CROWDSTREET

Commercial real estate investment decisions during uncertain times require a closer-look

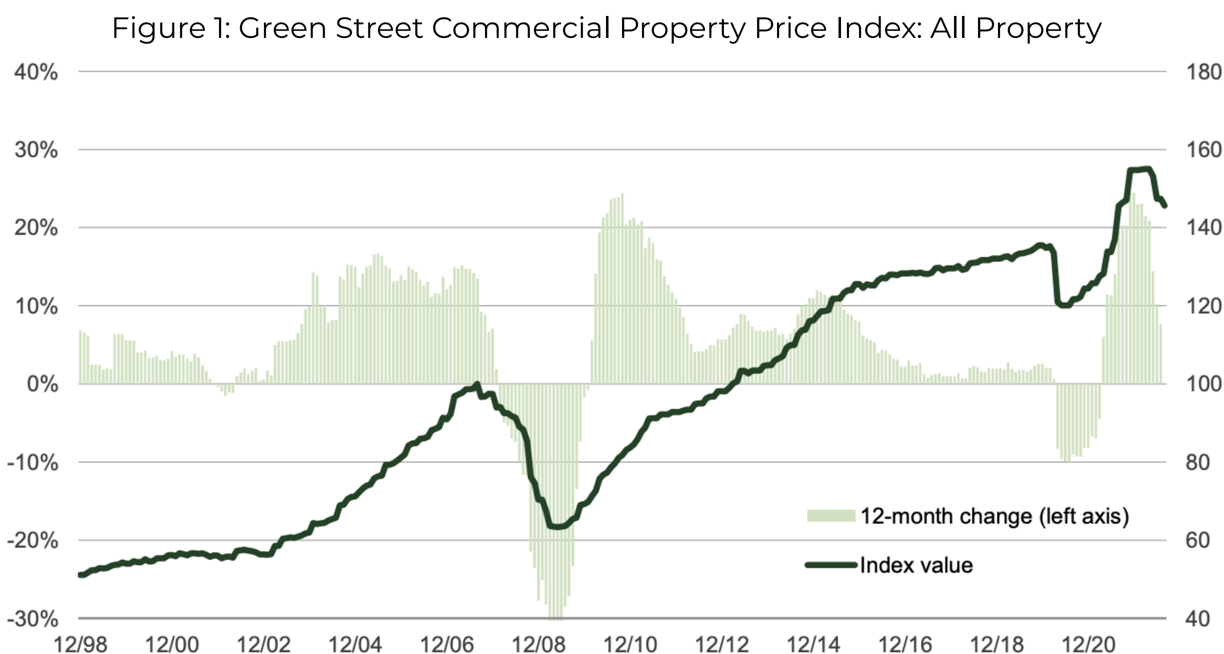
Five ways CrowdStreet is “baking in the risk” of market volatility into our deal review process.

What a difference a few months can make.

We entered 2022 with tremendous economic momentum. The U.S. economy had announced a torrid 5.7% GDP growth rate for 2021 with an unemployment rate that had dipped below 4% by December 2021. Similarly, the commercial real estate (CRE) market had just set record rates of asset appreciation for multiple asset classes with self-storage, industrial and multifamily recording one of the strongest increases in property value.* Yet, as we enter the fall, the market conditions we faced in January 2022 feel like distant memories. Interest rates have spiked, inflation is at levels not seen since the late 1970's, and there are genuine concerns that we sit on the precipice of a possible recession.

*Green Street, Commercial Property Price Index®, 2022.

Figure 1: Green Street Commercial Property Price Index: All Property



Source: Green Street Commercial Property Price Index®, Sep 2022.

While the events of this year have already hammered the equities market into bear territory (with what appears to be another leg down underway), particularly for any stock that was relying on the perception of future growth to justify its valuation, the ramifications for the CRE market have been different, at least so far.

For the first few months of the year, real estate values remained essentially flat after soaring on a monthly basis throughout 2021, achieving 24% appreciation* blended across all property types on an annualized basis. We have now seen asset prices fall from peak levels but the descent has been gradual in comparison to the S&P 500 and,

especially, the NASDAQ. GreenStreet's Commercial Property Price Index ("CPPI") stood at 145.7 as of September 2022*, down 6.0% on the year while the S&P 500 stock prices dropped more than 17% during the same period. Essentially, for almost the first three quarters of 2022, the underlying fundamentals of the CRE market (i.e. tight vacancies in the multifamily and industrial sectors, continued double digit year-over-year rent growth and an ongoing hotel sector recovery) kept the market intact despite turbulence in the capital markets that appeared as early as February 2022.

