VOLUME 1, ISSUE 5

STRATEGIC PROPERTY INVESTMENT QUARTERLY

A QUARTERLY NEWSLETTER FROM SPI ADVISORY, LLC

THIS QUARTER'S NEWS AND UPDATES:

FOREWORD FROM SPI CO-FOUNDER & PRINCIPAL, MICHAEL BECKER

“The Only Constant in Life is Change.” - Heraclitus

One constant since the beginning of time is change. However, another constant is the fear of change. 2022 was an erratic year filled with unanticipated change & fear for many. Most notably for multifamily investors, we experienced a sudden, dramatic rise in interest rates that differed materially from the market expectations set at the beginning of the year. These unexpected developments have impacted virtually all investment asset classes, not just multifamily.

But, as of recently, I’ve been taking solace in the fact that things constantly change & our current situation is only temporary. Soon enough, the capital markets will calm down & we'll all adjust to the new world & get right back to business. At SPI Advisory, we’re confident in our investment thesis & our properties. Just like each year before, in 2023, we will continue to identify what we feel are mispriced assets at any point in the cycle & aggressively pursue them. I’m personally looking forward to the calendar changing into the new year & taking advantage of the opportunities that lie ahead. Soon enough, 2023's opportunities will dissipate & no matter how many properties we buy, we’ll regret not buying more.

MACRO INVESTOR TRENDS: "STAYING THE COURSE"

Written by SPI Co-founder & Principal, Sean Mabarak

Despite financial conditions becoming tighter and tighter this year, we've grown more confident in our investment strategy and are starting to see significant opportunity form in the face of rising lending and cap rates combined with the materially higher post-COVID reset in rental rates.

Over the last 4-5 years, SPI's strategy has been to focus on Class A multifamily due to the risk premium for lesser quality assets declining precipitously during the prolonged period that followed the Great Financial Crisis of higher liquidity and lower interest rates. Even today, albeit with far fewer sales in 2022, the risk premium assigned to Class C vs. Class A multifamily is still far too low, especially in the face of a Fed-engineered recession.

At the onset of 2023, my strong recommendation is to *"stay the course"* and continue to purchase institutional-grade assets in primary markets while price discovery works its way through the workforce housing and value-add multifamily markets. This recommendation is supported by three primary trends: **(1)** price discovery materializes much faster at the institutional level, **(2)** this rapid repricing makes it incrementally more difficult for developers and their lenders to make sense of new projects, and **(3)** while prices have reset lower, rental rates have reset significantly higher.

For simplicity, the analysis below will reference only data on Class A, recently built, suburban Austin/DFW multifamily.

Prices for Class A multifamily have deteriorated from their obscene highs observed at the beginning of this year. In the second half of 2021 going into Q1 of 2022, it was commonplace for brand new construction deals to sell pre-stabilized *(at the certificate of occupancy)* for fully-stabilized year 1 buyer proforma cap rates of 3.75-4%. This resulted in the developer selling for materially higher pricing than originally modeled, and in a much shorter time horizon. Simply put, there were many developers who made generational wealth over the recent term. Today, we're seeing buyers require a 4.75-5% cap rate on <u>in-place numbers</u> in order to clear a deal.

So, as we close out 2022, repricing is developing much faster in new construction properties in comparison to the workforce housing space because these assets are primarily owned by institutions that must make their decisions quickly in order to guarantee solvency and profitability in the future. In addition, these developers are seeing even their bear-case scenarios begin to be challenged by rapidly increasing interest rates. Since many of the developers' debt is tied to completion and personal guarantees, when they face a scenario in which the cost of new construction starts to approach recent sales comps, their only viable options are either to recapitalize with long-term equity *(which is currently largely unavailable)* or, to sell. In these types of decisions, there's far less emotion involved than with individual owners and family offices; these developers' primary goal is to deliver whatever returns they can, as fast as they can, so that they can continue to build and be solvent in the future.

Furthermore, construction lenders are currently beyond their capacity to lend on any additional, new development projects until they've paid off a substantial number of existing loans. We for-

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esee this will put significant pressure on developers' ability to fund and build new projects, many of which were scheduled to break ground soon. Our theory that many previously permitted projects will result in delays or be canceled altogether in the next year or two is yet to be substantiated, but as the macroeconomic headwinds continue to pile up, it's only a matter of time.

The cap rates and unleveraged yields we are seeing today mimic what we saw in 2019, pre-pandemic. However, since then, rental rates have skyrocketed 30-40% as migration to Texas accelerated faster than our ability to build housing. This presents an opportunity to buy newly-constructed assets at 2019 unlevered yields or better with forward supply likely to pull back dramatically. *Seems like a no-brainer, right?* Well, when you put this all in a five-year model at today's rates of 5.75-6.25%, the returns look… *not great*. That's because the market cap rate of 4.75-5% is still inside the borrowing rate *(negative leverage)*, which erodes cash flow more rapidly the more leverage you take on.

When negative leverage occurs, any textbook on real estate investing will advise that you stay on the sidelines until cap rates normalize. **The problem with this strategy is twofold:**

1. **Just because rental rates increased 30-40% over the last two years doesn't imply that effective income increased comparably**. It takes time to normalize rents across the rent roll to reach this new level, and the delta is called loss to lease *("LTL")*. Pre-pandemic LTL averaged in the 2-5% range. Current LTL, on average, is 10-20% depending on if the current owner or developer was slow to respond to rapidly increasing rental rates. This discrepancy creates a clear path to going from a 5% cap rate to a 6-7% cap rate over a short period of time, even if you factor in flat to falling market rent growth in a recessionary environment.
2. **We can't justifiably model a reversion cap rate** *(the assumed cap rate upon resale)* **that's lower than the current borrowing rate**. But, we also cannot reasonably explain why or how borrowing rates will remain this elevated over the next 5 years when the current economy is revealing progressively more and more cracks with each additional rate hike…Lower rates seem inevitable over a 2+ year time horizon, but we simply can't model that. We can, however, run scenarios depicting what would happen *if* multifamily loan rates did fall back to 5% or 4%, or 3%, and, as you can imagine, those scenarios look VERY attractive.

