% high seen in June 2022. This trend should provide a real and substantive benefit to a Co-GP development program and contribute to outsized returns in the hands of responsible managers and developers that are able to patiently ride out the cycle to recovery.

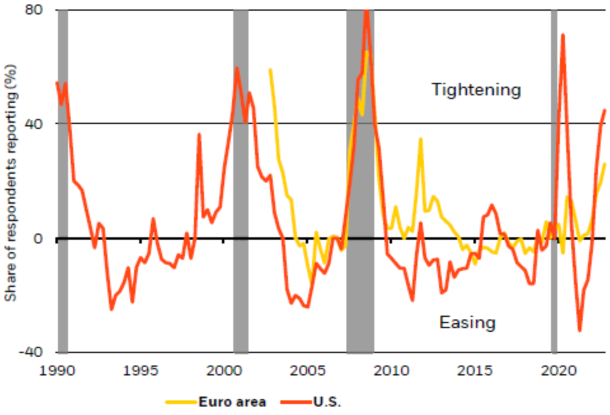
THE CASE FOR PREFERRED EQUITY

Current market conditions are presenting the ability to earn equity returns with debt-like protection, in the form of preferred equity investments.

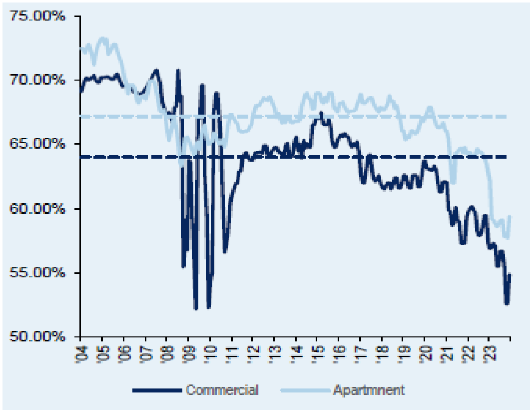
As outlined above, there is currently a gap in capital funding as lenders have revised their credit underwriting and reduced the loan proceeds they are prepared to advance. Preferred equity can provide a solution to this capital shortfall. Bank lending surveys show that credit conditions have been tightening since late 2022 as rates have climbed and recent regional bank failures in the US have exacerbated this tightening.

In particular, lenders have reduced their real estate loan leverage as property cash flows no longer support the same debt levels with higher interest rates. As a result, a significant refinancing risk exists for borrowers who had benefitted from shorter-term bridge funding issued between 2020-2021.

Corporate Bank Lending Conditions, 1980-2023[9]

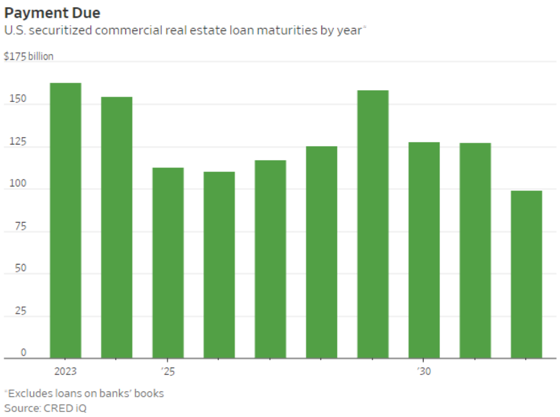


Historical Commercial & Multifamily LTV Ratios[3]

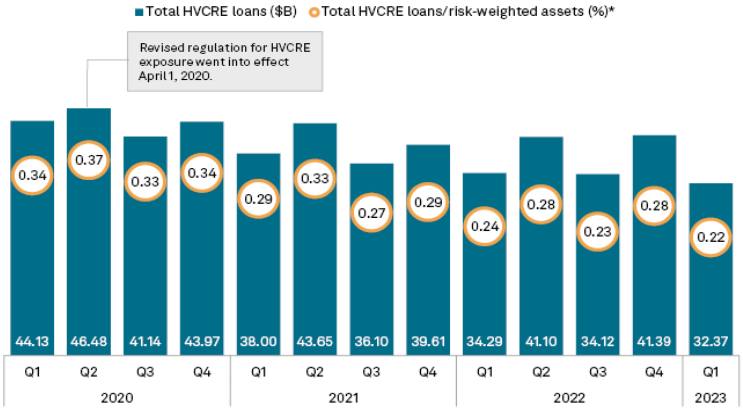


The next 36 months are expected to see a high volume of loan maturities. $163B in securitized debt reached maturity in 2023, the largest annual amount over the next decade. This figure does not include loans on banks' books. This volume of maturities presents a strong opportunity to provide capital support due to the recent pullback in activity across commercial lending markets. The financing gap in credit markets can further be observed by looking at the recent volumes of high-volatility commercial real estate loans ("HVCRE"), defined as credit facilities that primarily finance or refinance acquisitions, developments, or construction of real estate properties. In Q1 2023 the volume of HVCRE loans declined 21.8% from the prior quarter and reached its lowest level in years, according to S&P Global Market Intelligence.

