PATHFINDER PARTNERS

Intelligent, Innovative Investing™

THE PATHFINDER REPORT

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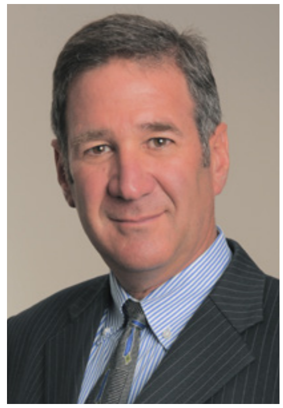
CHARTING THE COURSE

A Fork in the Road for the Fed

By Mitch Siegler, Senior Managing Director



The Federal Reserve has a conundrum. September's Consumer Price Index (CPI) report, which showed that the annual inflation rate had risen to 3.7% in August from 3.2% in July presents the Fed with difficult choices. The path to the left (aka "the rock") has the Fed moving the goalposts, backing off its longstanding 2.0% inflation target, settling for 2.5% or more. The path to the right (aka "the hard place") has the Fed staying true to its pledge to stop at nothing to bring inflation under control. The Fed's primary tool – higher interest rates – adds to the risk that excessive tightening tips the economy into a recession.

The Fed did not raise rates at its recent September meeting, which was widely expected. Futures markets peg the odds of a final 2023 rate hike in November at just under 50%. Many analysts believe the Fed is at or very near the end of its interest rate hikes. The case for inflation continuing to cool through year-end remains strong and we've avoided a recession so far. There's more work to do to slay the inflation dragon and plenty that could still go wrong in this fight. Stated differently, markets could still face unpleasant surprises.

Fed governors have visibility on a gazillion economic data points. Fed policymakers are undoubtedly concerned that the increase in the annualized rate of inflation as measured by the CPI rose more than 10% in just one month (from 3.2% to 3.7%). They also observe that the Core PCE Index (aka Personal Consumption Expenditures Index, which strips out food and energy costs – because who buys those things anyway?) is running even hotter, up 4.3% over a year ago. Interest rate hikes always take time to ripple through the economy, which is why the Fed prefers a slow and steady approach. However, the Fed has played catch-up on inflation for the past 18 months and inflation running well above the Fed's target rate will likely pressure Fed policymakers to "do more".

Some good and not-so-good news.

The Fed has made tremendous progress in beating back inflation, which is down dramatically from its 9.1% peak in June 2022. That said, progress has slowed this year and the current inflation level (3.7% or 4.3%, depending on your preferred measure) is still double the Fed's 2.0% target. Understandably, this remains a serious concern for Fed policymakers and investors.

The consensus among analysts and pundits is that rates will likely remain "higher for longer". Putting today's rates in context, we're at or near the top of the hill after climbing from sea level (0% Fed Funds rate) 18 months ago to 5.25% today. The CME Fedwatch tool, which we've written about previously, suggests even odds of an additional 0.25% rate hike this year with rates trending down in 2024. (The Fed's median projection in June was four 25 basis point reductions in 2024 and that projection following the September meeting is for just one 25 basis point cut next year; there are 100 basis points in a percentage point.)

Below, we'll unpack the current inflation situation but to say that there are lots of moving parts would be an understatement.

Shelter CPI accounted for 90% of the August CPI increase.

Shelter costs were up 7.7% in August compared with a year ago, which reflects a slowing of shelter inflation from the spring, when it peaked at 8.2%. Market indicators, like home prices and rents, have been softening for months and new apartment deliveries this year have led to concessions (four to eight weeks' free rent) in many markets and substantially lower rent growth than in 2022. Additional apartment deliveries in 2024 and 2025 suggest continued softness in rents and cooling shelter inflation as we look ahead.