*Green Street, Commercial Property Price Index®, 2022.

With that said, it's not to suggest that the CRE market hasn't already been adjusting to myriad factors in the capital and labor markets, because it has. And now pricing on deals is shifting. The bid/ask spreads on prices have widened out on many deals and we are beginning to see the effects in pricing discounts ranging anywhere from 5-15% or more depending on the property type, location, risk profile of the investment, and motivation of the seller. In certain special situations, we are beginning to see higher negotiated discounts but those scenarios are more asset specific than indicative of a move in the market. All this is to say, we are seeing movement in the market in terms of property values.

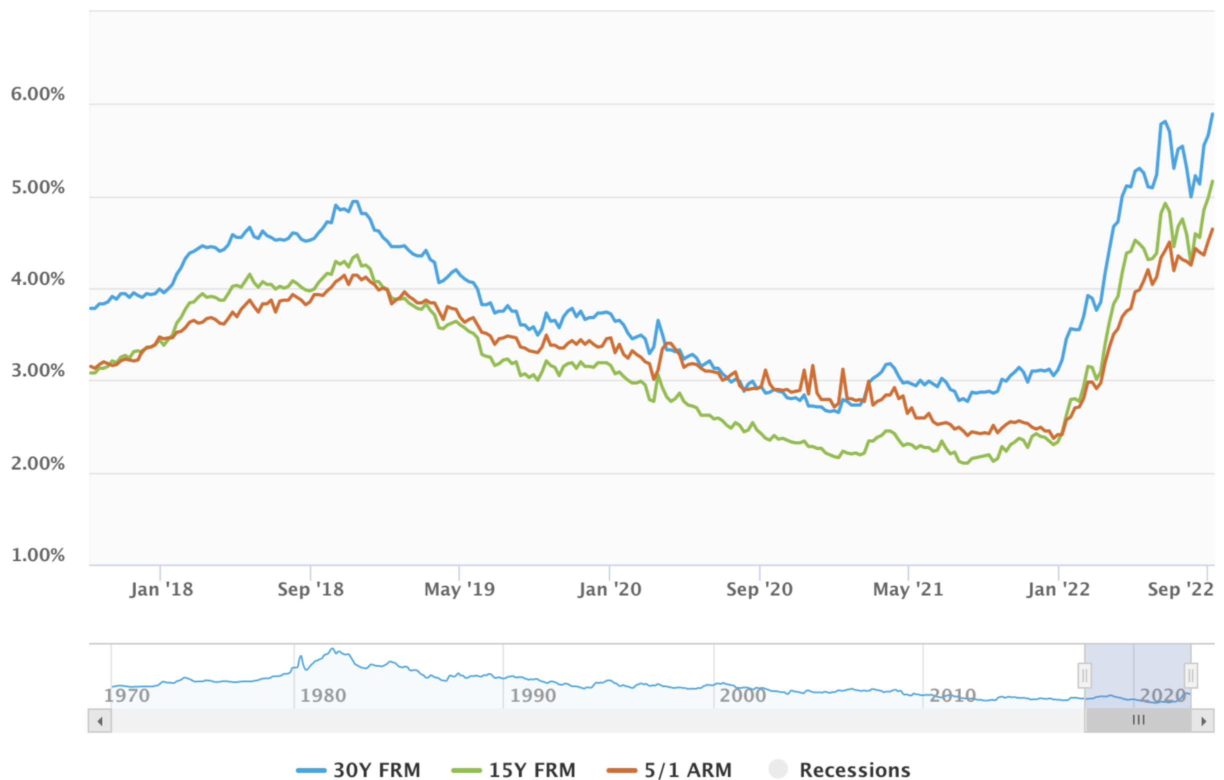
As we adjust and pivot into the best types of opportunities we see in this emerging real estate market dynamic, here are the five key changes we're factoring into our analysis and how that is translating into the type of deals likely to come to our Marketplace.

Changes in Interest Rates

What are we baking in? Interest rate caps or excess interest rate reserves on all variable interest rate deals. We believe the more reserves the better to help mitigate future interest rate risks. A deal with no reserves and no rate cap (or no insulation from potentially high future interest rates) is currently not eligible for our Marketplace.

What is the uncertainty? Interest rates are obviously higher today as compared to last year but, more importantly from a valuation perspective, they may remain higher for years to come. Factoring in higher "spot" or current rates at acquisition on fixed rate deals is easy but it is more difficult to account for the downstream effects of a changing interest rate environment on variable rate deals over a multi-year holding period.