In addition to the two main points above, if borrowing rates are higher than cap rates, but the equivalent risk-free rate over your investment horizon is notably lower than cap rates, it still seems sensible to buy the property all cash, *or with minimal leverage and lever up in a more favorable capital market environment*. For example, if the 5-year Treasury is 3.65% and your cap rate is 5% for a low-risk, high-quality multifamily asset, it probably makes the most sense to invest. If you take it a step further and have a clear path to a 7% cap rate over that 5-year period with substantial tax benefits, you'll be decidedly better off buying the property and yielding substantially higher than the market's current expectation for risk-free rates over the next 5 years. You're also better off when it comes time to sell the property and generate a substantial capital gain based on higher income. Throw in the potential for rates to fall in the

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next few years, and you create the opportunity to apply positive leverage to amplify returns and have a compounding effect on the resell values, further increasing ROI.

Taking all of this into account, one likely strategy for SPI in 2023 is to **target purchasing high-quality assets with low to modest leverage, while the number of developers needing to sell outpaces buyer demand**. We feel this opportunity will be most pronounced at the onset of the year and will dwindle as we approach 2024, so we intend to execute this strategy in early 2023. We plan to structure these purchases in a way that can weather a prolonged high interest rate environment but will also result in outsized benefits in the event that rates fall. **Using low leverage will allow us to then increase leverage in the future and allocate that equity to higher-yielding projects when workforce housing and value-add multifamily start to trade at an appropriate risk premium. Mike discusses that opportunity in more detail on the next page**. We're certainly not to that point yet, but I firmly believe that it's where we're headed, and it will happen concurrently with a flight to quality that will reinforce the values of the Class A deals we purchase in the interim.

Sean Mabarak,

Co-Founder & Principal

Strategic Property Investment

READ THIS ARTICLE ON THE BLOG

Q4'22 STATE OF THE MARKET: *"OPPORTUNITY AHEAD "*

Written by SPI Co-founder & Principal, Michael Becker

HI MICHAEL BECKER HERE...

For my article in our Q3 newsletter, "***Multifamily Demand Drivers***," I spoke about the fundamental undersupply of the US multifamily housing market and how, specifically, the 4 major Texas markets are projected to need to build over 650,000 units between now and 2035 in order to keep up with the demand. Additionally, **in previous newsletters**, I spoke about rising interest rates, and in this newsletter, **we sat down with JP Conklin at Pensford** to gather his thoughts on the interest rate market and its short-term and long-term impact on the debt markets. In this article, I will mingle these two thoughts together.

As we close out 2022, I feel that we're beginning to see the onset of some dislocation or pressure in the general commercial real estate market evidenced by the rising interest rates driving an increase in debt service costs and lowering loan proceeds on the new debt available in the marketplace… Additionally, there has been a substantial increase in Interest Rate Cap costs YTD resulting in a huge use of cash for floating-rate borrowers, as JP spoke about in his article. Specifically, in the multifamily space, we're seeing a lot of lenders sitting out of the market right now, which is a significant contrast to the robust number of options of debt funds, Life Co's, CMBS, banks, and, of course, the agencies *(Fannie/Freddie)* available when we started the year. Right now, our options have dwindled down to the agencies and some of the banks providing liquidity to the market at much more conservative terms. The Life Co's are still lending, however, their terms are typically sub-50% LTV on *"Trophy Assets,"* a negligible subset of the market. But, with the cost of debt today, it doesn't make sense for those types of deals to use leverage. So, today, if a Core *"Trophy Asset"* sells, it's typically to an all-cash institutional buyer who will put leverage on it later when the capital markets improve.

So, across the board, we've seen multifamily asset values contract from their Q1 2022 peak, but largely, there's been very limited transaction volume as a bid-ask spread in the marketplace between what sellers are willing to take and what buyers feel they need to move forward remains. In Texas, from my viewpoint, this phenomenon appears to be most pronounced in the workforce housing space, which consists primarily of 1970s and 1980s vintage properties. This specific segment of the market is where I anticipate the most value to be found in 2023, specifically in the latter part of the year.

Let me elaborate on my working investment thesis a bit….

Anyone who's followed me or heard me talk over the past many years has probably heard me discuss how our company, SPI Advisory, started out primarily investing in workforce housing deals. Over the last decade *(since we first started buying deals in 2013 and up until recently)*, cap rates have generally compressed in the multifamily space. As we started 2022, this anomaly had resulted in narrowing what had historically been a larger spread between the top of the property grade *(Class A deals)* and the bottom of the grade *(Class C deals)* to a point where there was virtually no significant difference in cap rates between the two grades. To illustrate this point, back in 2013 when I purchased my first multifamily deal, Texas multifamily cap rates were around 5% for Class A *(Newer Construction)*, 6.5% for Class B *(1980's Construction),* and 8-8.5% for Class C *(1960's & 1970's Construction)*. Whereas, by the beginning of 2022, all the property grades were right around a 4% +/- CAP across the spectrum.

As the spread narrowed, starting in 2017, we took the opportunity to sell our older assets and trade into newer

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assets at a similar cap rate. In retrospect, I will admit that we were slightly premature in that move as we bought deals at an 8%+ cap, moved revenue up substantially, and then sold them for a 6% cap while generating large profits along the way. Had I known that cap rates would reach 4%, we would have held out a bit longer. With that being said, I feel confident about how our portfolio quality is positioned today, as we own substantially newer and nicer deals compared to 4-5 years ago.

I attribute the dramatic compression in workforce cap rates over the past many years to have been driven largely by 3 main factors:

1. **We had an abundance of lending options available.** As lenders got more competitive, debt funds started to push leverage up further by allowing buyers to pay more for those deals and model better projected returns to attract capital. There was a substantial increase in the percentage of loans done by debt funds in 2021 compared to 2020 when agencies were the dominant lender.
2. **There's been an influx of new interest in the multifamily space fueled by a surplus of emerging podcasts spreading awareness of our industry** *(I'm partially at fault for this one)*. Additionally, there's been an excess of new multifamily *"Gurus"* surfacing to teach the masses their techniques on how to source deals and raise capital. Consequently, since 2020, there's been an oversupply of new sponsors who've flooded the space and started buying what they could afford *(typically older, vintage deals much like we did at SPI Advisory when we started out)*.
3. **Finally, a large amount of equity in the last 3 years came from the recycling of capital.** Due to cap rate compression, regardless of the expertise of the sponsor or the cost basis in the deal, multifamily sponsors have been able to buy a workforce housing deal, paint the exterior, renovate 10-20% of the units, and sell it for a substantial profit just 2 years later, making their investors rich along the way. Those investors would turn 1 dollar into 2 and then reinvest those funds into two news deals thereby fueling more and more demand for multifamily syndications.

