
# THE PATHFINDER REPORT

*January 2023*

## IN THIS ISSUE

# CHARTING THE COURSE

## *Is This an Economic Pivot Point?*

*By Mitch Siegler, Senior Managing Director*

There are a couple of things we know for certain and a long list of things we don't know the slightest thing about. 2022, now in the rearview mirror, brought that home in spades. As we begin the new year, several important economic trends seem to be coming into focus and a time of lower volatility and greater clarity may be approaching.

We see four potential, emerging trends: the worst supply chain disruptions may be behind us; economic growth is slowing; inflation seems to be cooling; and the pace of interest rate rises may be moderating. If these trends hold, there are profound implications for businesses and investors. Below is our parsing of the tea leaves on these four conditions.

**Dare We Hope that the Worst Supply Chain Disruptions Are Behind Us?** – The past year was a perfect storm for supply chain disruptions. Russia's war against Ukraine, launched last February, significantly disrupted markets for energy, food, fertilizers, raw materials, ocean shipping and more. While the end of the war remains out of sight, Russian advances have slowed, and Ukrainian resistance has remained strong. Geopolitical optimists might even hope that this conflict may be closer to its end than its beginning.

While nobody knows when and how this war will end, NATO countries seem united in providing military and financial support for Ukraine and Europe continues to make progress in becoming less dependent on Russian energy. American consumers are finally benefiting from lower gasoline prices, which have fallen by one-third, from a peak of $5.11 in mid-June to $3.37 in mid-January; average U.S. gas prices are now back to their pre-war levels. As energy costs are a primary input for so many manufactured goods and the key cost input for the trucking sector, lower gas prices will surely ripple through the supply chain in a major and positive way, contributing to cooling inflation and lessening the need for substantial Fed interest rate hikes later in 2023.

Exhibit "B", China's role as the world's factory, was a significant contributor to supply chain challenges last year and now, as China's zero-Covid policy is unwound, should be a major catalyst for lessening supply chain pressures. In turn, rising prices for manufactured goods last year should give way to more stable, even falling prices for electronics, furniture, apparel and other Chinese-made goods in 2023.

Furthermore, China's stringent "zero-Covid" policy – which led to closures of large factories and ports and even virtual shutdowns of major cities, crumbled in December. As Chinese officials essentially "let the chips fall where they may," the country's factories are beginning to gear back up. But much damage was done to China's economic engine and economic growth in China slowed dramatically last year (from 8.1% in 2021 to an estimated 2.7% in 2022, per the World Bank). The World Bank forecasts a recovery in China's growth to 4.3% in 2023 – still a roughly 50% decline from 2021 levels. We can only hope this month's lunar New Year, when hundreds of millions of Chinese travel from urban to rural areas, won't lead to reports of massive illness and death and a further setback for China's economy and global supply chains.

**Overall Economic Growth is Slowing** – Economic growth in China, the world's third-largest economy, has major implications for global growth. The World Bank slashed its growth forecast for the global economy in 2023 in part because of China's slowdown as well as elevated risks of a global recession. The bank expects global growth to slow from 3% in mid-2022 to 1.7% in 2023. This tepid level of growth, certainly nothing to write home about, would be enough to keep the world economy out of recession territory.

In the "what we don't know" department, many questions remain about how the economy will look this time next year. Will we be in a recession? Will we have a soft landing? The answers to those questions will likely be bound up in what the Federal Reserve (Fed) does this year, which will be driven in large part by inflation news.

**Inflation Appears to Be Cooling** – The mid-January announcement that inflation continued to slow on an annual basis in December provided welcome relief for Americans who've struggled to keep up with rising prices for groceries, gasoline, autos and more. It also provides a bit of cover for policymakers at the Federal Reserve (Fed) and for the Biden Administration.

The December Consumer Price Index (CPI) rose 6.5%, down from 7.1% in November and nearly one-third below the peak rate of 9.5% reached in June – the highest inflation reading in 40 years. December's "core" rate of inflation (which removes the impact of food and energy prices) ran 5.7%. While these rates of inflation are decidedly unsustainable, they're a darn sight better than what Americans experienced earlier in 2022.

The rate of inflation is moderating meaningfully though considerable uncertainty remains about the timing for it to return to a more normal 2%. As policymakers at the Fed monitor the economic tea leaves – watching employment data, equity markets, the 2-year/10-year yield spread, money supply growth and more – it is our hope that they'll make wise decisions to balance keeping a lid on inflation while allowing the economy to chug along.