Figure 2: Interest rates are rising - Freddie Mac's Primary Mortgage Market Survey®

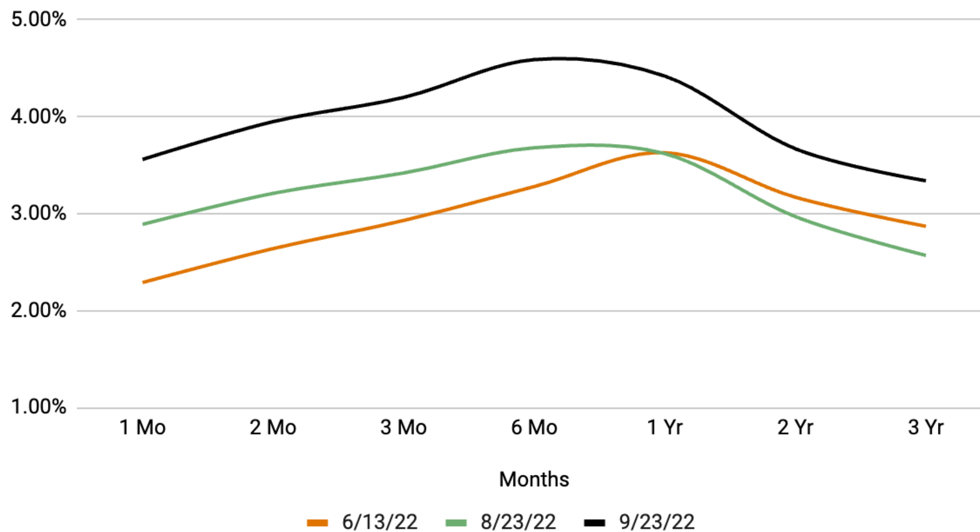


Source: Freddie Mac's Primary Mortgage Market Survey®, Sep 2022.

When contemplating variable rate deals, we utilize forward interest rate curves based on market indexes and we use the curve that ties to the index that the debt is based upon. For example, the Secured Overnight Financing Rate or "SOFR" curve index estimates that rates will increase to 4.42% by September 2023 from the current levels of around 3.03% in September 2022–this would be a huge jump in interest rates relative to what this same curve projected a year ago and, crucially important in 2022, you must check this rate frequently. Consider Figure 3, for instance. The projected rates according to the SOFR curve had tempered down slightly in August of 2022 as compared to June of 2022, but climbed back up in September of 2022 following the interest rate hike, which shows that forward interest rates are projected to be higher as compared to the previous two tracked periods.

When combining updated assumptions regarding starting interest rates and forward rate assumptions, while actual future rates are still unknown, you now at least can allot for that greater amount of uncertainty in the project underwriting and help to mitigate that future risk through increased cash reserves or by purchasing an interest rate cap.

Figure 3: Future Interest Rate Projections are Tempering



Source: 1-month term SOFR, Chatham Financial, Sep 2022.

What are we observing? A multitude of outcomes, most of which center around the question of whether or not the current amount of assumed future interest rate risk is overstated or justified. First, given the large amount of uncertainty over the question of what rates will look like two to three years from now, some groups are opting for fixed rate loans instead of variable rate loans to finance their deals. This approach defines your risk but also locks in much higher rates relative to the beginning of the year. The second approach is to opt for a cheaper variable rate loan but then purchase a rate cap which "caps" the amount the current rate is able to expand in the future. The only issue with this approach is that rate caps are exorbitantly expensive relative to last year–they can cost four to five times more this year, particularly when pricing a three year cap.

A third approach is to price a rate cap, underwrite the deal to the forward curve, and then reserve cash today to cover possible outsized expansions in future rates. This equates to self-insuring against major moves in interest rates. The upside approach is that, if rates don't expand as much as perceived, you could be rewarded with unused excess reserves. The downside is that you are only insured to the level you reserve.

At the end of the day, sponsors have to balance out the cost of fixed rate debt (generally more expensive than variable rates) versus the certainty of interest payments in an uncertain interest rate environment. There is no one single correct

approach, so we evaluate every deal as a unique situation and collaborate with sponsors to determine the most viable interest rate approach.

Decreases in Debt Proceeds

What are we baking in? We are baking in the assumption of a lower percentage of total debt on our deals (5 - 10% lower) and paying close attention to the debt service coverage ratios (DSCR) in our underwriting. We are then analyzing the targeted investor level returns with the reduced leverage and determining whether or not the risk-adjusted returns are still competitive, all else equal. If not, we are seeking adjustments in deal structures to bridge that gap.

