PATTERSON
REAL ESTATE ADVISORY GROUP

CAPITAL VIEWS

PATTERSON PERSPECTIVE

WELL, MY PERSONAL LIFE HAS BEEN GREAT…

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If you're in the commercial real estate industry, did you find that last year when you ran into someone you hadn't seen for a while, and they asked the typical question "Hey, how are things?", your answer usually started with a brief pause, some foot shuffles, throat clearing, and then you'd say, "Well, my personal life has been great." In other words, sort of confessing that maybe your business life wasn't going so great. Well, I can certainly understand that response, as I both said and heard it numerous times throughout the year.

The good news though professionally is I strongly believe that 2024 will be different – meaning better. Many issues remain for our industry, which I'll go over below, but it also seems clear to me that we have reached a bottom of sorts in the malaise that has impacted capital providers and buyers and sellers of properties. I'll explain.

Where do we still have issues?

- Construction debt from all sources remains scarce, especially so among the banks, for the same reasons that existed throughout 2023. This is primarily due to a build-up of real estate loan balances as they fund construction loans committed in 2022 or earlier without getting much, if any, real estate loan payoffs. Unlike last year, I do think we'll begin to see this change as the year progresses, allowing some banks to dip their toes back in the lending markets.
- Short-term interest rates, the index used for all construction financing, have remained high, and they won't change until or unless the Fed reduces the fed funds rate. This will continue to make transactions difficult to underwrite and will chill activity in our industry for the first part of the year.
- I have written about the difficulties of office as a product type now for several years, and I don't think there's more to be said other than we will be struggling and dealing with what this means for our industry for many, many years.

Why do I think we're in for a much better year in 2024?

- While construction financing is based on using SOFR (which can change daily) as its index, buyers of properties for the most part will get debt fixed at long-term rates – in other words, the index is the US Treasury yield. There, we've seen large reductions in the yield over the autumn of 2023, and with the Fed's "hint" after their December meeting that rate cuts of up to 75 bp's are likely in 2024, the 10-year Treasury yield quickly fell again. So much so, that in the week or two after the Fed's comments, I heard from several life companies about how borrowers were, for the first time in 2023, wanting to lock in long-term rates, implying that the life company borrower was either buying a property, or re-financing a property they already owned. In either case, this results in a pending loan payoff for a bank.

- Though construction financing uses short-term rates as the index, when a construction lender determines how much it is willing to lend on a deal, it is usually looking at the long-term rate for underwriting purposes. I believe the reduction in the long-term US Treasury yield will result in construction lenders lowering the rate they use in their loan sizing underwriting, which will elevate the loan-to-cost ratio they can achieve.

- Equity investors, who have largely been on the sidelines since the summer of 2022 will, I believe, determine it is time to get back to investing. The reduction in long-term rates and the Fed's signal that short-term rates could decline this year, as well as the nervousness we humans experience when we don't have much activity for a long period of time, will help this situation.

- The impact of lower Treasury yields is easing pressure on cap rate expectations of buyers for multi-family. A buyer using long-term, fixed-rate debt to finance their purchase (which is almost all buyers for longer-term holds) can now borrow permanent debt below 6%, maybe dropping to the mid or low 5's if Treasuries continue to decline. This allows a buyer to get accretive debt at a cap rate in the low 5% range, something that hasn't been the case since 2022.

- I believe the comment of the previous paragraph will spur a tremendous amount of property sales, first from sellers who have to sell (due to pressure from their existing lender to pay off the loan, the need to get equity returned, etc.), followed by sellers that have wanted to sell for the past 18 months but haven't liked the market pricing.

- Property sales will lead to payoffs at the banks. Once the banks begin seeing loan payoffs and believe the payoff stream is likely to continue, they will consider making new loans. I believe this will also ease the pressure from banks to require large deposit balances as a condition of making a loan due to the improving liquidity position the banks will have.