**The Pace of Interest Rate Rises may be Moderating** – The Fed is not finished raising interest rates and most analysts expect rates to remain at or above current levels for an extended time – likely much of this year. We're encouraged that the *rate of change* in interest rates has been slowing and many analysts expect the pace of change to continue to moderate, with the peak of the Fed rate hike cycle possibly occurring this March.

"I expect that we will raise rates a few more times this year, though…the days of us raising them 75 basis points at a time have surely passed," said Patrick Harker, president of the Federal Reserve Bank of Philadelphia on January 5. The Fed Funds rate – now 4.50%-4.75% – will likely rise 25-50 basis points in February with another (dare we hope final?) increase at the Fed's March meeting. That would put the Fed Funds rate later this quarter in the 5.00%-5.50% range. (A basis point is 1/100 of a percent.)

Since investors are scared silly about inflation, they should be cheered by cooling producer and consumer prices. And as markets hate uncertainty, a flattening of the rate hike curve should provide welcome relief to investors in the year ahead. While we're not expecting boom times in 2023, lessened anxiety and lower volatility are always welcome. Here's to a better year ahead.

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# FINDING YOUR PATH

## *What Goes Up, Must Come Down (To Earth)*

*By Lorne Polger, Senior Managing Director*

The book has now closed on an eventful 2022.

We certainly had a whipsaw year, a tale of two cities. The first half of the year was the end of arguably the greatest boom in the history of the apartment business. Multifamily rents continued to soar. Construction starts and development projects were at all-time highs. Capitalization (cap) rates settled (for a time) at all-time lows. Pathfinder took advantage of it. We sold one of our properties in Tempe last May to an institutional investor at a 2.8% cap rate, the lowest cap rate we have ever achieved on the sale of a property.

But then, whoops, the "I" word kicked in. Inflation. Just like we had predicted, after the government threw money out of helicopters like it was free (except it really wasn't). We found the pronouncements we heard from many of our friends in the brokerage community in the spring of 2022 ("it doesn't matter that interest rates are going higher, rents will keep on growing and that will cover the additional interest cost"), a little hard to believe. And eventually, so did the market. Sales, which were on a tear during the first half of the year, fell off a cliff during the second half. Some of the numbers are quite staggering. For example, while total sales volume for the Phoenix market was down 19% for 2022 as compared with 2021, year-over-year sales volume for December was down a whopping 83%. Denver? Down 88% for November. Similar story in many of our other markets.

We experienced a similar story with rents. 2021 and the beginning of 2022 had unprecedented rent growth across the U.S. Covid put a pause on rent growth in 2020, but the huge pent-up demand for apartments changed that beginning in 2021. And that surge lasted through part of 2022. The national year-over-year average rent growth in 2021 was up 13.5%, more than double any previous year. Some markets were even stronger. Phoenix was up over 25%. Denver, Seattle, and Portland were all in the mid-teens. Keep in mind that historically, Pathfinder has underwritten annual rent growth in the range of 3-4%. But by the spring of 2022, we started to see the signs of a looming slowdown. In some cases, what was meteoric growth of over 20%/year, slowed down to a trickle or even regressed. Occupancy also showed signs of softening.

If you look at annualized statistics, the numbers do not really tell the story of what happened in 2022. Annually, the average multifamily asking rent rose across the U.S. by 6.2%. By historical context, that was strong performance. The year started as a continuation of 2021, with rents rising through the normally tepid first quarter. But the spring blooms began to wilt. As the economy and demand began to cool in the late spring, rents began their inevitable deceleration. What were $200 or in some cases even $400 increases on lease trade-outs for us slowed to $50 increases, and with some properties, flat rents. And as the year progressed, rent growth slowed significantly. Nationally, asking rents fell 0.6% in last year's fourth quarter.

Frankly, we don't think that is a bad thing. Hyperinflation hits everyone hard. 20-30% annualized rent growth, while a great story for a syndicator trying to raise money for a specific deal, results in unaffordability for the masses, followed quickly by on an onslaught of political backlash (most notably of late, in the form of both eviction restrictions and rent control measures). Having nearly half of Americans spending an inordinate amount of their income on housing is not healthy for these families, for the real estate industry or for the U.S. economy.