What is the uncertainty? Because interest rates are higher, the cost to service each dollar of debt in a deal is now also higher. Holding net operating income ("NOI") constant, the only way to maintain the same Debt Service Coverage Ratio ("DSCR" and defined as NOI / Debt Service) today relative to January is to reduce the amount you borrow. Generally, healthy DSCRs can range from 1.25 to over 2 depending upon the property type and business plan. Any time an asset falls below a 1.0 is a red flag in that it indicates that the deal may not be able to sustain its debt payments. This is why, in many cases, the amount of debt proceeds or the percentage of the purchase price or development cost, has decreased in 2022. In an environment where rents are increasing at a rapid pace, future NOI may appear more than sufficient to cover the debt but such an analysis is inherently speculative. As a result, lenders are sensitive to the level of NOI at acquisition and, because of this, many lenders are hedging in the current environment by lowering the amount they are willing to lend.

While reducing the amount of debt in a deal is generally considered prudent from a risk perspective, it also typically comes at the expense of targeted leveraged returns. And in that case, the evolving question is whether or not the reduction in targeted returns is commensurate with the level of reduced leverage, something we are paying particular attention to in 2022.

What are we observing? Compared to 2021, Loan-to-Cost ratios are down 5-10% on average this year almost universally. To the extent possible, we are seeking to maintain similar leveraged targeted returns after factoring in reduced debt proceeds, which is leading to two scenarios:

1) We are seeing price reductions anywhere between 5-15% and even as high as 20% in a few instances. These price reductions are often compensating for the lower leverage / higher interest rates as well other considerations such as increased rate cap costs.

2) Enhanced structures to investors. In some instances, the targeted net returns to investors no longer look attractive once reduced debt proceeds are factored in, even with small purchase price price adjustments. In such cases, we work with sponsors to find an enhanced deal structure by negotiating a better waterfall structure, which can provide a stronger risk adjusted return to Crowdstreet investors all else equal (e.g. higher preferred returns and/or more favorable splits above the preferred return).

Increases in project costs

What are we baking in? Increased total project costs on certain development deals. And in a tight labor market, we are preferring deals where sponsors have stronger command over general contractors and, in turn, where general contractors have stronger relationships with subcontractors and can therefore both negotiate on prices as well as adhere to estimated construction timelines.

What is the uncertainty? One of the biggest pain points while underwriting a ground-up development project in the current climate is the volatility in construction costs which include hard costs of materials like lumber, concrete and steel, and the availability and the cost to hire construction labor (which typically averages over 40% of total construction costs). Hard costs started fluctuating after pandemic-related shutdowns created shocks in the supply chains which impacted the supply of materials to its end-uses. With limited availability and high demand for these materials, costs spiked, especially for lumber which reached record-levels of $1,500 USD/1000 board feet in 2020 (a 175% increase in the industry index between April and September of 2020). Concrete prices, although not nearly as volatile as lumber prices, have been on a steady incline having increased for 17 of the last 18 months, as of August 2022.

Figure 4: Lumber prices have been volatile but returning to normal growth levels

Source: Trading Economics, Sep 2022.

The cautiously optimistic good news is that with some easement in the supply chains, lumber prices have since decreased to $435 USD/1000 board feet which brings these unit costs closer to the pre-pandemic levels. But as hard costs are leveling off a bit, construction labor shortages continue to be an issue, although this dynamic also appears to be easing a bit as a weaker economic outlook takes hold and lower margin projects are beginning to put on hold.

In addition to ground up construction costs, costs to renovate and maintain existing properties are also increasing which include costs such as common area renovations, Tenant Improvements (TIs) for commercial deals, real estate taxes, as well as payroll costs for property management. Increases in all of the above expenses counter top line rent growth and create a drag on NOI growth, thus diluting the value of its inflation hedge.

What are we observing? In markets where project costs continue to increase, some groups are buying supplies ahead of time. This strategy is not only intended to reduce cost but also increase the level of certainty of having the necessary materials on site at the exact time needed to adhere to construction schedules. Although opportunistic deals are requiring more scrutiny and analysis, even a relatively straightforward deal such as a core plus or value-added business plan is also requiring an additional layer of review. We are adding layers to our review process by pressing harder on questions like, “How is the sponsor sourcing their

materials and what level of certainty does the sponsor have today in its pricing?" or "Does the sponsor have a go-to supplier and is this supplier proven to be reliable?" These questions are important to press on because even a core plus deal has exposure to increases in operating costs.