As the market recalibrates to higher interest rates, I'm observing general cap rate expansion across the board. However, the market is again starting to price in the risk of asset quality where it largely did not over the past several years. As a result, the cap rates of Class A deals are much "stickier" and we're seeing the workforce housing *(Class B & C)* caps expand at a much faster pace. In particular, I'm seeing the least desirable Class C deals -- *ones with boilers, flat roofs, chillers, or inferior locations* -- have their cap rates expand the most. Speaking from personal experience, owning a flat roof chiller deal sucks.

This divergence in cap rates makes sense to me when you consider the creditable replacement cost argument you can make in regard to Class A buildings, but it isn't equally as applicable to functionally obsolete, 40-60 year old workforce housing… If developers cannot successfully model a profitable exit, they cannot attract debt and equity to build the project, and, as a result, new supply will pull back, thereby putting upward pressure on rents until deals new construction "pencils" again. So, unless development costs fall substantially, there is a floor on how low Class A deals can go in consideration of "per pound play" and the equity buy off on the discount-to-replacement cost play in a low supply, rising population environment. On the other hand, workforce housing deals are driven much more by fundamentals and debt terms, so the floor is much lower compared to newer construction.

Coupled with cap rate expansion, here are a few additional pressures workforce housing operators face today:

- **The workforce housing tenant base, who generally maintain lower-paying jobs, are more stretched today than ever before due to rising inflation eroding their purchasing power**. As a result, organic rent growth slows faster in the workforce housing deals compared to Class A deals. Additionally, delinquency and bad debt is much more frequent and pronounced as a percentage of revenue here, too. I believe when we hit a recession, this will substantially erode the revenue in workforce housing deals.
- **The workforce housing space is where Debt funds lenders focused the majority of their lending over the past few years.** At the beginning of the year, the typical debt fund structure was 80% leverage with a 3-year maturity and two 1-year extension options. These were typically floating rates with +/- 4% spreads over LIBOR or SOFR. Both LIBOR and SOFR will have gone from practically zero when the year started to north of 4% by year's end, thereby making the debt service on these deals more than double to around 8% all-in rates. These debt fund borrowers are getting squeezed a few ways with rising interest rates which are likely mitigated somewhat by having an interest rate cap in place. However, these borrowers will likely have to buy a replacement cap which are exorbitantly expensive today *(we have those pressures on our Freddie Floaters, so I am very familiar with it)*. This is a huge use of cash along the way.
- **Current Debt Yields sizing rates will prevent workforce housing borrowers from the ability to refinance.** A debt yield is similar to how you calculate a cap rate, except the formula is NOI / Loan Amount = Debt Yield. In 2020 and 2021, the debt funds' deals typically sized to a Year 3 stabilized Debt Yield of around 7% *(I heard of some debt funds at the beginning of this year quoting 6% stabilized Debt Yields…crazy)*, which means going-in, Debt Yields were in many cases around 4%. Fast forward to today, and most banks, the debt funds that are still active and agencies are all backing into Debt Yields of between 9-10%. This absolutely crushes loan proceeds for these deals, and there's no way these borrowers will be able to size for a refinance at their current loan balances.
- **To compound this, most of these loans have interim Debt Yield test covenants.** Meaning that 18 or 24 months into the term, the lender will check in on the current Debt Yield to see if the 7% Year 3 Debt Yield is at least at 6% 18-24 months into it. If not, they have re-margin requirements built into the loan documents which obligate the borrower to pay the mortgage down to a level at which the NOI supports a 6% Debt Yield. If they can't do that, it will trigger a hard cashflow sweep where the lender will suck all of the cash through a lock box to ensure the borrower doesn't distribute any money out. This is a difficult condition to operate under.
- **Throw in the mix that a huge percentage of workforce housing owners today just entered the business within the past few years.** That means they're less experienced and will be the ones making decisions for better or worse. Also, many are likely not well capitalized since they haven't had the luxury of going full cycle by selling numerous deals over the past decade to generate liquidity. As I mentioned earlier, these operators bought what they could afford, with as much leverage as they could, as they didn't have the capital or track record to obtain better quality or lower leverage deals.

What I just described above is brewing below the surface in many of the workforce housing deals right now. This makes me think of the Warren Buffet quote *"When you combine ignorance and leverage, you get some pretty interesting results."* So, I believe a lot of deals are dead right now, they just have some liquidity in their entities to keep up for the time being, but as soon as that liquidity dries up is when the bodies will start to drop. Many of these sponsors don't have the cash to solve their own problems, and I am unsure how well capital calls will be received by investors if the deal is underwater to its debt basis.

Q4'22 STATE OF THE MARKET:
"OPPORTUNITY AHEAD "

Written by SPI Co-founder & Principal, Michael Becker

LIKELY OPPORTUNITY IN 2023

On the good news front, we are seeing early indicators of inflation roll over in real-time, and the Federal Reserve just signaled that they will slow the pace of rate hikes to monitor the lagging effects rate hikes have to the economy. Reading between the lines, I speculate that this means a pause is nearing, which will be followed ultimately a few to several months later by rate cuts as we battle a likely rise in unemployment and a weaker economy. It truly feels like there is light at the end of the tunnel in the Fed's fight against inflation.

If what I think is going to happen actually happens, it's a mixed bag for apartment investors. The good part is that borrowers will get a ton of relief with interest rates going down, which will result in causing rate cap costs to fall dramatically and making new loans size much better, in particular for the agencies. The bad part is that you would expect delinquency to rise and rents to stagnate or fall for a period of time. If history holds, that will be most pronounced in the workforce housing space.

Couple my expected decline in workforce housing fundamentals with a powder keg filled with the inexperienced, undercapitalized sponsors that are over-leveraged, there must be problems in this space. I think the spark that will make the powder keg explode will be the 18-24 month Debt Yield test all the debt fund lenders will test for. So, look to debt fund deals done in 2020 and 2021 as the clock runs out on those deals. When those sponsors can't re-margin the loans or refinance out, they'll be forced to sell in a distressed scenario. That's what I believe is going to be the opportunity we have in 2023, likely in Q3 or later, as everyone works through the property-level liquidity as the rate hikes have been an incremental process since March 2022.