We think 2023 is going to be quite different. This year, we believe the markets will calm down, and behave in a more traditional manner. Most economists predict annual rent growth in the 3% range, which would be back to a historical average. National forecaster Yardi Matrix recently revised their annual apartment rent forecast down to 3.1% from 3.5% but noted that the market has positive drivers. They expect the growth to occur in the first two to three quarters of the year. Further, they believe that a potential recession would not be particularly deep or lengthy. A far different situation from the outsize rent growth we experienced over the last two years. The demand-supply equation has changed. Demand for apartments is moderating from record levels as the economy cools, excess savings are depleted, affordability is stretched, and the post-pandemic migration is played out.

At the same time, 2023 will be an extraordinarily strong year for new supply. According to brokerage firm Berkadia, more than 565,000 new apartment units will come online in 2023, the largest number in 50 years, and over 150,000 more units than came online in 2022. The highest concentrations of new deliveries will be in the sunbelt states, which will have to dampen the increases in rent growth there.

How will the markets absorb all those new deliveries? Slowly, we believe. And that will be the tale of two cities between Class-A and Class-B housing stock moving forward. At Pathfinder, we continue to favor suburban, Class-B apartments. With rents clearly decelerating now, the market is waiting to see where the bottom could be. We think we are at or near the bottom in Class-B – which represents a tremendous value when compared with Class-A properties (about 20% less, in our markets) and an unbelievable value compared with new, Class-A properties (60% less in our markets!). While we have seen some rent reductions and concessions of late, we have typically seen renter demand kick back in once we hit prime leasing season in the spring.

The tale of the other city for 2023 is Class-A. With so much new supply coming online, we expect these properties will have much slower lease-ups than expected. That, in turn, will result in significant rent concessions in that space. And the trickle has already turned into a stream (not predicting a raging river yet, but we'll see how it plays out over time). New deliveries in some of our markets are giving away up to ten weeks for free on a new one-year lease (which is almost a 20% concession in total annual lease payments). Austin, Orlando, Nashville, and Phoenix come to mind as markets with the highest vulnerability. That said, many markets will probably experience essentially flat rents in the best properties, and price backtracking wouldn't be surprising.

And the difference in new Class-A rents and Class-B rents is significant. The gap between new construction Class-A rents in Seattle and Class-B rents? About double. Phoenix clocks in at a 77% differential, Denver at 72%. Those are big spreads and give owners like Pathfinder a comfortable margin of safety knowing that we are not going to lose tenants to those types of buildings (and by the way, we're probably not going to lose many to homeownership either, especially with mortgage rates hovering in the mid-6's today). Couple that with long-term, low leverage, fixed-rate debt across almost all our properties, and we're sleeping pretty well these days.

And that is essentially the difference between owners who are in it for the long-term and have that same view on investing, and those that are built more for the quick fly. The former can ride the waves up and down, since that is an inevitable part of market cycles, whether in real estate, stocks, or bonds. Build a portfolio for safety and the bumps don't hurt too bad. Build it for the short-term and the bumps can be painful. Over the next year or two, some won't survive the bumps, at least not without getting badly bruised along the way.

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# GUEST FEATURE

*An Article about Nothing*

*By Brent Rivard, Managing Director*

Me: "What's going on?"

My Commercial Real Estate Friends: "Nothing."

This call and response has been the primary theme of the last nine months. Since the Fed started increasing interest rates to battle non-transitory inflation, the commercial real estate capital markets feel like they are at a standstill. So, when it was time to write my article, the word that kept coming to mind – the theme, if you will – was "nothing."

Maybe I could write an article about nothing. Jerry Seinfeld built a television sitcom empire around it for nine seasons with *Seinfeld*, a show about nothing. During its run, the show helped popularize the phrase "yadda, yadda, yadda" used to gloss over the boring details of any story. So here goes…

**Real Estate Transaction Volume is Way Down**

According to Costar, commercial real estate transaction volume across all property types was down nearly 25% in the third quarter of 2022 as compared with the prior quarter and is expected to be down another 22% in the fourth quarter of 2022. Yadda, yadda, yadda... But the details show that the fourth quarter of 2022 still accounted for over $150 billion in transaction volume, which is better on a standalone basis than some years in the past decade. The markets are still transacting more than nothing, it just feels like a lot less compared to the level of the last few years.