Next Buyer Analysis

What are we baking in? With interest rates and project costs changing, we are updating our next buyer analysis to ensure that exit values still make sense.

What is the uncertainty? When conducting a next-buyer analysis, we consider the current project's business plan, take the assumed exit price, and then "wear the hat" of a potential next buyer. We then analyze whether or not a next buyer would have sufficient in-place NOI to place a new (upsized) loan on the project as well as reasonably underwrite another five years of returns that fit the new business plan for the asset. In essence, we work to determine if the exit price we assume five years from now would make sense for a new buyer to pay. While inherently speculative in nature, by conducting this exercise on each deal we evaluate, it helps to identify which deals have assumptions that give them a higher probability of actually achieving their exit goals. Given that debt is projected to become more expensive, not only must we assume more expensive borrowing costs for the next buyer, but it is also prudent to believe that the next buyer will not pay a compressed cap rate for the property as we've continually witnessed over the past decade.

What are we observing? We are observing certain deals come into screening with moderate growth assumptions that enable it to underwrite attractively for a next buyer while other deals appear overly challenging to achieve reasonable targeted returns for a next buyer. . When we see deal flow with prudent assumptions in the current environment, we continue to analyze it. Where deals only pencil when assuming a flat or compressing cap rate environment and/or which cannot sustain a higher borrowing cost for the next buyer, we decline the deal and move on.

Changes in Market Fundamentals

What are we baking in? Cap rate expansion, moderating rent growth assumptions and increases in ground rents.

What is the uncertainty? As we speed towards what we ultimately believe will look like a more normalized market, there are multiple changes in the market fundamentals that must be taken into account. First, we are assuming slight to moderate cap rate expansion over the next five years. Second, while we assume that rents can continue to grow from their current levels, we also assume their rate of growth will decrease rapidly down to levels consistent with long-term trends. Third,

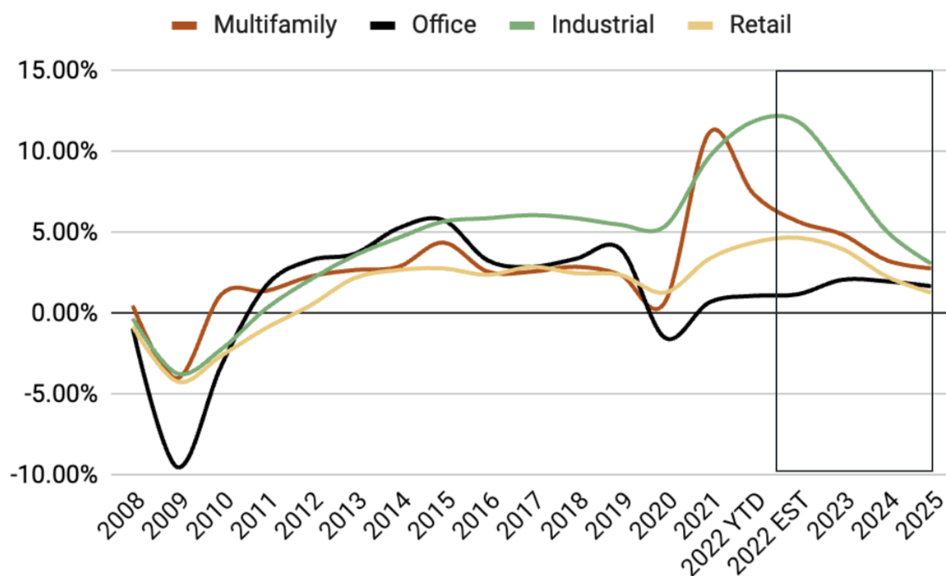
some of our deals sit on ground leases and, as goes interest rates so goes ground lease rates. As a result, we are updating our beginning ground rent assumptions as well as our assumed future growth rates.

What are we observing? Cap rates compressed substantially in 2021, especially for the multifamily, industrial, and self-storage sectors. We viewed these compressed cap rates as unsustainable and we are already observing some cap rate expansion (20-50 bps since the start of 2022), most notably in the multifamily and industrial sectors, as property values adjust downward. In our opinion, these price adjustments are now creating a more sustainable outlook going forward. We expect some additional expansion to occur later this year but the overall levels of cap rate expansion to remain relatively in check, especially for asset classes with high underlying demand.

