TIMBERLAND PARTNERS INVESTMENTS

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Investment Insights

Multifamily Investments in a Higher-for-Longer Interest Rate Environment

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Key Takeaways

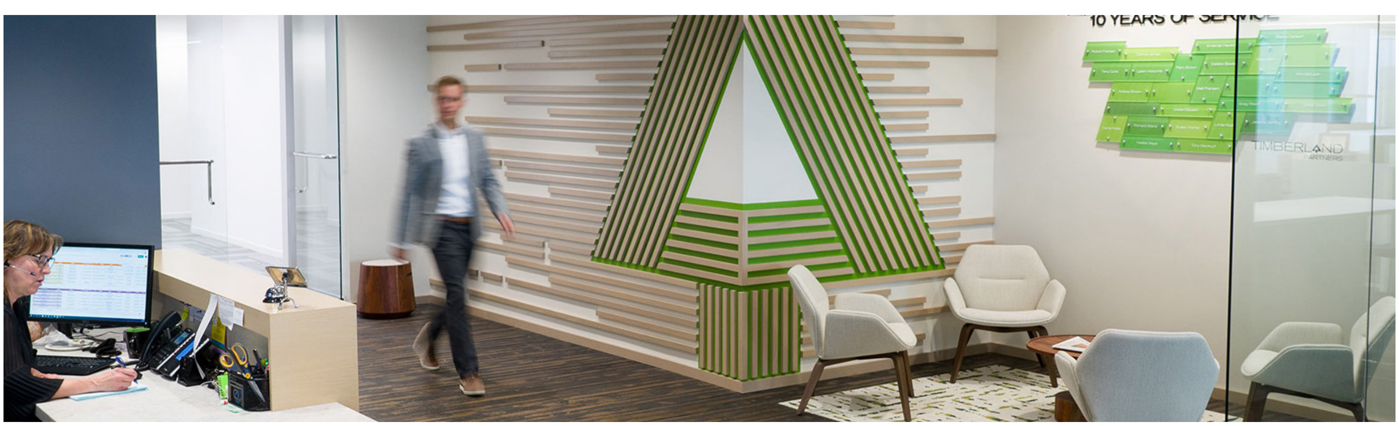
- Higher interest rates since the Federal Reserve's tightening cycle began in 2022 have contributed to a significant decline in real estate transaction volumes, with buyers and sellers facing challenges due to increased capital costs and valuation uncertainties.

- Multifamily real estate has outperformed in various market conditions, capturing would-be home buyers during higher interest rate scenarios, and proving resilient during downturns as housing remains a fundamental necessity.

- Real estate held for multiple years often delivers positive returns in real terms, and acts as a reliable and predictable hedge against inflation. Low and stable inflation (0-3%) provides suitable conditions for rent growth.

- Many developers and syndicators who utilized floating rate loans in the 2020-2022 period are now facing significant challenges as their debt service has increased. Some will be forced to sell in this environment, which may offer compelling acquisition opportunities for well capitalized buyers.

- Fannie Mae and Freddie Mac loans provide many benefits for multifamily borrowers, especially for stabilized property acquisitions and refinances, including competitive rates and higher proceeds, flexible loan terms and durations, streamlined rate lock options, and non-recourse protections.



The Impact of Higher Interest Rates on Real Estate Financing Today

DECREASED TRANSACTION VOLUMES

Higher interest rates, which have persisted since the Federal Reserve's aggressive tightening cycle began in 2022, have significantly impacting real estate financing. This environment has led to a noticeable decline in transaction volumes as buyers and sellers grapple with the increased cost of capital and valuation uncertainties. According to the Mortgage Bankers Association's (MBA) annual multifamily lending report, $246.2 billion in new mortgages were issued in 2023, representing a 49 percent decrease from 2022 levels. Transaction volumes rebounded slightly in 2024 and are expected to continue positive momentum.