The wild card that is harder for me to handicap is the fact that a lot of the debt fund lenders were large multifamily owners such as Related or Starwood. They might be savvy & depending on the scope of problems capitalized enough where they will be able to take the properties back and work them out themselves vs. selling into the market at whatever price it takes to clear it off the books like a bank would. If that happens in large scale, it mutes the level of opportunity I see coming at this space.

This is what I expect to happen in 2023, and I hope to channel my inner Marty McFly and go back in time to the 80's to take advantage of this dislocation. I am sure happy that we will be basically a 3-to-1 net seller this year and have raised a bunch of cash through sales for us and our investors in 2022.

To be clear, I do not think this is the Great Recession of 2008 all over again. The scope of the problem isn't nearly as widespread as it was then. The banks, Life Co's, and agencies all had solid underwriting fundamentals for their loans. I believe for multifamily, this is largely concentrated in the workforce housing deals with debt fund loans put on in 2020 and 2021 of which there were a lot of them. The owners of workforce housing deals with 7-10 year agency loans should largely be fine and, if they choose to, can ride this out. So, overall this is a subset of the multifamily space I think will be most impacted.

I also don't think that this opportunity will be around for too long -- probably somewhere between 6 to 12 months of opportunity before the market clears these deals out and we are more or less back to normal.

Why is that?

Well, there's a ton of capital on the sidelines in general waiting to be deployed. To me, interest rates appear close to topping out with inflation likely rolling over and history tells us that the Federal Reserve on average cuts rates 9 months after the last hike, which means the first rate cut appears to be likely in Q4 2023 or Q1 2024. Moreover, we have the agencies to provide liquidity to the multifamily industry that will put a floor on how bad this can get which you don't have in office, industrial, or retail property types. Finally, the 4 major markets in Texas need 650,000 more units to keep up with the projected demand between now and 2035, so the fundamentals will still play a big role in investor appetite once the capital market issues resolve themselves.

In the meantime, I am getting prepared as much as we can to be ready to capitalize on this upcoming opportunity.

CHEERS,

Michael Becker

CO-FOUNDER & PRINCIPAL

STRATEGIC PROPERTY INVESTMENT

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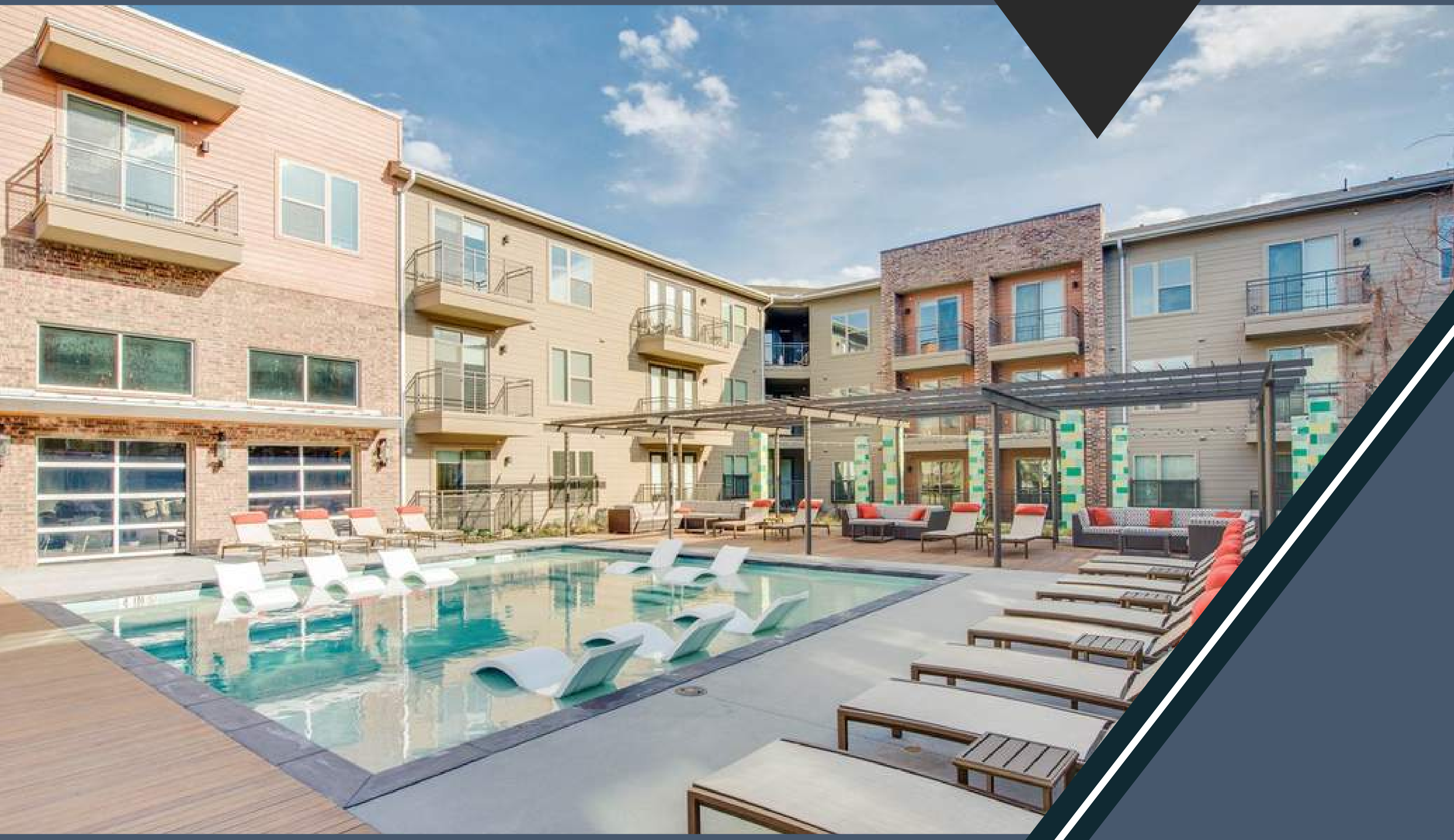
PRESS RELEASE

SPI ADVISORY ACQUIRES CLASS A, 340-UNIT DOWNTOWN DALLAS FARMERS MARKET APARTMENT COMMUNITY:

SKYLINE FARMERS MARKET



ON JULY 26TH, 2022 SPI Advisory ("SPI") finalized its acquisition of the institutional quality multifamily apartment community in Downtown Dallas, *Cortland Good Latimer*.