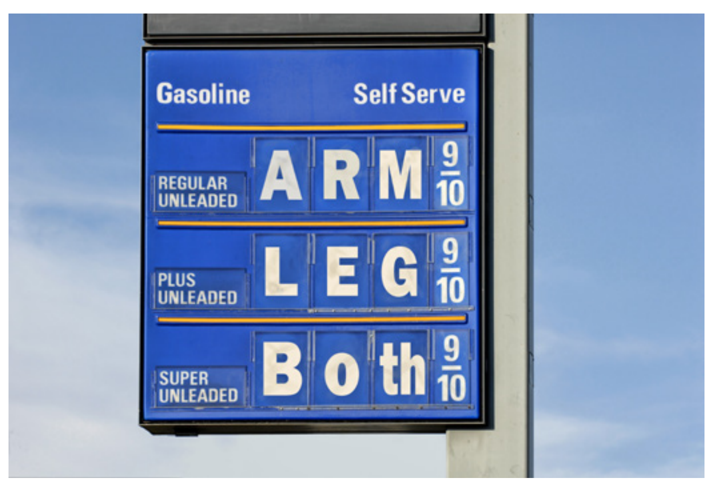
Renters have been the beneficiaries, but prospective homebuyers don't have great options. With the average 30-year fixed mortgage rate knocking on the door of 7.0% (6.94% in August, per Zillow – above 7.25% at press-time), it's challenging to buy a home. That crimps the market for first-time homebuyers and move-up buyers (why sell your current home with a 3% mortgage to "trade up" to a 7% mortgage?).

Gasoline CPI in August ran 10.6%.

After returning from a four-day fact-finding trip in mid-September with several Pathfinder team members to Salt Lake City, Austin and San Antonio, I visited the gas station in California for the first time in two weeks. Sure, premium gas is more expensive but $6.17/gallon, really? The pump prices in Utah and Texas had a "$3" in front of them; that's a conversation for another day. Gasoline prices nationally rose 10.6% in August (per the Bureau of Labor Statistics or BLS) but never fear, gas is excluded from the Core PCE data preferred by the Fed – and higher gas prices affect just the 98% of Americans whose cars are powered by internal combustion engines.

Wage inflation is a major concern.

There were 8.8 million open positions in the U.S. on August 1, according to the BLS. With an unemployment rate of just 3.8%, there aren't enough idle workers to fill those jobs. Already, wage inflation, at 5.3%, is running 40% above the August CPI of 3.7% and a wage-price inflationary spiral is every economist's (and politician's) nightmare.

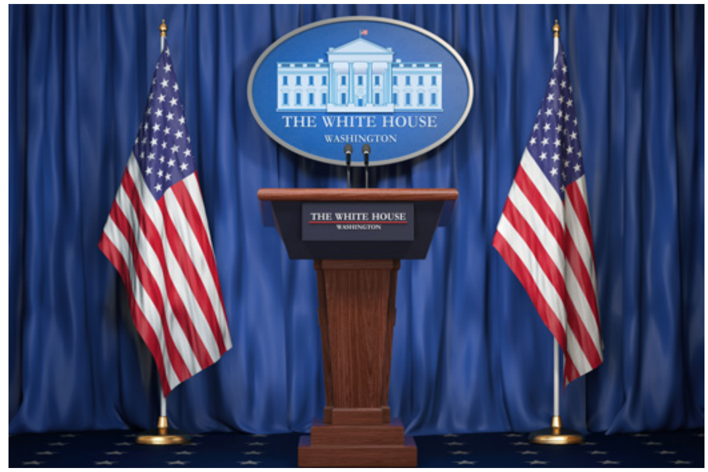


We've all heard stories about restaurants and hotels boosting wages to attract workers. Today, negotiating leverage seems to be squarely on the side of workers. We're also hearing about more labor actions and strikes – at Starbucks, in Hollywood and with the Big Three automakers, among others. Hollywood writers and actors have been on strike for months fearful of the impact of artificial intelligence on their futures. Now, the United Auto Workers has initiated targeted strikes against GM, Ford and Stellantis (which owns Jeep), seeking a 36% pay increase plus cost-of-living adjustments over four years, a 32-hour workweek with overtime, the restoration of retiree health benefits and defined benefit pensions instead of 401(k) plans. Nobody knows how this will end but pricier Big Three labor agreements are unlikely to position these companies to better compete against Tesla and non-union foreign companies like Toyota. As to inflation, higher new and used car prices are a virtual certainty.

The politics of a presidential election year could further pressure the Fed.

As inflation heated up in 2021, the Fed was slow to act, characterizing inflation as "transitory". The Fed reversed course in January 2022 and has been on a quest since then to slay the inflation dragon. A series of 11 interest rate hikes have cooled the economy, particularly the stock market, housing market and corporate and consumer borrowing. Inflation has fallen more than 50% from its peak last summer, but it remains too high.