There's a major disconnect between what sellers think their properties are worth ("Sure, happy to sell for the price the brokers thought I could get at the peak last spring," they say) and what buyers are willing to pay ("Surely, a soft economy with the possibility of a recession sets the stage for lower income and property values," they say). Brokers, loathe to waste their time, are increasingly reluctant to even list properties for sale for sellers with unrealistic expectations, so there are fewer properties for buyers to consider, leading to lower transaction volumes.

**Inflation is Beginning to Cool**

Inflation started to wane in the second half of 2022. Yadda, yadda, yadda… After reaching a peak of over 9% in June 2022, the Consumer Price Index rose 6.5% year over year in December. That's not nothing. We've all felt it at the pump as gas prices have dropped by one-third to an average of $3.37 a gallon in mid-January. This progress is encouraging and as we watch inflation peak and retreat, the market is hoping lower inflation will lead the Fed to slow its pace of rate increases.

The Fed says "we'll do whatever it takes to bring inflation under control" – and they should, since inflation has brought down kingdoms, empires and governments since the beginning of civilization. The bond market reaction: Yadda, yadda, yadda.


Speaking of the Fed, after keeping the Fed Funds rate at around 0% as recently as a year ago, we've experienced seven rate increases in the past 12 months and the Fed Funds rate sits today at 4.50%-4.75%. So, it costs businesses and homeowners a lot more to borrow now. Home mortgage refinances are in the cellar and home values have fallen. To some, that's a big deal. To others: Yadda, yadda, yadda…

Consensus has the Fed increasing rates at least one more time in February and perhaps a final time in March. Let's hope that's the end of it. If so, uncertainty around borrowing costs should decrease, encouraging buyers and sellers to transact. As a side benefit, investors with idle cash have been able to earn some interest on those balances during the past year, allowing them to get paid at least something to wait for opportunities. Maybe it's only 3-4% but that's a darn sight better than nothing.

**Multifamily Rent Growth is Cooling – and We Knew This Day Would Come**

The experts have started to release their forecasts for multifamily rent growth in 2023 and they're well below the peak levels of 2021 and below 2022's still strong levels. Yadda, yadda, yadda…

First Vice President and National Director of IPA Research, Greg Willet, predicts overall apartment rent growth of 3.1% in 2023, with most of that growth in Class-B apartments. That's well below the double-digit clip during 2021 and compares favorably to the long-term trend line for rent growth. 3.1% is not nothing! Yes, we may be used to high single-digit and even double-digit rent growth over the last couple of years but rent growth moderating to the 3% range is good on many levels. At a minimum, it should take the pressure off of elected officials to pursue rent control measures in many markets.

**Washington, D.C.**

The Republicans recently took control of the House of Representatives after a protracted fight over who would be the Speaker of the House. Yadda, yadda, yadda…

If the weeklong struggle to elect a Speaker is any indication, we likely don't need to worry much about new Federal regulations, though we'll keep our eye on it.

The truth is, there is a lot more than "nothing" going on. While many in commercial real estate are sitting on their hands waiting on changes in economic data and uncontrollable market conditions, some are keeping active, tracking the data closely, updating strategies and digging in on their current portfolios.

At Pathfinder, we find ourselves in the second camp. We're spending our time in the weeds of our portfolio, controlling what we can control. The overall dynamics of multifamily real estate investing in our key markets has not changed. There are still more people looking for apartments to rent than there are available apartments so we're keeping our properties fully occupied. Our strategy of borrowing primarily on a fixed-rate basis has largely insulated us from the recent interest rate increases. The weighted average fixed interest rate for our Pathfinder Partners Income Fund, L.P. portfolio is 3.2% fixed for seven to ten years. That's a pretty good place to be and allows us to focus on improving operations and not worry about rising borrowing costs.

The other impact of market uncertainty is that it can create opportunities for investors. Multifamily investors did very well over the last several years. It's never easy to produce strong returns but there were many investors, new and old, who took risks to juice returns hoping for the market to be unstoppable. Many of those investors did great in the prior market but will struggle in an uncertain future market or one where rents aren't growing at record levels.

We're busy researching the data and believe there will be opportunities to buy properties from those who employed high leverage or used floating rate debt, which may be coming due this year or next.