- The housing affordability gap, the difference in cost between owning a home vs. renting, has never been higher in the United States than it is now. Mortgage rates are one of the biggest factors in this calculation. Although they have declined over the past few months, this gap will continue for some time, providing a reason to think that rental housing will be in high demand for years to come.

- Rate reductions will allow new development to be underwritten using lower exit caps. The 6.5% or 7.0% untrended return-on-cost expectation of equity investors will correspondingly decline. This is necessary as very few properties now hit those return levels. This will cause new construction to be financeable again.

- Equity investors will acknowledge what has been obvious for some time, that given new construction starts have largely stopped for almost 18 months, there will be a dearth of deliveries two or three years from now. Delivering a new project at that time will prove to be very beneficial.

- My guess is we'll begin to see the "trickle" of the above begin to happen immediately in 2024, with a possible floodgate of activity happening late spring and into the summer once Fed rate cuts begin.

- We continue to see construction cost reductions…not huge, but real. Reductions are more for materials than for labor, but we hear frequently from our developer friends that when they bid a job, unlike prior to 2022 when often the list of sub-contractor bidders was very, very small (in some cases zero), now it's not uncommon for multiple bids to show up.

Well, my personal life really has been great…

Speaking of my personal life, it really was great in 2023. I saw my three sons and two grandsons multiple times. I also learned I have a third grandson on the way early in 2024 (which, if you're counting, means six sons and grandsons), and recently learned I will have the first girl (a granddaughter) in my family when my second son and his wife welcome their second child this summer. When I got that news, I told my son I have waited my whole life to hear something that great. And extra cool, my Missouri Tigers finally decided to play football this fall. I think this was their first season doing so since the 1960's.

I hope your personal life was also great in 2023, and that it, as well as your business life, are both even better in 2024!

Since inception, Patterson has closed 470 transactions encompassing almost $10.8 billion in capital placement.

RECENT TRANSACTIONS

CLIENT	**POPE & LAND**
PROJECT	**CUMBERLAND CENTER I**
MARKET	Atlanta, GA
TYPE	Office
ASSIGNMENT	Bridge Loan

CLIENT	**ALBANY ROAD REAL ESTATE PARTNERS**
PROJECT	**126TH AVENUE NORTH**
MARKET	Tampa, FL
TYPE	Industrial Outdoor Storage (IOS)
ASSIGNMENT	Acquisition Loan

CLIENT	**TRUX**
PROJECT	**TRUX PARKING SITES**
MARKET	Various
TYPE	Parking and IOS
ASSIGNMENT	Acquisition Debt & Equity

CLIENT	**HOLDER PROPERTIES**
	& EAST WEST PARTNERS
PROJECT	**DWELLINGS AT NOWELL CREEK**
MARKET	Charleston, SC
TYPE	Build-to-Rent
ASSIGNMENT	Construction Loan & Equity

CLIENT	**FLOURNOY DEVELOPMENT GROUP**
PROJECT	**THE HIGHLANDS**
MARKET	Knoxville, TN
TYPE	Build-for-Rent
ASSIGNMENT	Preferred Equity

CLIENT	**MADISON CAPITAL GROUP**
PROJECT	**GARTEN**
MARKET	Charlotte, NC
TYPE	Apartments
ASSIGNMENT	Construction Loan

CLIENT	**MADISON CAPITAL GROUP**
PROJECT	**MADISON CANTON**
MARKET	Canton, GA
TYPE	Apartments
ASSIGNMENT	Construction Loan

CLIENT	**LEGACY SOUTH**
PROJECT	**OPERATING COMPANY INVESTMENT**
MARKET	Nashville, TN
TYPE	Investment
ASSIGNMENT	Equity

CLIENT	**MIDDLE STREET PARTNERS**
PROJECT	**1000 JACARANDA**
MARKET	Venice, FL
TYPE	Apartments
ASSIGNMENT	Construction Loan & Preferred Equity

CLIENT	**ICM ASSET MANAGEMENT**
	& WATERLOO PARTNERS
PROJECT	**RIVER PARK 10**
MARKET	Atlanta, GA
TYPE	Industrial
ASSIGNMENT	Construction Loan & Equity