Historically there has been a debate about whether cap rates are directly correlated with an increase in interest rates. When you observe historical data it is arguable that there is some correlation, but the principles of supply and demand tend to act as the main driver of property values and hence their cap rates. With the amount of liquidity the Fed injected into the economy over the past two years, despite the Fed's current efforts to mute lending liquidity by imposing higher reserve requirements upon banks, we believe there will continue to be plentiful amounts of capital chasing hard assets for years to come. Thus, while we expect cap rates to "normalize" that definition equates to a return to a cap rate environment more consistent with the 2016-2018 period.

We are also noticing moderating rent growth assumptions in deals and in data. See Figure 5, for instance. CoStar is forecasting rent growth to moderate this year and by 2025 from double-digit to single-digits for industrial and multifamily, with office growth expected to remain relatively stagnant, and retail growth to temper down slightly.

Figure 5: Rent growth forecast for CRE



Source: CoStar Data, Aug 2022.

And lastly, we are observing 50 - 75 bps increases in starting ground rents from roughly 3.0% of the value of the underlying land at the beginning of 2022 to up to 3.75% today. Ground leases tend to have a positive correlation with interest rates so, in a rising rate environment, it is reasonable to expect upticks in ground lease rates. Ground rent is essentially a borrowing cost because you're substituting equity (in the form of fee ownership of the ground underneath a project) for a payment to lease it from the ground owner. Therefore, it's important to pay attention to because it can affect the overall operating cost of a project.

Moving forward, there are two primary factors we are watching. First, as rates continue to increase, we may see further increases in ground lease rates; another 50 bps expansion over the next year is plausible.

Second, while certain ground leases are tied to fixed increases in rents over time while others may reset periodically based on variable measures, most notably CPI. In an inflationary environment it is this latter form of ground lease structure that we must pay particular attention to and factor in the possibility of higher ground lease payments in the years ahead.

With all these risks in mind, what lies ahead for commercial real estate investors? Sit on the sidelines or invest?

The overall volatility in the market is undeniably calling for added scrutiny while making investment decisions. But despite current low confidence levels in the overall economy and plunging equity markets that appear panicked, the adjustments we have witnessed thus far in 2022 in the commercial real estate market appear mostly rational. While rocky, these adjustments are moving the commercial real estate market back to a more sustainable outlook. As we noted at the outset of the year, we welcome moderating rates of growth and corresponding assumptions as it relates to underlying market fundamentals. It has been and continues to be our opinion that a perpetuation of 2021's market conditions, i.e., rapid rent growth and record-breaking price appreciation of most asset classes, even for as few as two additional years, would create a market dynamic that poses a major risk of crashing.

Additionally, the steep increase in interest rates this year and the resulting difficulty to obtain debt, paired with the volatility in construction costs has created an environment where, not only is the market actively being repriced but it is also becoming increasingly difficult to add new supply. As a result, on acquisitions we are seeking opportunities for a "discount story", which we want to see reflected in the purchase price. As for new development, we are seeking opportunities to partner with more experienced developers who possess stronger capabilities in obtaining construction financing and delivering projects on time and on budget.

In both outlined scenarios, we view the current market dynamic as one where those operators and developers that prevail in 2022 will stabilize into a market a few years down the road with fewer competitors around them, which may position them well for exit once the market settles into a state of normalcy. Finally, our thesis of moderate growth by 2025 is generally consistent with the outlook for commercial real estate growth, in terms of forecasted rent growth, revenue growth, and price appreciation, according groups like Green Street* and CoStar**.

**Green Street Advisors - U.S. Commercial Property Outlook, Sep, 2022*
***CoStar - Data, Sep 2022*

As we have highlighted, CrowdStreet's Marketplace criteria is evolving in lockstep with the changes we are witnessing. We are constantly updating our assumptions based on the risks and opportunities we see, both current and future, and we are taking into consideration the downside risks before ultimately approving an investment for listing on the Marketplace. However, while that holds true, we also

recognize that every investment decision holds a certain degree of risk that can be realized despite all downside considerations during review.

We took a similar approach during the COVID-19 pandemic when our investment committee at CrowdStreet quickly adapted to a more nuanced review process. By mandating that we must be able to answer the question of “Why this deal right now?”, with conviction, we navigated the massive uncertainty of the early phase of the pandemic and brought only those deals to the Marketplace that could live up to the standards which took into account the downside risks of the time. While today is a different environment that requires a slightly different approach, we are navigating 2022 with the similar mantra of “Why this deal right now?”

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