Here's to looking forward to a better 2023. Yadda, yadda, yadda…

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# GUEST FEATURE

## *Resiliency: An Important Driver of Value for Businesses and Investors*

*By Brent Stuhley, Acquisitions Director*

Astute investors and business leaders have sufficient humility to not confuse a bull market with their own intelligence. It's easier to achieve success when you have strong tailwinds. The challenge is how to survive and thrive in the face of a down market or other headwinds.

Resilience for investors and businesses is the ability to anticipate, prepare for, and adapt to adverse events to keep operating. It is a concept like contingency planning and can include preparing for disruptive events such as natural disasters, cyber-attacks, pandemics, and financial crises. With the events of the past few years, we know all too well the importance of being prepared for anything. The ability to identify potential financial, operational, and organizational risks, put plans in place to mitigate them, and be able to adapt if an event does occur are critical to developing long-term resilience. Our PERI™ (Pathfinder Economic Resiliency Index) was borne out of the need to understand and mitigate potential economic risks and challenges in our investment markets at the onset of the global pandemic. In February 2020, the unemployment rate was 3.5%. By April, following nationwide closures, the unemployment rate had more than tripled to 14.7%. The pandemic created significant economic disruptions, prompting the National Bureau of Economic Research to declare a recession in March 2020.

Offices in core urban locations emptied as employees worked-from-home. The retail and hospitality sectors took major hits from capacity restrictions, stay-at-home orders, and temporary closures. The travel, leisure and oil/gas industries saw revenue fall off a cliff as a huge segment of the U.S. population stayed at home to reduce the chance of contracting the coronavirus. Large manufacturers, like those in the auto sector, shifted gears, slashing production levels as they sought to social distance their line employees.

As a real estate investment firm focused on owning and operating apartment communities, we needed to understand how these unprecedented disruptions to our health, mobility, and the general economy could impact our business, including our residents' ability to earn a living and pay their rent.

With massive uncertainty around the extent of the pandemic's impact on various regions and specific industry sectors, we began to study the resiliency of our markets. Our initial thesis was that Pathfinder's markets would be more resilient in the face of the health/economic crisis than other markets due to the predominance of industries capable of adapting to new modes of operation (work from home) or by virtue of their being a hub for essential services. For example, we believed San Diego was a more economically resilient market than Las Vegas due to the former's high employment in sectors such as defense manufacturing, government, and high-technology jobs, as opposed to the latter's dependence on gaming, entertainment, and travel.

To examine our theory, we studied the distribution of industry sectors and employment growth in select metropolitan areas throughout the country. The objective of the PERI™ was to measure and compare the economic resiliency of Pathfinder's six western markets (Denver, Phoenix, Portland, Sacramento, San Diego, and Seattle) as compared with an index of 50 U.S. metro areas. The index was comprised of gateway cities (like New York City and San Francisco), high-growth areas (like Austin and Phoenix), entertainment hubs (like Orlando and Las Vegas), cities focused on traditional manufacturing (like Detroit and Chicago), and various centers of government employment (like Boston and Washington D.C) to measure the impact of government jobs. The index cities were chosen in part to provide geographic diversification.

| Metro Area | PERI |
|---|---|
| Washington D.C. | 2.33 |
| Austin | 1.95 |
| Raleigh | 1.80 |
| Sacramento | 1.64 |
| San Francisco-Bay Area | 1.62 |
| Boston | 1.48 |
| Denver | 1.35 |
| Phoenix | 1.20 |
| Atlanta | 1.17 |
| Nashville | 1.11 |
| San Diego | 1.11 |
| Dallas | 1.10 |
| Seattle | 1.04 |
| Portland | 1.01 |
| New York City | 1.00 |
| Indianapolis | 0.89 |
| Chicago | 0.83 |
| Pittsburgh | 0.83 |
| Miami | 0.82 |
| Houston | 0.81 |
| Los Angeles | 0.72 |
| Orlando | 0.68 |
| New Orleans | 0.48 |
| Detroit | 0.38 |
| Las Vegas | 0.17 |
| **50-Metro Average** | **1.00** |

The index score for each market was determined by two components: 1) the 20-year average of employment growth (20% weighting) and 2) the concentration of employment in three industry sectors seen as resilient and non-resilient (80% weighting). We selected a longer 20-year time horizon to study employment growth since this period included robust growth, two recessions and unprecedented growth in the technology sector. A superior employment growth rate is a positive contribution to a metro area's overall economic resilience while an inferior growth rate indicates potential weakness during tough times.