CLIENT	**MADISON CAPITAL GROUP**
PROJECT	**MADISON BONITA**
MARKET	Bonita Springs, FL
TYPE	Apartments
ASSIGNMENT	Construction Loan & Preferred Equity

CLIENT	**MCNEAL DEVELOPMENT**
	& THE MACALLAN GROUP
PROJECT	**PEEPLES VALLEY**
MARKET	Cartersville, GA
TYPE	Build-for-Rent Townhomes
ASSIGNMENT	Construction Equity

MEET YOUR NEW CHARLOTTE MARKET DIRECTOR: AUSTIN SMITH

AUSTIN SMITH, ***Market Director***
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Austin Smith joined Patterson Real Estate Advisory Group in the fall of 2016 and serves as the Market Director in Patterson's Charlotte office. Austin's primary focus has been the sourcing and placement of joint venture equity, co-GP equity, senior debt, and preferred equity/mezzanine debt across the Southeastern U.S. and for multiple property types. Since joining Patterson, Austin has been directly involved in the closing of over 85 transactions totaling $3.5 billion in volume. Prior to joining Patterson, Austin worked in JPMorgan's Real Estate Banking group in Atlanta, providing balance sheet loans to institutional real estate developers, owners, and investors throughout the U.S. Prior to JPMorgan, Austin worked with GE Capital Real Estate in Atlanta supporting the Southeast debt originations team.

Austin graduated from the University of Georgia with a BBA in both Finance and Real Estate. He is an active member of NAIOP and ULI. In his spare time, Austin enjoys spending time with his wife, golfing, and cooking. He's an active volunteer with various First Tee chapters.

Suzanne Holman, Patterson's COO, sat down with Austin to discuss his new role within Patterson.

What are you most excited about as you step into your new role as Charlotte Market Director for Patterson?

There's a lot to be excited about, but I'm most enthusiastic about the opportunity to lead our organization and support existing and new clients in the market. I've always been drawn to the entrepreneurial and problem-solving nature of our business and this role affords the ability to tackle those missions head on.

I'd say the other item I'm most looking forward to is getting re-engrained to Charlotte's real estate community. Having lived and worked on various projects in Charlotte and its surrounding submarkets for years, I feel there's a strong foundation, but also a significant amount of untapped potential.

What do you plan to accomplish in your first three months?

Anything and everything that lays the groundwork for future success! In all seriousness, there's a major emphasis on getting up to speed with Charlotte's latest developments, submarket fundamentals, thematic trends, and demand drivers. Equally important, and really in lockstep with that, is connecting with as many industry members as possible. Our business is heavily dependent on relationships, and deepening existing relationships while cultivating new ones will be key coming out of the gates.

You've been with Patterson since 2016. Is there an experience that stands out as particularly important or most memorable during your time with the firm?

Definitely – embarking on an 18-month journey across our offices in Charleston, Nashville, Tampa, and of course, Charlotte. Coming out of the pandemic, I was eager to try something new, and worked with our team to create a rotational program. The overall experience was invaluable – it provided the opportunity to see and learn about our respective markets firsthand, not to mention living in some pretty cool cities! That said, given the true 'team' structure of our firm, I think the most impactful element was simply being in the office everyday with our market leaders – learning how they each approach deal evaluation, challenges, negotiations, etc., and building a strong rapport through that process.

What makes Charlotte special from a commercial real estate perspective?

Charlotte has a multitude of attributes and factors that when coupled together, creates an environment ripe for commercial real estate development and investment.

Let's start with arguably its top attribute – a diverse economy anchored by corporate stalwarts in global banking, energy, technology, and healthcare. North Carolina's skilled workforce and high quality of life are driving continued job additions and diversification, all evidenced in the MSA's unemployment rate of 3.1%, down roughly 40 bps from 2023's peak rate, driven by the addition of nearly 40,000 jobs.

From a demographic perspective, population growth continues to outperform, totaling over 21% since 2010, while median household income increased over 20% (compared to less than 15% nationwide), a testament to the skilled workforce and quality jobs in the market.