Upon acquisition, SPI announced its intent to rename & rebrand the complex as '*Skyline Farmers Market.*'

READ THE PRESS RELEASE

READ ABOUT SKYLINE FARMERS MARKET

INDUSTRY SPOTLIGHT

JP CONKLIN

Written by Michael Becker, Principal & Lily Turner, Marketing Coordinator

JP CONKLIN
FOUNDER & PRESIDENT
PENSFORD FINANCIAL & LOANBOSS

JP CONKLIN is the Founder & President of Pensford Financial Group, the esteemed commercial real estate interest rate advisory firm & the equally notable commercial real estate debt management software company, LoanBoss, Inc. JP obtained his Bachelor's degree in Economics from the University of North Carolina at Chapel Hill. Not only is JP a commercial real estate market expert & respected independent financial services strategist, but he's also a US Army veteran & father of five. JP's professional background is in interest rate derivatives aimed primarily at commercial & multifamily real estate. He works with brokers & borrowers looking at financing & wanting to manage their interest rate exposure on hedging strategies, which usually involve CAPs, swaps, & defeasances.

On December 2nd, SPI Co-Founder & Principal, Michael Becker ("MB") sat down with JP to learn more about his background & gain some insight into his perspective on how the current interest rates play a role in the current & near future state of capital markets.

MB: "JP, HOW WOULD YOU DEFINE **INTEREST RATE CAPS** IN THEIR SIMPLEST FORM?"

JP: "I think of Interest Rate Caps as an insurance contract," JP answered. "Say I want to borrow 10 million in cash from a lender to secure financing for some investment...if the Secured Overnight Financing Rate *("SOFR")* index is at 0%, like it was at the beginning of the year, I can then purchase a 2% SOFR strike Rate Cap which ensures that, if SOFR rises to say 3%, the Rate Cap contract will pay me the difference of 1% on 10 million invested divided by however many days in the month capping the maximum interest rate," explained JP. "Sometimes these Rate Cap strike rates are determined by the lender, other times, clients just want to hedge at a certain level. Because Interest Rate Caps involve a lot of moving parts, our job at Pensford is to help walk our clients through all of the different considerations they should make before making such a purchase & in determining this structure so that they can best execute their business plan."

MB: "AS SOFR CONTINUES TO RISE & LENDERS CONTINUE TO IMPOUND FOR THEIR BORROWERS TO REPURCHASE A RATE CAP WHEN IT EXPIRES, **WHAT IMPACT ARE YOU SEEING FOR SOME OF YOUR CLIENTS WITH ESCROWS?"**

JP: "Yeah, I mean, escrows are up 10x or more... One of our client's escrows just jumped to $39K/month. Unfortunately, there's no *'magic wand'* solution for this in sight, that impound is being driven by market costs divided by 24 months," JP expressed. "Normally, when an event like this happens, 70% of our clients reposition the same way, but that has not been the case this time. We've had some clients refinance floating to floating, forgoing cash flow in an attempt to take advantage of obtaining a higher strike that will lead to lower escrow amounts. Other clients have gone from floating to fixed that don't necessarily want a 10-year fixed interest rate loan, but recognize that their time horizon is long enough that they decide to risk a yield maintenance penalty to pick up some extra cash flow savings in the short term."

MB: "HOW DO YOU ADVISE YOUR CLIENTS CONSIDERING TRANSITIONING FROM A FLOATING TO FIXED INTEREST RATE LOAN?"

JP: "So, because it's not our risk at the end of the day, we try to steer clear of making too strong of a recommendation & instead just provide our clients with things to consider. I would say that, yes, floating interest rates have been exceptionally painful recently due to compounding cap escrows. But, historically, the worst time to lock in a loan rate is during the Fed tightening cycle because that usually means that they're going to be stopping & starting to cut at some point in the near future," JP explained. "So, if you've traditionally been a floating interest rate borrower & you want flexibility, I would advise you not to abandon that rate now in light of the recent short-term disadvantages, likely in about a year or so there's going to be a backside to this curve. Additionally, because borrowers are locking in higher rates relative to a year ago with pretty conservative underwriting terms, I can see a scenario where, 2 or 3 years later down the road, a lot of them are going to want to refinance at some point. And if they've locked in a long-term fixed interest rate, they're going to have an expensive prepayment penalty," JP advised. "If interest rates follow the typical path, which is within 2 or 3 years of the Fed starting a tightening cycle, the bottom falls out & rates are down 3% or more."

> "If you've traditionally been a floating interest rate borrower...**I would advise you not to abandon that rate now in light of the recent short-term disadvantages**."

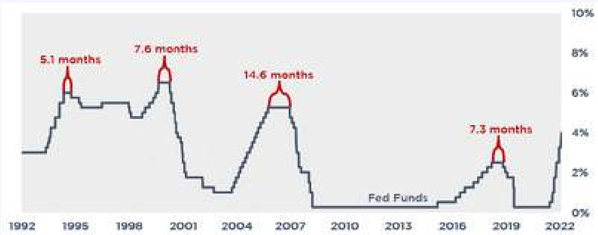
MB: "THE 10-YEAR TREASURY REACHED AROUND 4.25% EARLY LAST MONTH & NOW WE'RE AT AROUND 3.50%… WHAT'S GOING ON? HOW DID WE GET HERE? AND, HOW DO YOU PREDICT THE DECEMBER HIKE WILL IMPACT THESE RATES?"

JP: "On the fixed rate front, I credit the 10-Year Treasury run-up due to the fact that economic data was still strong in addition to the Fed doing 4 consecutive 75 basis point hikes with inflation at a standstill. At this time, it made a landing point of 5% seem feasible. Since then, we've seen some small wins on the inflation front including yesterday when core PCE, which is the Fed's preferred measure, came in quite a bit lower than expected (around 2.5% annualized). So, what we're seeing is the market saying that not only is inflation cooling, but the economy is slowing, we're entering a recession, & the Fed is going to begin cutting rates," JP stated. "So, think of yourself as a bond buyer looking at buying a floating interest rate SOFR note at a 4% yield…You might lose out on some yield in the near, short-term, but a couple of years down the road, that rate is going to look pretty good… So, money starts coming into 10-year treasuries & pushing the yield down. I'd say there's still a probability we could see it increase even more… Either way, I think that what everyone agrees on is that the economy is cooling, even if things like the labor market haven't caught up yet. So, the Fed is going to have to come to an end at some point & we've already actually seen them starting to change its rhetoric around the tightening cycle," JP resolves.