In theory, the Fed is shielded from political pressure but that's not always how things really work. The Fed's near-term (and easier) decision is whether to hike rates by another 25 basis points this fall or just call it a day,



leaving rates unchanged. The harder Fed decisions will be deciding how long to maintain rates at current levels, when to begin reducing rates and how quickly to let rates fall.

With just over a year before the presidential election, the Fed's already tricky balancing act – between tamping down inflation yet not tipping the economy into recession – is also colored by politics. It's inevitable that the Fed will face mounting pressure to declare victory in its inflation fight, halt further increases and begin the process of easing rates. Nobody complains about a full punchbowl at a party, and many are unhappy when the Fed takes the punchbowl away. The problem with this – and sugar highs generally – is the longer-term cost of giving up the fight before the inflation battle is won could be extremely high.

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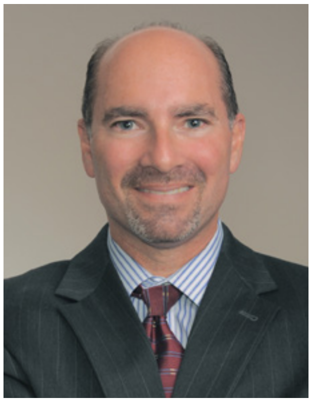
FINDING YOUR PATH

Here We Go Again

By Lorne Polger, Senior Managing Director



The commercial real estate industry is facing some tumultuous times with a slowing economy, higher interest rates, significant reductions in availability of debt and equity capital, potential oversupply of new construction in some markets, and a wall of looming loan maturities. Multifamily, although much better protected than office and retail, is not immune from some of these strong headwinds.

Pathfinder was formed in 2006, in advance of the 2008 Great Recession, with the mindset that the economy was heading into a tailspin, and that chaos would create opportunity. There are enough indicators now for us to believe that problematic real estate situations caused by the referenced headwinds, along with excessive leverage, overly exuberant assumptions, and increased costs of debt, while just beginning to blossom today, will be in full bloom over the next couple of years. As a result, we believe that we'll soon see opportunities for this next cycle of opportunistic investing.

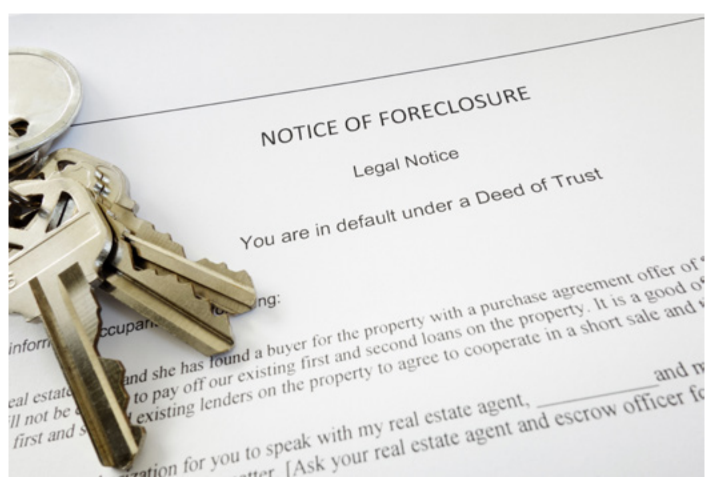
Many Loans Issued in 2020-2022 Mature in 2023-2025 – and the Refinance Environment is Far Less Friendly.

From mid-2020 through mid-2022, a near-zero short-term interest rate environment and an abundance of equity capital created an environment where many multifamily investors overpaid for investments due to the highly competitive market, and then overleveraged their acquisitions to allow them to meet required return thresholds. Assumptions including strong occupancy, high forecasted rent growth and limited supply were used to justify aggressive acquisitions which predominantly used floating rate debt that was often, but not always, hedged with interest rate protection.

Values across all commercial real estate asset classes rose by 27% during 2020 and 2021, and apartment values were up a whopping 31%. While this was great for real estate investors in the short-term, it is not sustainable in the long-term. Historically low interest rates, a strong labor market and supply chain challenges resulted in the highest inflation rate (9.1%) in 40 years by June 2022. Once the Federal Reserve realized inflation was not "transitory", it began a period of significant monetary tightening. The Fed has been adamant that it considers bringing inflation back to 2% as its top priority and will continue its policy of higher interest rates until such time that it believes its goal has been met. It is unclear today whether the Fed has stopped raising rates, or will impose another 25-basis point increase, but it is becoming clearer that higher rates will be here for an extended time.