The three resilient sectors we selected were high technology, finance, and government/defense because of their workforce's ability to work remotely and/or the essential nature of the services provided. The three non-resilient sectors were tourism, capital goods manufacturing, and energy/natural resources. We believed that as the U.S. entered a recession created by the pandemic, plummeting demand would disproportionately impact these sectors.

All models make assumptions and PERI™ is no exception. The metro areas selected cover some, but not all, of the major population centers in the country. Also, the employment sectors included do not reflect the entire employment universe, and weighting used for each component of the index was determined based on our understanding that resiliency is determined as much or more by the nature of employment in a market than the long-term employment growth trend.

Economic resilience has perhaps never been more important than today for real estate investment. The risk spectrum has broadened and the last several years especially have been fraught with unpredictable risks, from public health to geopolitical unrest, which have impacted commercial real estate. The office and hospitality sectors are prime examples. No longer can investors overlook the concept of resilience and view it as an added feature versus a core requirement of property/market selection, portfolio diversification and investment management.

A market with consistent employment growth in sectors that can adapt quickly to disruptions, maintain continuous business operations, and protect principal is best positioned to survive an economic slowdown and ride out uncertainty. The markets that scored high in the PERI™ have a distinct advantage when dealing with disruptions such as the pandemic or other crises because their economies have more embedded operational flexibility and/or provide essential public services. All of Pathfinder's core markets ranked in the top half of the PERI™ and several ranked in the top quartile.

Resilient markets directly benefit apartment owners because they maintain strong user demand (reflected in high occupancy) in times of economic disruption or market volatility. The essential need for housing means demand is steady throughout the economic cycle, including recessionary environments. That's what we saw during the pandemic: residents were reluctant to move, they hunkered down in their apartments, which often doubled as offices and/or schools. We also experienced very strong collections during the pandemic, indicating that residents prioritized their housing over more discretionary items.

Regular and predictable income supported by strong market demand and high barriers to entry offer greater stability compared with other asset classes. Despite the pandemic-driven economic uncertainty, apartment rents and occupancy levels have generally increased while other asset classes, such as retail or office, have suffered.

Naturally, the concept of resilience extends beyond real estate. Over the last few years, business leaders have been reminded repeatedly of the interconnectedness and unpredictability of businesses, economies, and societies. Businesses benefit greatly when developing resilience in their workforce, products or services, and infrastructure. Resilience reduces the immediate impact of crises by enabling companies to anticipate, prepare for, and cushion against shocks. In addition, resilience also enables companies to respond to a crisis in opportunistic ways and shape the competitive environment to their advantage.

Amazon is a good example of a business which adapted to and capitalized on opportunities that arose from

pandemic-related disruptions. While other businesses were struggling to keep up with online demand, Amazon quickly adapted their operations by hiring additional staff, diversifying supply chains, increasing inventory levels, and implementing contactless delivery. Amazon saw their market share and profitability surge during the pandemic. In 2020, The New York Times reported that Amazon's revenues grew 37% from 2019 with profits rising nearly 200%.

For Pathfinder, the PERI™ serves as a risk management tool to monitor the economic resilience of markets over time, giving us the ability to make informed decisions and proactively pivot should conditions change. However, this concept applies to all businesses, which should continue evaluating resilience even as crises fade. Resilience does not just mean simply maintaining short-term, operational continuity. True resilience is more expansive and can be a driver of value. It requires focus on financials, operations, technology, and organization. A company's capacity to absorb stress, recover critical functionality, and thrive in new circumstances will set it apart from its competitors over the long term.

Characteristics of resilience inherent in successful businesses include the ability to identify and assess a threat or risk, strong leadership, flexible processes that can be quickly adapted, and a focus on customer experience and retention. The risks of not adequately developing business resilience are financial loss, threats to business continuity, damaged reputations, and a slow recovery. As we have learned from the events of the last few years, prepared businesses were able to dynamically respond to adverse events in the market, enabling them to flourish in a challenging environment.