"On the floating rates side of the equation, it's almost certain that the Fed will do 50 basis points at the December 14th meeting. I also expect at least another 25-point hike come February 1st & another 25-point hike come March 2023. Basically, the message that the Fed is sending right now is that they'll put us at 5% at the end of March, & that while they're slowing their pace, we're probably going to end up higher than expected…like somewhere around 5.5%," JP rationalizes. "If this ends up being the case, I think the most likely path after the March meeting is 2 more hikes leading into Summer 2023 before leveling off at 5.5%. Whether we end up at 5% or 5.5% will be driven by the economic data coming out, with inflation being the most notable… But, the end is certainly near & there is a light at the end of the tunnel," JP stated. "Now, we're just trying to measure when the Fed will stop hiking interest rates, because generally, on average, once the Fed stops, they begin cutting within 9 months, with the longest they've ever gone being 14 months. So, if the Fed stops in March of 2023, there's a good chance they start cutting rates by the end of 2023 & certainly by early 2024. My personal instinct is that rate cuts are going to begin in early 2024 rather than late 2023 because the Fed keeps suggesting that they're going to allow rates to be high & financial conditions to be restrictive in order to make sure they best stomp on the throat of inflation. So, my conclusive prediction is that we'll have higher rates for longer, but the pace will slow substantially giving capital markets an opportunity to thaw a little bit in the first half of the year."

TIME UNTIL NEXT CUT - FROM LAST HIKE

- In the last four tightening cycles, the time between the last hike and first cut…
  - Averaged 8.7 months
  - Never exceeded 14.6 months



Source: JP Conklin, Pensford

MB: "AS OF NOW, AGENCIES ARE STILL LOANING MONEY, BUT, BY & LARGE, BANKS ARE BEING EXTREMELY SELECTIVE WITH BORROWERS & LENDING AT MUCH MORE CONSERVATIVE TERMS. **DO YOU SEE A RISK ON APPETITE THAT WILL LEAD US TO 2019 OR 2021 KIND OF LENDING STANDARDS?** OR **DO YOU FORESEE BANKS STAYING PRETTY CONSERVATIVE ON THEIR LENDING TERMS?"**

JP: "Yeah, I think next year, base case scenario, lenders are still pretty conservative with their lending terms, but at least they'll be willing to do some lending. I think right now banks are so worried about the final landing spot because one **(1)** we don't know how to underwrite a deal if we can't project the interest expense, two **(2)** all the loans we currently have on the balance sheet are stressed because they weren't underwritten for SOFR being at 5%+, & three **(3)** we'd expected many of these loans to refinance by now, but instead, they're being extended, which eats at our allocations for new financings. Truly, I think banks are just taking a pause in order to best evaluate how things are going to go in the near future," JP construed. "When I think about this, I think back to the 2008 financial crisis & say *'This feels totally different because banks didn't even have money to lend,'"* JP laughed. "As long as borrowers don't start defaulting, lenders will eventually come back into the market…they're not going to be able to just sit on their hands forever; People will get tired of sitting on the sidelines. Just like back in 2020, everybody paused and said, *'Is this the end of the world?'* before realizing *'Nope, it's okay. Let's get back to business.'* & then it just took off."

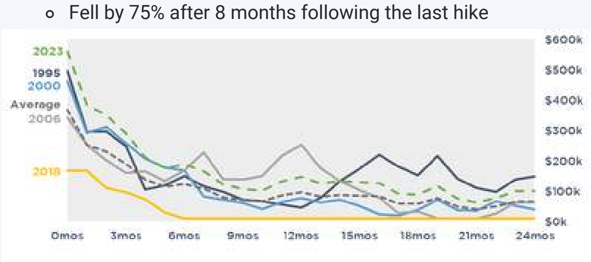
Just like back in 2020, everybody paused and said, ***'Is this the end of the world?'*** before realizing ***'Nope, it's okay. Let's get back to business.'"***

MB: "SAY THE FED STOPS HIKING INTEREST RATES IN MARCH, **WHAT WILL HAPPEN TO CAP COSTS? HOW MUCH OF THE CAP COSTS TODAY IS A RISK VOLATILITY PREMIUM? AND, HOW MUCH ESSENTIALLY FUNCTIONS AS PRE-FUNDING INTEREST?"**

JP: "Basically, the more 'deep in the money' the strike is, the more it functions as prepaid interest," JP expounded. "We've had a lot of clients this year buy lower strikes because they figured 'I'm not going to have to pay the interest expense anyway, so if I'm going to have a buy a Cap, I might as well put my money towards pre-funding interest & not into a nebulous volatility component that may or may not have value over the next 3 years,'" JP resolved. "A huge part of it though is volatility…Like I shared, I thought the Fed was not going to hike this year at all & now we're going to land around 5%, so, now, I've got to charge my clients for the instance of 7-8% occurring; it's a lottery ticket for me, so I've got to charge them for that…The good news is that we've actually gone & looked at previous Fed tightening cycles & found that when they end, Cap prices tend to plummet 50% in less than 3 months because all that volatility gets taken out of the equation. At this point, we'd stop charging 8% for the hypothetical scenario the Fed would then be signaling is not going to materialize."

CAP COSTS AFTER THE LAST HIKE

- On average during the past four Fed cycles, cap costs…
  - Fell by 50% after 3 months following the last hike
  - Fell by 75% after 8 months following the last hike



Source: JP Conklin, Pensford

MB: "SO, SAY THE FED STOPS HIKING INTEREST RATES IN MARCH OF 2023 & THE 5% STRIKE LEVELS WITH SOFR, WOULD IT BE FAIR TO EXPECT THE VOLATILITY PREMIUM OF THE CAP COST TO BE AROUND HALF OF WHAT IT IS NOW BY SUMMER 2023?"

JP: **"Exactly right."**

MB: "AND, WHAT ABOUT THE 2% STRIKE IN A 5% SOFR WORLD? WHAT KIND OF DROP IN CAP COSTS SHOULD WE ANTICIPATE BY SAY, SEPTEMBER 2023?"