Commercial real estate developers and investors, particularly those with uncapped floating rate debt, will feel the pressure of rising interest rates, particularly if their loan matures in the next year or two. Today, five-year loans are priced by the agencies in the high 5% to low 6% range, with bank loans in the 7% range. Some borrowers will choose to pay down their debt, whereas in a lower cost-of-capital environment, they would have re-levered. ***Maturity defaults will surely rise; the only question is by how much.*** As of July 2023, multifamily CMBS loans in special servicing remained low at 3.3%, but the rate has been inching up.

As noted in a recent *Globe Street* article, $87 billion of multifamily loans which were originated during 2020-2021 will mature in 2023, another $96 billion will mature in 2024, and another $63 billion in 2025 – that's nearly a quarter trillion dollars in total. Those maturities will occur at a time of significantly higher debt costs than when the loans were originated. And, at a time when lenders are not stretching to make loans.



Those borrowers will likely have four options upon loan maturity. Either conclude a cash in refinance (pay down a portion of the principal balance to right-size the loan for the current loan parameters), pursue some type of loan extension/modification, sell the property and likely take a significant loss, or give the keys back to the lender. Bank and debt fund maturities are heavily concentrated in the 2023 to 2025 period, which is not surprising given that these loans were more likely to be for transitional properties or to finance new construction. In contrast, government sponsored entities (i.e., Fannie Mae and Freddie Mac loans) have maturities concentrated in the second half of the decade and beyond.

Of note, banks are heavily exposed to this market (you didn't think office buildings were their only headache, did you?). According to *Globe Street*, banks made 52% of the loans that will mature by 2025. A recent *Wall Street Journal* article noted that banks roughly doubled their lending to landlords from 2015 to 2022, with small and medium-size banks originating many of these loans. The problem today is that banks are under tremendous pressure to pay depositors a return on their deposits to keep them from fleeing to higher-yielding investment alternatives (at press-time, the yield on 6-month treasuries is 5.53% and bank Certificates of Deposit and money market accounts need to compete). Without inexpensive deposits, banks have less money to lend and to absorb losses from loans that default. As a rule, while banks do not want to take the keys back on any deal, a loan impairment can hurt a bank's capital ratios, potentially leaving them and their borrowers with fewer options.

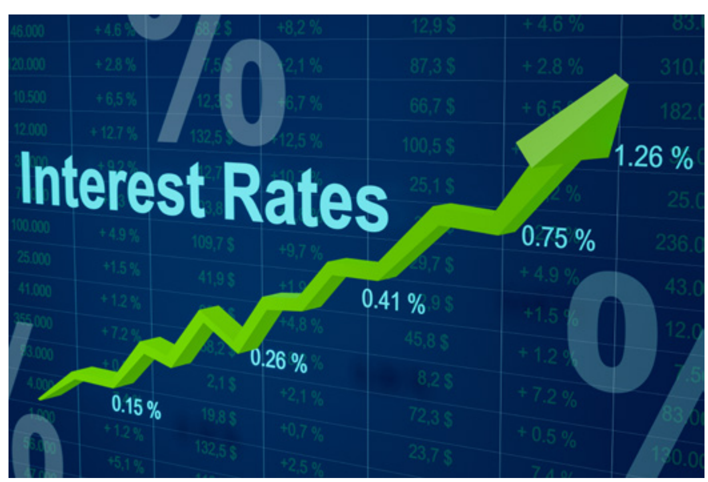
Interest Rates Remain Elevated after Unprecedented Interest Rate Hikes; Floating Rate Borrowers Particularly Impacted

The Federal Reserve's stated objective is to restore price stability by reducing inflation to 2% (core Consumer Price Index (CPI) was far higher, 4.8% in July) and the Fed is willing to accept a higher unemployment, up to 4.5%, in the process. This would translate to total job losses of 1.8 million over the next year, which could be particularly tricky in a presidential election year.

The markets are predicting that rates will begin to decline in 2024 and this view is supported by the Fed's dot plot, a projection mapping out policymakers' expectations for where interest rates could be headed in the future. Fed officials now see the Federal Funds rate slowly coming down to 4.6% (from 5.25%) in 2024 (*Yahoo Finance*). Officials see unemployment rising to 4.1% in 2023, well below the previous 4.5% forecast. Unemployment is expected to tick up to 4.5% next year and remain at that level through 2025. With key measures of inflation still notably hot (particularly core CPI), the Fed is wary of pivoting prematurely and of a double-dip, wherein inflation reaccelerates much like it did in the '70s and '80s.