Charlotte's stakeholders made a catalytic decision in the early 2000s to develop the LYNX Blue Line, North Carolina's first modern-day rapid rail service, connecting major job centers to nearby residential neighborhoods. Demand to be nearby a light rail station, from both a corporate and individual perspective, has helped spur over $4 billion of development along the light rail since 2017 alone.

Keeping with connectivity and infrastructure, Charlotte is in a prime location – centrally located within the nation's fastest-growing region. Between an extensive interstate network, major airport, and airline hub, Charlotte has established itself as a key distribution center in the Southeast. And from a resident's perspective, what's not to like about being in a major city, and just a two- or three-hour drive to the mountains or beach.

What's something that's always on your mind as it relates to serving your clients?

Number one has always been and will continue to be achieving a desirable outcome for our clients. Getting to that point really starts with understanding a client's needs and objectives, which can go beyond an individual project. So, we work to develop a deep understanding of each client's business, which in turn puts us in a position to best advise on optimal capital strategies. It's in our DNA to go the extra mile for our clients and capital partners – as such, our firm's collaborative structure allows us to leverage any and every internal resource, making this possible.

In line with this, I place an emphasis on transparency. From evaluating risks and opportunities during the initial deal evaluation to keeping clients informed on live capital feedback and through a closing process, keeping an open line of communication is truly vital to a successful outcome.

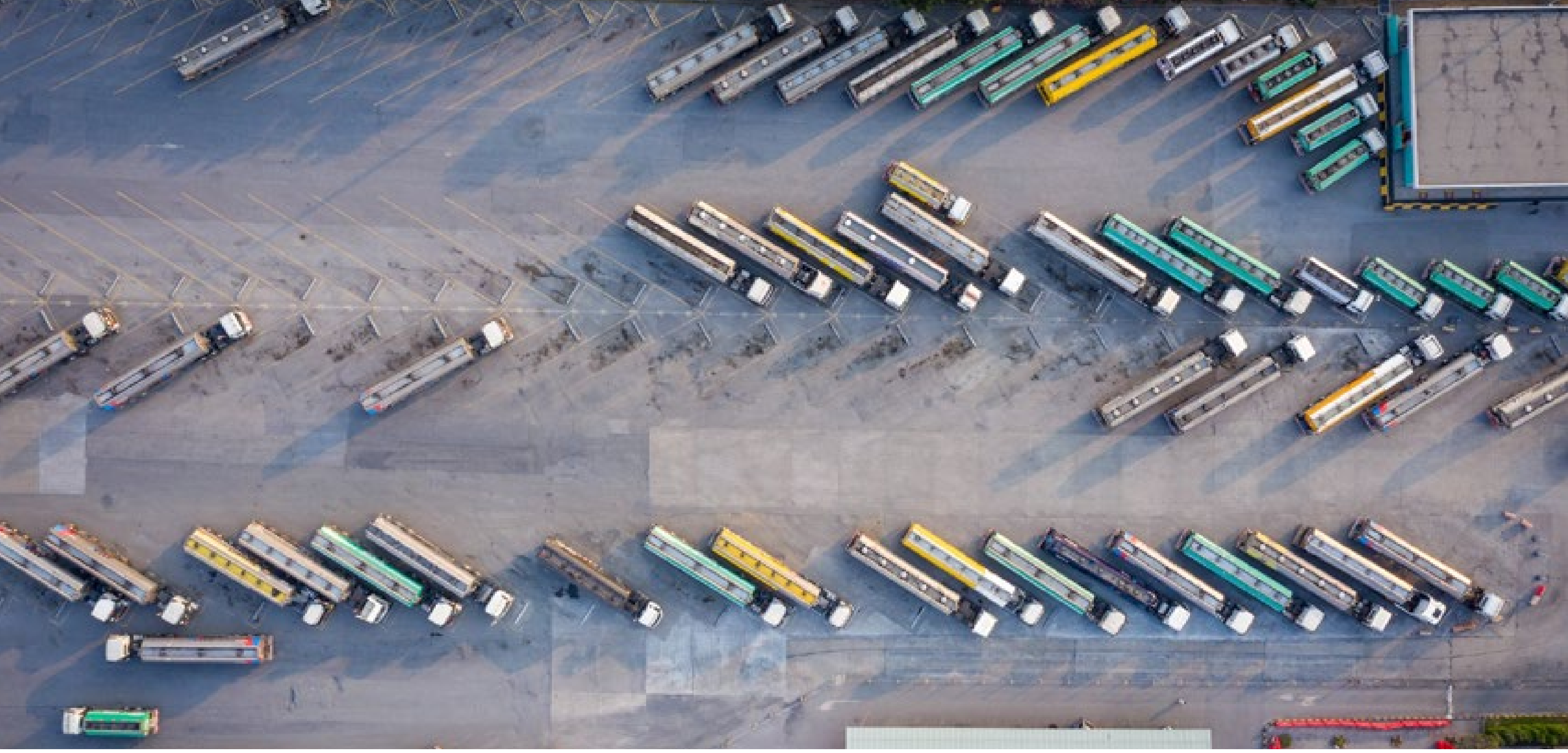
Favorite food, drink, recreation in Queen City?