REFINANCING CHALLENGES

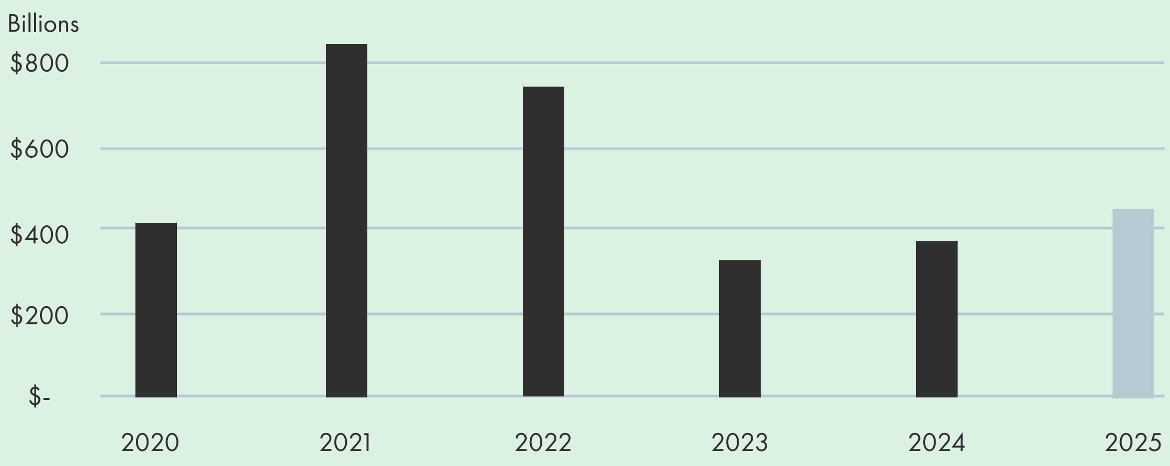
The ability to refinance existing debt has become increasingly challenging, particularly for properties acquired during periods of historically low interest rates.

Loans originated in the low-rate environment of the late 2010s and early 2020s are now maturing into a market where interest rates are significantly higher. Many owners now face the prospect of refinancing at significantly higher rates, potentially impacting their cash flow and profitability. Roughly $998 billion of U.S. commercial real estate loans are estimated to mature in 2025. The Federal Reserve estimates 15% of those loans may fail to qualify for refinancing due to insufficient debt service coverage ratios under today's high-interest rate conditions.

THE RISE OF PRIVATE LENDING

Money center and regional banks have tightened credit standards under heightened regulatory oversight and balance sheet concerns, reducing the availability of capital from traditional real estate lenders. This secular shift has fueled the rise in private lending sources or 'private credit', who are stepping in to fill the gap. Private lenders often offer more flexible terms, faster execution and certainty of funding to borrowers. However, for stabilized assets, long-term agency financing through either Fannie Mae or Freddie Mac often remains the most compelling financing option available.

U.S. Real Estate Transaction Volume



Source: MSCI Real Assets

Historical Performance of Multifamily Real Estate in Different Interest Rate Environments

HIGH INTEREST RATE ENVIRONMENTS

Multifamily real estate has demonstrated resilience in various interest rate environments. In periods of inflation and high interest rates, rent growth can accelerate as landlords adjust rents to reflect rising costs. However, higher interest rates can also lead to a decline in multifamily asset values due to the increased cost of borrowing and reduced buyer demand.

CBRE's long-term outlook suggests multifamily cap rates could stabilize around 4.5%, a level that reflects a normalization from the ultra-low rates of recent years. The extremely low interest rates observed in recent years, stemming from the global financial crisis and the COVID-19 pandemic, are considered anomalies and are unlikely to return.

DECLINING INTEREST RATE SCENARIOS

Interest rates typically decline during recessions as central banks seek to stimulate economic activity. Multifamily assets have shown resilience in such downturns, as housing remains a fundamental necessity. Demand for cost-effective housing options, such as class B multifamily assets, tends to rise during economic downturns.