The Summary of Economic Projections, a consensus of Fed officials' assumptions for monetary policy and economic conditions, showed that most members now expect fewer rates cuts next year as compared to their June estimates. Following this past week's meeting, most officials now expect the Fed's key interest rate to end up somewhere between 4.88% and 5.62% in 2024, versus the previous range of 4.38% and 4.62%. That indicates fewer rate cuts and that rates could remain elevated for longer than previously expected. This would imply that treasuries could drift up through 2023 as these cuts may fail to materialize. ***As a result, we believe interest rates will be higher for longer, negatively impacting the commercial real estate market and more specifically, both borrowers and their lenders with floating rate debt and looming maturities.***

We have begun to see examples, for properties acquired at the peak (2021-2022) with floating rate debt, where cash flow is inadequate to cover elevated debt service and fund capital improvement projects (i.e., cash flow is now inadequate to execute the business plan!). Loan draws for renovations have been suspended by sponsors or their lenders, which will reduce income growth. For newly constructed apartments being delivered in various high supply markets over the next two years (cities like Austin, Salt Lake City and Orlando will see record



deliveries), we believe select projects will experience slower, concessionary lease-ups that fall short of rent projections underwritten two or three years ago in a very different economic environment. In addition, take-out financing from construction loans will be at significantly higher interest rates and lower leverage ratios than anticipated at project inception in 2020-2021. Significant cash infusions will be needed to refinance those loans. This need for additional equity will create opportunities through rescue capital vehicles, forced sales, and in some cases, foreclosures.

The Types of Opportunities We're Forecasting

High Leverage Acquisitions Made in 2021 and 2022

With market rents surging in 2021 and 2022, a record number of apartment investors utilized floating rate debt securitized as commercial loan obligations (CLO) to amplify leverage to 75% or higher to acquire properties at historically low capitalization rates. These loans are most impacted by the Fed's raising short-term rates at a time when rent growth and occupancy rates slow or even fall.

Multifamily rentals accounted for two-thirds of the CLO's issued in 2021 ($30 billion) and 81% of those issued in 2022 ($24 billion), according to real-estate data firm Trepp. In addition, many of the acquisitions were financed with high leverage loans financed by debt funds.

Nearly $88 billion in securitized mortgages are at risk of default, and 42% of them are backed by apartment buildings ($37 billion). Trepp estimates multifamily CLO's originated primarily by debt funds comprise most of these at-risk apartment loans.

Opportunistic acquisitions of properties financed with maturing floating rate debt could remain elevated for an extended period if interest rates remain at or near current levels, requiring additional equity for loan refinances. For floating rate borrowers unable to infuse fresh equity, the only option besides selling at today's depressed prices is to purchase a new interest rate cap that is 8-10 times more expensive than the original to qualify for a short-term loan extension, while also potentially having to infuse additional capital to meet debt service coverage ratios. Not all borrowers will be willing or able to do so.

New Construction Projects

While projects currently under construction are running at record highs, many of these are mid- to high-rise buildings with multi-year construction periods.

Regionally, projects under construction will increase inventory by more than 10% over the next couple of years in several markets including Austin, Charlotte, Denver, Miami-Ft. Lauderdale, Nashville, Raleigh, and Salt Lake City. While permits were also robust in 2022, tighter credit markets will likely slow down projects that have not already secured financing.

We believe there will be significant opportunities to provide rescue capital for newly constructed properties over the next several years. Higher leverage construction loans with aggressive underwriting assumptions will require additional capital due to reductions in available leverage and higher debt service requirements for permanent financing. Many properties may be forced to sell at discounted prices should they not accept rescue capital to fill the gap in their capital stack.

We've been here before. Pathfinder's roots in the distressed investing space run deep. We do not expect to see anywhere near the volume of opportunities that we saw from 2007-2012, but there will be opportunities. Since the beginning of this year, there has been about $50 billion in capital raised for distressed investment along with about $100 billion in existing commercial real estate funds. We will position ourselves and our investors to be able to capitalize on some of these opportunities over the next couple of years.