When my wife and I were here in 2022, we lived in Plaza Midwood and fell in love with the neighborhood – tons of great restaurants, bars, and connectivity to other in-town neighborhoods. Narrowing down to favorites:

Dinner – Supperland or Fig Tree for an occasion, but for a casual night Calle Sol in Plaza Midwood is tough to beat.
Drink - Craft, Workman's Friend, or Legion Brewing.
Recreation - If staying local, it'd be jumping on the Little Sugar Creek Greenway and/or spending a day at Veterans or Freedom Park. With a little extra time, I'm always trying to get out on the golf course and would be remiss if I left out Whitewater Center.

Anything else we should know about you or about Patterson's plans for Charlotte?

I want to thank my wife, family, and the Patterson team for all the support. Between several years in Atlanta, to moving across our Southeastern offices, the opportunities I've been afforded have been nothing short of spectacular, and none of it would've been possible without their encouragement and faith. We're confident the best is to come as we make our way to Charlotte and grow the business!



THE RISE OF ALTERNATIVES

BILL MEALOR, *Senior Managing Director*
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Many of our clients have recently asked us where investors are looking to deploy capital. An easy response would be that equity investors want to invest in multifamily and industrial assets…but in preferred equity and debt positions at an attractive basis. While we believe opportunities for common equity with good sponsors exist within most traditional asset classes, there are few investment themes gaining broad acceptance in a world of nuanced investing. An exception to the lack of thematic investing, however, can be found in the increased capital flow to alternative asset classes.

Alternatives typically include data centers, senior housing, self-storage, cold-storage, student housing, and MOB / life sciences. Previously over-looked asset classes like industrial outdoor storage ("IOS"), manufactured housing, mobile home parks, and marinas, to name a few, are also gaining momentum amongst institutional investors while traditional asset classes look to re-establish footing. Over the past 18 – 24 months, we have worked on several IOS, manufactured housing, self-storage, and cold storage transactions, and even explored glamping. Sponsor and investor inquiries have increased about student housing as it is gaining a significant amount of attention due to its strong rental rate growth and current demand trends.

Part of the interest in these asset classes is fueled by their attractive return metrics, investment barriers, and overall strong fundamentals. Often, many of these investments exist in a fragmented micro-economy with a lack of institutional operations; however, they benefit from strong secular demand trends and generate proven cash flows, creating opportunity for professional operators, who are institutionally capitalized, to enhance yield through more diligent operations. The operational intensity of these assets alone can be a barrier to entry. Investors, therefore, generally rely on strong partners who are expert in their fields. In addition to attractive underlying fundamentals, there also are macro trends driving capital reallocation as portfolio managers are having difficulty sourcing attractive investments in traditional asset classes.