JP: "By September 2023, Cap costs will certainly be less driven by that volatility component. Additionally, I predict that by then the market will begin realizing the Fed is cutting in advance of their prediction that rates will fall in early 2024, & for that reason, Cap prices should certainly be much lower at this time next year. My base case is a drop in Cap prices of at least 25%."

MB: "SO, DO YOU PREDICT THAT THE FED REACHES 5% IN MARCH & THEN PAUSE, OR THAT THEY GO TO 5.5% THROUGH MAY OR JUNE?"

JP: "My base case is that we'll probably reach 5% by March because I think we'll see a lot of improvement in inflation & a lot of deterioration in economic data between now & then. If we start to see inflation coming down, the Fed will begin to cut because there's really no reason to keep hiking at that point, even if the labor market is underperforming & unemployment climbs. Inflation is the main driver here – if it's still persistently increasing, the Fed will keep hiking."

MB: "WHEN THE FED BEGINS TO CUT, HOW MANY BASIS POINTS AT A TIME DO YOU EXPECT?"

JP: "By the time the Fed begins to cut in what I expect to be Q1'24, it will largely depend on market stability & the labor market. If at that point we're losing 500,000 jobs/month, I think they'll drop 3% in a year or less. Otherwise, I predict it will be much more gradual – probably like 50 basis points, followed by 50 basis points, then 75 basis points, & then they'll see if they can drag it out without letting inflation creep back in," JP justified.

MB: "WHAT DO YOU PREDICT WILL BE THE FED FUNDS INTEREST RATE BY THE END OF 2024?"

JP: "I predict that by the end of 2024, interest rates will land somewhere between 3-3.5%. In the past, the average drop is around 2.75%. We've gotten comfortable with the idea that interest rates go right back down to 0%, but if they don't have to, they won't. So, 3-3.5% seems like a more reasonable expectation."

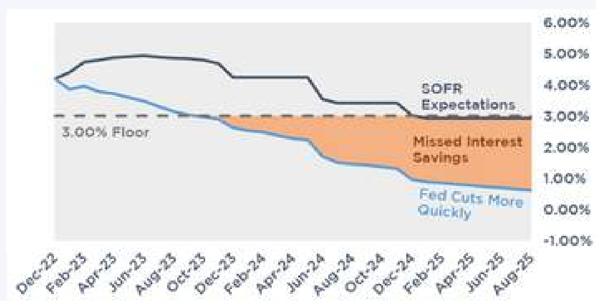
MB: "BASED ON THAT, COME 2025, DO YOU SEE SOFR IN THE 2-3% RANGE & NOT 0%?"

JP: "That's my prediction, yes," JP affirmed. "Unless there's some sort of exogenous shock that forces the Fed to 'slash & burn' rates to 0%, I believe they're going to avoid going down to 0% as much as they can. I think they will use somewhere around the 2.5% range as a new baseline by that point & start underwriting deals using that, not 0%."

INTEREST RATE FLOORS

- With Fed cuts already on the horizon, negotiating out/lowering floors will have been critical if they become more accommodative than expected

Borrowers can also "buy out" the floor to mitigate its impact



Source: JP Conklin, Pensford

MB: "WHAT ABOUT THE 10-YEAR TREASURY RATE? WHERE DO YOU SEE US FINISHING THIS YEAR & NEXT YEAR?"

JP: "This year, I think we'll finish between probably 3.75%, maybe 4% on the high side. Next year, in 2023, I would predict it's probably 3% or lower as the market prices drop."

READ THE FULL ARTICLE

Q3 2022 DEAL SNAPSHOT

Written by Lily Turner, *Marketing Coordinator*

SPI kicked off the 3rd Quarter of 2022 with the acquisition of Skyline Farmers Market. In September, SPI closed out the quarter with their disposition of Finley Apartments.

ACQUISITION

SKYLINE FARMERS MARKET

On July 26th, 2022, SPI Advisory, LLC acquired the institutional apartment community, ***Skyline Farmers Market***, formerly known as *Cortland Good Latimer*. Developed in 2016, Skyline Farmers Market is a Class-A, 340-unit apartment complex located at 835 South Good Latimer Expressway in the heart of Downtown Dallas' revived & growing Farmers Market neighborhood. In addition to being situated directly adjacent to Farmers Market's 26,000 SF food hall and artisanal vendor market, the property also shares close proximity to the eclectic Dallas entertainment district, Deep Ellum, the Dallas CBD, Baylor University Medical Center, & Dallas Arts District.

READ MORE

"Read more" **about SPI's acquisition of Skyline Farmers Market** as covered by established multifamily news sources such as ***The Real Deal, Bisnow Dallas-Fort Worth, ConnectCRE, The Dallas Morning News, Dallas CultureMap***, *& more.*

THE REAL DEAL The Dallas Morning News BISNOW culturemap DALLAS connect CRE

READ MORE

DISPOSITION

FINLEY APARTMENTS

On September 15th, 2022, after a 3.5-year hold period, SPI Advisory, LLC and its investors disposed of the Tyler, TX apartment complex, ***Finley Apartments***. The B-class, 200-unit apartment complex built in 1979 offered residents close proximity to the University of Texas at Tyler and East Texas Medical Center.

CHECK OUT OUR PORTFOLIO

Have you seen our portfolio? Click the button to learn more about each of the properties SPI & its syndicated, joint venture, & advisory partners have acquired, managed, & disposed of since 2014.

VISIT OUR WEBSITE

**Nothing in this newsletter constitutes an offering. Offerings are only completed through a Private Placement Memorandum (PPM). Past results are no guarantee of future results.*

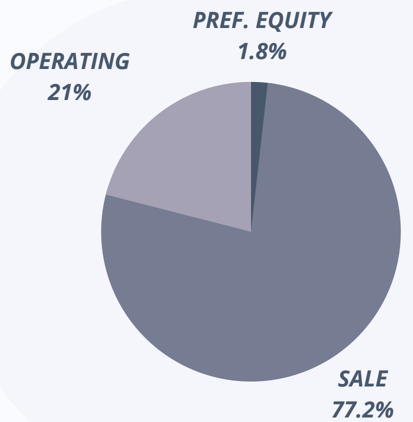
Q3 2022 PERFORMANCE

2022 DISTRIBUTIONS	Q1	Q2	Q3	TOTAL
OPERATING DISTRIBUTIONS	$4,764,000+	$4,827,500+	$3,555,000+	**$13,146,500+**
CAPITAL DISTRIBUTIONS	$27,933,000+	$140,744,500+	$13,362,000+	**$182,039,500+**
TOTAL 2022 DISTRIBUTIONS	**$32,697,000+**	**$145,572,000+**	**$16,917,000+**	**$195,186,000+**