Simultaneously, class A assets benefit from more favorable financing conditions in a falling-rate environment. Refinancing becomes a tool to reduce interest expenses and overall debt service costs. Construction loans also become more viable, enabling new development to meet demand. However, in regard to new development, cheaper debt may not negate falling demand fundamentals in a recessionary environment.

National Rent Trends

Source: Fannie Mae Multifamily ESR

Rent Growth Performance (%) Recessionary Quarters 2000-2021

Source: Moody's

B/C properties averaged substantially higher rent growth than A properties during recessionary quarters.

The Relationship Between Inflation and Real Estate

Inflation, or loss of purchasing power, is characterized by a broad increase in prices for goods and services, and can materially affect real estate values. While low inflation correlates with normalized rent and asset growth, high inflation can lead to monetary tightening and increased interest rates, which tends to put downward pressure on values.

There is often confusion on measurements of inflation — particularly the cost of housing component. Private data sources tend to look at asking rents, or prices new renters are paying. The consumer price index (CPI), meanwhile, looks at in-place rents and what households — captured by Owner's Equivalent Rent (OER) — are paying on average. The result is that CPI measurements tend to both overstate and lag what consumers in the market may be experiencing.

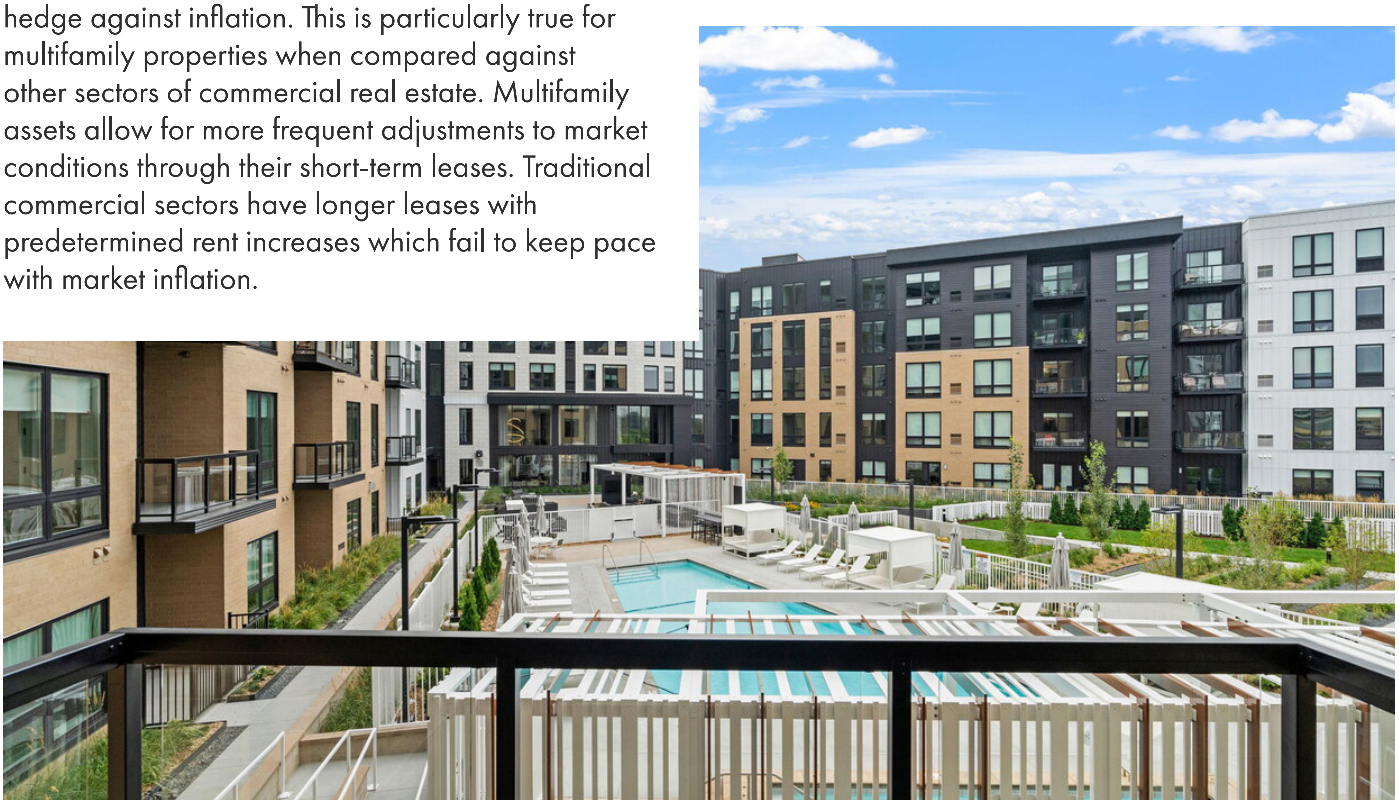
According to MSCI, real estate held for multiple years typically delivers positive returns in real terms, or in other words, acts as a reliable and predictable hedge against inflation. This is particularly true for multifamily properties when compared against other sectors of commercial real estate. Multifamily assets allow for more frequent adjustments to market conditions through their short-term leases. Traditional commercial sectors have longer leases with predetermined rent increases which fail to keep pace with market inflation.