PORTFOLIO MANAGEMENT DRIVERS

Fund Rebalancing

Many portfolio managers won't consider an office investment right now. There is too much headline risk even if an opportunity could be acquired for an attractive basis. Office previously was one of the largest investment targets. Those funds need to be redeployed into other asset classes – much in the same way that retail allocations were redeployed to industrial following the GFC during the e-commerce expansion. Alternative assets benefit from these redirected allocations.

Multifamily & Industrial Fundamentals

It is difficult to underwrite to compelling return levels for multifamily and industrial deals. These once darling investments now require more scrutiny of supply, rent growth, and demand as fundamentals are going the wrong way in many markets. For example, investors are seeking a 6.5% to 7.0% untrended ROC to invest in multifamily development. It is difficult to underwrite to these returns, stymieing capital deployment. Fewer compelling opportunities in these traditional bell-cows further stresses capital deployment, benefitting alternative assets.

Fund Life Horizons

Most investors fell well short of investment targets over the last 12 – 18 months. Closed-end fund investors are feeling pressure to deploy capital before the expiration of their investment horizon; however, they must look to new asset classes given the current office landscape and multifamily and industrial fundamentals in many markets.

The rise in popularity of alternatives isn't simply because capital needs to find the next thing. Cold storage and self-storage benefit from COVID related demand changes. Data centers benefit from ever-evolving technical and infrastructure demands. One of the primary reasons that IOS is capturing more capital flow in this environment is the asset class's close relationship with the logistics industries. Disruptions to supply chains, onshoring, and reshoring have driven growth across the industrial sector. These logistical tailwinds, combined with barriers to entry largely driven by difficulty in gaining entitlements, have created a favorable supply / demand balance for IOS.

Given we have closed several IOS transactions recently, the balance of the article focuses on IOS and how it exemplifies some of the alternatives' challenges and appeal to investors.

WHAT IS IOS? IT'S MORE THAN AN OPERATING SYSTEM

Since we took on our first industrial outdoor storage portfolio roughly two years ago, we have found that there is significant capital appetite for this rapidly institutionalizing asset class. To be sure, IOS, like all these alternatives, has been around for a long time and institutional investors have invested in these assets; however, the broad market acceptance wasn't typically there.

A lot of uses fall within the IOS asset class. Generally, IOS assets are land projects that have very low building coverage. The building to land ratio is less than 20%. Land is zoned for industrial use enabling tenants to store products outside. "Products" commonly range from vehicles, construction equipment, materials, and containers. Small buildings on-site may facilitate intermodal transfers, loading of throughput goods, servicing for vehicles or any variety of uses, but the main demand drivers are the available land permitted for its use and its location.

In addition to use, lease structures are a highly differentiating feature between projects. In its simplest form, IOS offers longer term, NNN lease structures with business entities having going concerns; however, truck parking and storage yards that have shorter term leases, month-to-month leases, or even leases to individuals for truck parking are considered forms of IOS. Shorter term leases sometimes create the opportunity for owners to increase yield through close management in this evolving landscape. We have financed truck parking, longer term credit leases, MTM leases, and other structures all over the country. One thing is for sure, both equity and debt appetite can vary based on lease structure and use.

We have noticed a few consistent attributes amongst most alternative assets that set them apart from traditional assets. IOS can exemplify some of these unique characteristics.

Truck Parking Site, Covington, GA.

IOS THEMES THAT APPLY TO OTHER ALTERNATIVES

Some themes that make IOS challenging also make it an attractive pursuit for those investors willing to invest the time. Many of these same attributes are prevalent in manufactured housing, mobile home parks, self-storage, and cold-storage as well as other niche asset classes.

Fragmented Ownership

Much of the ownership is held by non-institutional owners and is highly fragmented. Deal sizes tend to be small, making the acquisition process tedious. Institutions prefer scale. Buying small sized deals from non-institutional ownership comes with plenty of challenges but also creates interesting opportunities.