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# ZEITGEIST – SIGN OF THE TIMES

**Rising Apartment Supply Doesn't Meet Housing Shortfall; Rising Construction Costs, Higher Rates May Dampen Supply**

According to a December report from the *U.S. Census Bureau*, more than 19 million of the nation's 44 million rental households (43%) spent more than 30% of their income on rent and other housing costs from 2017-2021 (the general rule of thumb dictates housing costs should be less than 30%). The situation has been exacerbated by the unprecedented rent growth of 2021 and 2022 – approximately 25% – and historically high inflation. As a result, new household formation is slowing, and apartment rent growth is moderating.

In parallel, more than 400,000 apartment units were completed in 2022 and nearly 500,000 are expected to come to market in 2023 – more than any year since 1986, according to *CoStar*. Despite the increase in supply, the U.S. is still facing a shortfall of more than four million housing units and most cities will remain drastically undersupplied for many years.

As a result of the affordability issues and increased supply, many experts are predicting a moderation of rent increases in 2023. Pathfinder has long predicted that the robust rent growth of 2021 would moderate in 2022 and slow further in 2023, which we have been seeing. Both *Yardi* and *Moody's* expect rent growth to decrease to about 3% with some markets – especially those with high new supply – experiencing flat rents. Despite the changing market fundamentals, historically high home prices and rising mortgage rates continue to buoy rental demand, providing a future layer of stability for the industry. According to a *Freddie Mac* study, about 15 million U.S. households have been priced out of buying a home due to the recent increases in interest rates, further strengthening the nation's pool of renters. We expect new apartment supply to slow in response to high construction costs and interest rates, which require higher rents for new projects to be economical.

**Post-Pandemic Resident Events**

When the Pandemic hit in March 2020, apartment resident events –used by landlords to build community and increase resident retention – quickly shifted

from boisterous ice cream socials in the clubhouse to lackluster meet-and-greets over Zoom. As the pandemic wanes and in-person events reemerge, the lingering effects of Covid-19 have forced property owners to reevaluate their tried-and-true community building techniques.

The attractiveness of previously popular events like indoor happy hours and fully-occupied yoga classes have diminished. In a post-Pandemic landscape, many residents are more conscious of their personal space and shy away from larger indoor gatherings. In response, landlords are holding more outdoor events like summer pool parties and afternoon "yappy hours" in the community dog park.

Monthly rents – especially as a percentage of income – are meaningfully higher than they were before the Pandemic and pay-to-play events like food trucks, potlucks and secret Santa exchanges are falling out of favor. Instead, communities are shifting to more landlord-funded events like wine tastings, outdoor movie nights with food, casino nights, hosted happy hours and nutrition or cooking classes. Some landlords have moved toward work or educational-related themes like free professional headshots or resume writing workshops. In today's environment, successful landlords are pivoting to meet residents' changing preferences and recognizing there can be a meaningful return-on-investment for well executed community events.

*(Editor's Note: Pathfinder appreciates the value of resident events and holds a quarterly event at each of our properties. We're big fans of hosted food trucks, holiday costume contests, dog-friendly happy hours and BBQs at our community pools. We believe these events keep our residents engaged and ultimately reduce tenant turnover costs.)*

# TRAILBLAZING: HIAWATHA, SEATTLE, WA

*"In the Center of Culture and Diversity"*

*"Excuse me while I kiss the sky."*

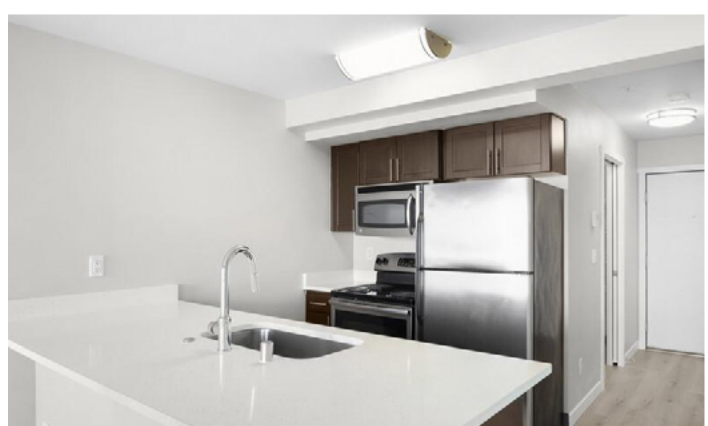
– Jimi Hendrix

Seattle's Central District is a vibrant and diverse residential neighborhood just outside the hustle and bustle of downtown Seattle. Once home to Jimi Hendrix, Bruce Lee and Quincy Jones, the area has rich history in arts and culture. Over the last decade, several apartment projects have been built to accommodate an influx of new residents drawn to the area because of its strong community and proximity to downtown. In 2021, Pathfinder acquired Hiawatha, a 2014-vintage apartment community in the Central District.