Real Estate Loan Maturities[10]

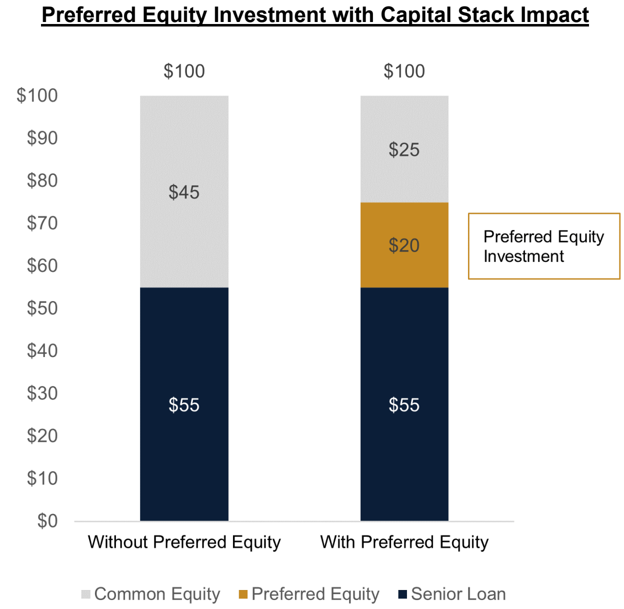


Aggregate High-Velocity Commercial Real Estate Loans Trend[11]



Preferred equity can help borrowers supplement the reduced mortgage proceeds anticipated for projects on a go-forward basis. In the current environment, proceeds are being reduced either due to lenders' underwriting to lower attachment points (LTV/LTC) or borrowers being unable to qualify for a full refinance package as a result of cap rate expansion pressures caused by the latest rise in interest rates.

The following hypothetical example illustrates how preferred equity could be used for an acquisition to address the issue of reduced loan proceeds and supplement the senior mortgage to capitalize a purchase. In the case of a purchase funded with only common equity and a senior loan, a sponsor is responsible for a much larger capital raise in today's environment, which could lead the project's returns to suffer on exit given the larger equity investment required. With preferred equity included in the capital stack, traditional leverage levels are maintained which allows for an improved sponsor-level return and a blended interest rate only slightly above the rate on the senior mortgage.



The preferred equity structure provides investors with a fixed rate of return, and often an additional limited participation in upside of a project's given profit-sharing allocation with a priority position to the common equity. As a result, it can have both debt and equity-like features. With sound underwriting and appropriate recourse terms, this strategy allows investors to deploy capital at a lower cost basis than equity investors in an uncertain market with ongoing volatility at returns well above senior debt.

THE CASE FOR DISTRESSED INVESTMENTS

A third opportunity of particular relevance is to invest in assets that are distressed. Distressed real estate assets can take many forms, but those that typically warrant attention from investors are ones that require financial restructuring, either due to over leverage, high projected future capital costs, or market conditions, and are therefore priced at a significant discount to fair market value.

As significant levels of debt maturities occur in 2023 and beyond, a meaningful share of them will be shorter-term bridge loans that were based on a future value being achieved through value-add measures and advanced assuming cheap permanent financing of 4-5% was available. As those rates and end values are no longer attainable, existing lenders have begun the process of selling their notes and/or their properties either at par or a significant discount. Purchasing these properties at their discounted value provides an excellent opportunity to capitalize on the current resetting of property values and gain an entry point at levels not seen in years.

As the late Sam Zell, who passed away earlier this year, wrote in his now famous 1982 letter "The Grave Dancer" about distressed investing, "Investors in distressed property are motivated primarily by the expectation that the equity value of a real estate asset acquired at less than its original cost-to-construct will in time increase to a point that justifies its original indebtedness. Thus, the successful "grave dancer" must generate cash flow by achieving and maintaining high occupancy rates in an overstocked market through good management. And he must be able to carry the property." Given that the long-term outlook of residential and industrial asset classes remains strong, distressed assets particularly in the office sector[12] may offer outsized returns for a limited period of time.

KEY TAKE-AWAYS

Given the current state of the market, revisiting your investment strategy is required to address new realities that have shifted the basis for real estate fundamentals and the investment thesis of the last ten years. This thesis, which relied on driving value with existing assets through relatively cheap debt, will not necessarily apply in today's new normal.

Investing through a Co-GP structure and alternatives such as preferred equity investments can offer attractive risk-adjusted returns. Given investors' comfort with the resilient multi-family asset class, there remain significant opportunities in high growth markets to achieve a successful risk-adjusted outcome.

ABOUT PEAKHILL EQUITY PARTNERS

Peakhill Equity Partners ("Peakhill") is an opportunistic equity platform focused on Co-General Partner ("Co-GP") and priority equity investments in ground-up and value-add projects in Canada and the U.S. Peakhill seeks to identify and execute on opportunities with superior risk-adjusted returns through its entrepreneurial structure, development expertise, balance sheet, and strategic relationship with its U.S. and Canadian lending arm, Peakhill Capital. With 6 offices and a team of over 50 professionals located across Canada and the U.S., Peakhill continues to expand its reach and ability to service clients.

Peakhill Equity Partners' Co-GP and priority investment platform offers distinct advantages to our investor partners that sets us apart from traditional real estate investors:

- Peakhill invests early in the development process and offers creative financial structures recognizing the unique complexities of each transaction
- Peakhill's team brings over 55 years of real estate development and finance experience in Tier 1 and Tier 2 cities across the U.S. and Canada to our partnerships
- Peakhill maintains deep relationships with lenders and institutional equity investors both through existing relationships of the investment management team and our lending arm (Peakhill Capital)
- Peakhill provides significant credit enhancement to its projects through signing or co-signing loan guarantees

[1] Data: FRED via Moody's Analytics; Chart: Axios
[2] Reventure Consulting
[3] Morgan Stanley Research – State of the CRE and REIT Market (May 11, 2023)
[4] CBRE H2 2022 US Cap Rate Survey
[5] Federal Reserve Board, as of May 9, 2023
[6] Cushman & Wakefield 2023 Multifamily Market Update
[7] Emerging Trends in Real Estate 2023, PWC and ULI
[8] St. Louis Federal Reserve
[9] BlackRock Investment Institute, 2023 Global Outlook Report
[10] CRED IQ 2023
[11] S&P Global Market Intelligence June 2023
[12] According to Trepp, as of September 2023, $9.8billion of CMBS loans tied to office buildings were in special servicing.

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