Aggregation Strategy

Because ownership is fragmented, buyers tend to capitalize partnerships programmatically or with the intention of buying multiple projects and scaling a portfolio. This creates the opportunity to arbitrage cap rates by buying from a non-institutional owner at a higher cap rate and selling a scaled portfolio to an institutional owner willing to pay a compressed cap rate. In a market in which values are hard to determine and cap rates are difficult to peg, some investors feel like they mitigate cap rate expansion risk by aggregating a portfolio and scaling to an institutional exit. This is a common strategy within many of the alternatives as deal sizes are comparatively small to traditional asset classes.

Property Value Improvements

Often, non-institutional ownership creates the opportunity to institutionalize management practices and the physical plant. In the case of IOS, a sophisticated buyer with capital can inject needed funds to improve the premises with security fencing, cameras, access, and better layouts. In addition, many non-institutional owners manage for occupancy and don't push rent, creating added opportunity for value creation.

Low Capital Intensity

Some alternative asset classes, like IOS, have relatively low cap-ex requirements. For IOS, there are few building repairs required, the leases are largely NNN, and capital requirements are relatively low. Manufactured housing also can require relatively lower ongoing capital, especially upon stabilization. In these communities, the majority of the tenants own their homes and pay pad rent to the community owner on NNN leases, relieving the community owner from ongoing capital infusion.

FINDING DEBT

One of the challenges is sourcing debt for these alternative asset classes. While equity investors may be comfortable with these nascent asset classes, lenders may be slower to adopt for a variety reasons, including lack of familiarity with operations.

Over the last few years, we have financed longer term, single tenant IOS deals subject to five+ year NNN lease structures with strong tenants. We also have financed month-to-month leases for lay down yards and even daily truck parking. In each case, banks provided debt financing. Structures can vary drastically based on lease profiles as lenders are still working to understand the asset class. Despite compelling lease structures, some lenders still view the collateral as land and, therefore, take a higher risk-weighting against the loan (meaning bank loans aren't available or they are lower leverage and more expensive than income generating properties with buildings).

Recourse tends to go away and leverage up for longer term lease structures or for cross collateralized pools. Given that these deals tend to be smaller individual acquisitions, some clients choose to aggregate a portfolio on an all-equity basis and finance pools of assets in a single, traditional loan. We have also structured guidance facilities that enable clients to acquire assets pursuant to certain guidelines and overall line coverages. In some instances, lines can be structured with rate reductions and leverage increases depending on overall coverage across the line. Life companies or larger institutional options emerge for stabilized portfolios.

While there are compelling fundamental reasons to invest in alternatives, the combination of limited opportunities in traditional asset classes and pressures on portfolio managers to deploy capital has led to deeper interest in alternative investing recently. Investors are seeking yield and finding it in alternatives. As long as fundamentals in these emerging asset classes remain strong, we expect investors will continue to seek these opportunities. Lenders are getting more comfortable with these asset classes as well. We expect that alternatives will hang around and become a more meaningful allocation in portfolios.

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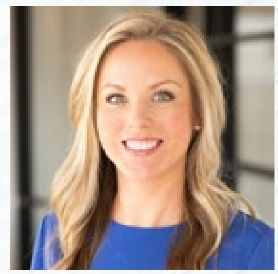

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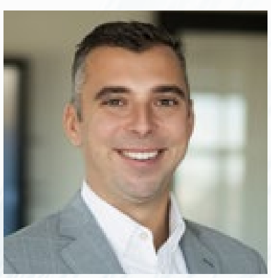

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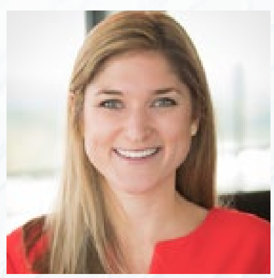

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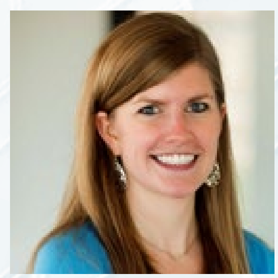

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