Q3 2022 DISTRIBUTIONS

$13.6MM+ IN TOTAL CAPITAL DISTRIBUTIONS

$16.9MM+ IN TOTAL DISTRIBUTIONS



DIST. TYPE	AMOUNT
OPERATING	$ 3.55MM+
SALE	$ 13.06MM+
PREF. EQ.	$ 0.30MM+
TOTAL	**$16.91MM+**

8,200+ UNITS MANAGED

Q2 2022 UNITS: 7,748
- DISPOSED UNITS: 200
+ ACQUIRED UNITS: 655

= Q3 2022 UNITS: 8,203

9.9% INCREASE

In Net Rental Income
3Q 2021 v. 3Q 2022

JOIN OUR DATABASE

Unaudited. For Internal Use Only.

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INVESTING INSIGHTS

"TAX & INVESTOR DASHBOARD UPDATES"

Written by Principal, Jennifer Warder

My article this quarter will be a bit different in that I will be covering two separate topics: **1)** *Tax Season Preparation* and **2)** *Investor Dashboard Updates*.

TAX SEASON PREPARATION

Although, as a company, we work in the background throughout the calendar year to prepare for tax season, this is the time of year where that work starts to intensify.

One of the ways that you can help yourself (& our team) prepare your K-1 data for the upcoming tax season is to ensure that the tax address we have on file for each of your Profiles on your Investor Dashboard is up-to-date, **especially if you have moved**. Here's how you can do that:

1. Go to www.spiadvisory.com.
2. Click the *"Investor Portal"* button in the top-right of the navigation bar to log in.
3. Once you log into your Investor Dashboard, click the downward arrow (▾) next to your name on the top-right of the page to open a dropdown menu with additional items; then, click *"Manage Profiles"* at the bottom of the dropdown menu.
4. Once on the "Manage Profiles" page, for each of your existing Profiles, click to *"Edit Contact Info"* and review the addresses stored with the indicator of "Use for Tax Purposes" selected. Update any addresses that are outdated. **NOTE: Please make sure to update your Individual Profile first, then update your remaining profiles.**
5. Make sure your spouse or any other signers associated with how you've invested also log into their Investor Dashboard to make updates to their Profiles.

Once we begin providing your K-1s in Q1 2023, you may have some questions for us. Here's an article I wrote for our Q1 2022 Newsletter that addresses reviewing the K-1.

INVESTOR DASHBOARD UPDATES

We're excited to announce that we will be rolling out major updates to your Investor Dashboard in the **first half of 2023**. Below is key functionality you can expect. In addition to the typical functionality you have available today, here's a sampling of some of the additional actions you will be able to take. You will be able to:

- Submit a secure online form to request Bank Account changes for your distributions.
- Upload documents to us securely via your login.
- Review K-1 data for Sections E-I of the K-1 form year-round.
- Access Help videos with instructions on how to use the Dashboard.

As we get closer to the official rollout of these updates, I will provide more details and ensure that you have advanced notice of the timing involved. Again, you can expect to see the changes described above in the first half of 2023.

IN THE MEANTIME, FROM SPI TO YOU... WISHING YOU HAPPY HOLIDAYS AND A HAPPY NEW YEAR!

Jennifer Warder,

PRINCIPAL

STRATEGIC PROPERTY INVESTMENT

READ IT ON THE BLOG

#SPICares – Vogel Alcove

$30,000+

RAISED IN SUPPORT OF OUR 2022 #SPICARES PARTNER, VOGEL ALCOVE

IN NOVEMBER OF THIS YEAR, SPI Advisory held a fundraiser to show our continued support for our #SPICares initiative partner, Vogel Alcove. SPI Advisory already donates both our time and money to Vogel Alcove, because we truly believe that they make a difference in the lives of the most vulnerable population in our community. **But this year, we wanted to do even more.** Especially as we watched the number of homeless Dallas youth jump from 3,000 in 2021 to 4,500 in 2022.

The main objectives of this fundraiser were to introduce our Dallas investors to Vogel Alcove, educate them on some of the remarkable things the nonprofit accomplishes in the city where SPI's main office is located, and, finally, inspire them to pledge a donation to go toward the operations of the organization and all of its incredible staff & volunteers.

By the end of the fundraiser, on November 4th, 2022, **SPI Advisory and its investors raised a total of $30,072.60 to support Vogel Alcove.**

Vogel Alcove is a one-of-a-kind nonprofit 501(c)(3) organization located in Dallas, TX operating with the mission to provide refuge, rehabilitation services, and basic necessities to the children & families facing the traumatic effects of homelessness within the metroplex. Since its doors opened in 1987, the organization has served well over 17,000 homeless children & their families in DFW providing them with food, employment, education, transportation, mental and health care, and a safe environment to thrive & grow. The detrimental effects of homelessness can last a lifetime, and that's why Vogel Alcove strives to provide services to "***help families heal their trauma, empower parents to build stability, & let kids just be kids.***"

We met with **Greg Brinkley, Vogel Alcove's Chief Development Officer** to learn more about the organization, its current priorities, and how individuals and other companies can get involved.

READ THE FEATURE

ABOUT SPI ADVISORY, LLC

SPI ADVISORY, LLC is a Dallas-based private equity firm that has been a principal investor in over $2 Billion worth of multifamily real estate, with $1.6 Billion in current Assets Under Management.

SPI is transforming the way high net worth investors identify, assess, secure & sell high-yield, tax-efficient multifamily real estate investments.

SPI offers tailored joint venture partnership and advisory services as well as passive investing opportunities in institutional quality multifamily assets to our increasingly diverse client base.

KNOW A FRIEND OR FAMILY MEMBER WHO MIGHT INTERESTED IN JOINT VENTURE OR PASSIVE INVESTING OPPORTUNITIES WITH SPI?

Share the Wealth!

The best compliment is a referral.

REFER A FRIEND

CONTACT US

JOIN OUR DATABASE

FOLLOW US

ON OUR SOCIAL NETWORKS

SUBMIT A TESTIMONIAL

LEAVE FEEDBACK

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