COMPARING PRIVATE REAL ESTATE VS. LISTED REITS

Private real estate tends to benefit more from inflation than publicly traded Real Estate Investment Trusts (REITs). REITs exhibit a stronger correlation to broader equity markets, which can increase volatility and dilute their inflation-hedging potential. Private holdings, by contrast, allow owners to directly capture rent increases and operational efficiencies, enhancing returns in inflationary times.

	Private real estate	REITs	80% private real estate/20% REITs
Total returns (average annual)	8.1%	10.7%	9.0%
Volatility (standard deviation)	8.4%	21.6%	9.0%
Risk-adjusted returns (Sharpe ratio)	0.78	0.43	0.83

Data for the period January 1, 2000-December 31, 2020. The indexes represented are as follows: U.S. private real estate (NCREIF Fund Index–Open End Diversified Core Equity (NFI–ODCE), listed REITs (FTSE NAREIT U.S. Real Estate Index). Performance over different time periods may have been less favorable than shown above. It is not possible to invest in an index. Performance for indices does not reflect investment fees or transaction costs.
Source: MacroBond.



Strategies for Mitigating Interest Rate Challenges

FIXED VS. FLOATING STRUCTURES

The ease and availability of debt financing in commercial real estate is a differentiator compared to other asset classes. Fixed rate loans shield borrowers from rate volatility, while floating rate loans expose owners to rising interest expenses if rates climb further. Today, investors with fixed, long-term loans are generally better positioned than those with adjustable, short-term debt.

In the 2020-2022 period, floating rate loans at record low interest rates were popular with developers and syndicators with value-add strategies. However, these operators are now facing significant challenges as their debt service has increased, along with weakening fundamentals due to new supply being delivered. Some owners will be forced to sell in this environment, which may yield compelling acquisition opportunities for well capitalized buyers.

AGENCY LOAN BENEFITS

Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs) created to provide liquidity, stability, and affordability to the U.S. mortgage market, across market conditions. Agency loans provide many benefits for multifamily borrowers, especially for stabilized property acquisitions and refinances:

Rates and Proceeds
The agencies can offer consistently competitive rates and higher proceeds by selling their guaranteed mortgage-backed securities to the investor market.

Flexible Loan Terms
Flexible terms are available, including fixed or floating interest rates, loan durations, and interest-only options.

Rate Lock
Both GSEs offer streamlined rate lock options, allowing borrowers to manage interest rate and credit-spread risks.

Non-Recourse
With most agency loans, borrowers are protected from personal liability, and the debt is secured only by loan collateral (e.g. the apartment asset).

[1] A product of both the interest rate and amortization period.

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