Hiawatha is a 112-unit, mid-rise apartment project located two miles east of downtown Seattle. The property lies at the crossroads of major transit lines and freeways (Interstate 5 and Interstate 90), providing residents with easy access to Seattle's employment centers and amenities. To the north of the property is Capitol Hill, a popular neighborhood known for its thriving dining and nightlife scene, and to the south is First Hill, home to three major healthcare facilities – Harborview Medical Center, Swedish Medical Center and Virginia Mason Medical Center.

Hiawatha includes a mix of studio and one-bedroom apartments averaging 584 square feet. The apartments


*Hiawatha – Building Entrance*



*Hiawatha – Renovated Kitchen*

feature modern finishes and fixtures, washers and dryers and oversized windows. Select units offer balconies and skyline views. Residents enjoy secured parking, electric car charging stations, 24-hour package lockers, bike storage, a courtyard community area and two rooftop gathering spaces with views of Mount Rainier and the Seattle skyline.

Pathfinder purchased Hiawatha from a local family who self-managed the property and utilized short-term debt; their business plan was to quickly renovate and reposition the property. Because of delays associated with the pandemic, they were unable to execute their plan and refinance and listed the property for sale.

Hiawatha was 80% occupied when we went under contract in April 2021 and is now 93% occupied. Last year, we repainted the building's exterior and upgraded the common areas with new furniture, a barbeque and outdoor games. We also added value by repurposing the vacant ground-floor commercial space into two additional apartments, a leasing office and a gym. Since acquisition, we have renovated 59 apartments (61%), upgrading the countertops, paint, flooring, lighting and baseboards.

The neighborhood is highly walkable and residents enjoy nearby recreation and entertainment options including Judkins Park (six blocks of grass fields, sport courts and water features), Jimi Hendrix Park, Lumen Field (home to the Seattle Seahawks) and T-Mobile Ballpark (home to the Seattle Mariners) – both about 1.5 miles from the property. At Hiawatha, residents don't have to travel far to enjoy the best of Seattle.

## *Seattle: Did you know?*

Seattle's Downtown Design Review Board recently approved BioMed Realty's Denny Park South, a two-tower high-rise development encompassing over 600,000 square feet of life science and technology. The project will span a full city block (1.6 acres) in the heart of downtown Seattle along Denny Way and Dexter Avenue; less than three miles from Hiawatha.

# NOTABLES AND QUOTABLES

*"Integrity"*

*"Knowing what's right doesn't mean much unless you do what's right."*

- Franklin Roosevelt, *American President*

*"In looking for people to hire, look for three qualities: integrity, intelligence, and energy. And if they don't have the first, the other two will kill you."*

- Warren Buffett, *American Entrepreneur*

*"Integrity without knowledge is weak and useless, and knowledge without integrity is dangerous and dreadful."*

- Samuel Johnson, *English Author*

*"Integrity is doing the right thing when nobody's watching and doing as you say you would do."*

- Roy T. Bennett, *Zimbabwean Author*

*"It is true that integrity alone won't make you a leader, but without integrity you will never be one."*

- Zig Ziglar, *American Author*

*"Nothing is at last sacred but the integrity of your own mind."*

- Ralph Waldo Emerson, *American Author*

*"Whoever is careless with the truth in small matters cannot be trusted with important matters."*

- Albert Einstein, *American Scientist*

*"If you have integrity, nothing else matters. If you don't have integrity, nothing else matters."*

- Harvey MacKay, *American Businessman*

*"I prefer to be true to myself, even at the hazard of incurring the ridicule of others, rather than to be false, and to incur my own abhorrence."*

- Frederick Douglass, *American Social Reformer*

*"I am not bound to win, but I am bound to be true. I am not bound to succeed, but I am bound to live up to what light I have."*

- Abraham Lincoln, *American President*

*"Subtlety may deceive you; integrity never will."*

- Oliver Cromwell, *English Politician*

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