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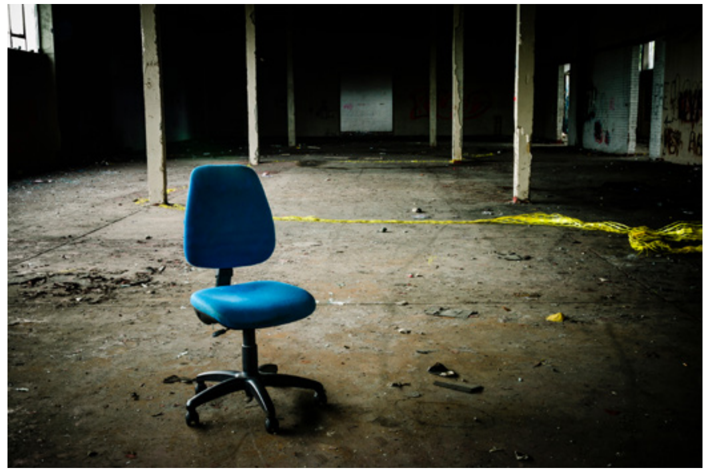
ZEITGEIST – SIGN OF THE TIMES

Which Comes First – Electric Vehicles or Charging Stations?

Electric vehicles (EV), just 2% of the cars on the road in the U.S. today, represented 9% of U.S. car sales over the past two years and almost four in ten Americans (38%) are considering buying an EV as their next vehicle purchase, according to a recent *Pew Research* survey. In April, the Biden administration announced a series of ambitious proposals on auto emissions, the most aggressive of which targets 67% of all car sales to be electric by 2032. In response, some existing apartment communities are installing charging stations to attract residents with an EV and compete with neighboring communities that already offer charging.

In many municipalities, charging stations are a development requirement for new apartment communities. But installing a charging station at existing, older communities can be challenging and expensive. An EV consultant recently priced the installation of commercial charging stations at ten of Pathfinder's larger properties – located in San Diego, Denver, Portland, Phoenix and Sacramento – and the average cost per station was over $21,000 with costs in some communities significantly higher due to required electrical infrastructure upgrades.

The good news for apartment owners is that EV charging stations can generate income via tenant usage fees, although estimating the revenue can be challenging – and the bar is high to pay back a $21,000 initial investment. At communities where charging stations don't exist, most residents won't have an EV,



so installing one requires landlords to assume that (i) some portion of the existing residents will buy an EV and (ii) the community will attract new residents who already own an EV. (Economists dub this the chicken or egg dilemma.) Despite the required leap-of-faith, landlords are increasingly installing EV charging stations in an effort to retain existing tenants, attract future tenants and hopefully, generate some income along the way.

An Update on the Office Sector – It's Still Bad

In 1989, the business guru Peter Drucker, said *"Commuting to office work is obsolete. It is now infinitely easier, cheaper, and faster to do what the 19th century could not do: move information, and with it, office work, to where the people are. The tools to do so are already here: the telephone, two-way video, electronic mail, the fax machine, the personal computer, and so on."*

34 years later, the state of the global office market is a reflection of this prediction. A recent *McKinsey* report estimates that by 2030 there will be an $800 billion loss in office values among the World's nine "superstar" office markets – Beijing, Houston, London, New York City, Paris, Munich, San Francisco, Shanghai, and Tokyo. A 2022 analysis by NYU and Columbia University estimated that U.S. office values could fall 40% (or $453 billion). The decline in values is a result of the rapid increase in the number of hybrid workers, which tripled between March 2020 and January 2023, and *McKinsey* believes the current rate of office attendance could persist.

The decline in office occupancy is also affecting retail sales, especially in central business districts, which will eventually affect tax revenues. In New York City, for example, 24% of the City's 2020 budget came from office and retail property taxes. As both sectors decline, cities may need to reduce services or increase tax rates in an environment where many are already struggling to resolve homelessness, crime and transit issues.

And the bad news? *McKinsey's* $800 billion figure represents a 26% decline in value under a moderate scenario. In the severe scenario, values would drop by 42% ($1,292 billion) and could be worse if compounded by rising interest rates.

TRAILBLAZING: THE FUTURE OF APARTMENT SECURITY

"How AI-Powered Surveillance is Improving Resident Safety"

According to a recent study by the *LR Foundation*, nearly two in five (39%) Americans feel less safe than they did five years ago – up 44% since 2019. Safety has also emerged as a pivotal factor for apartment renters, ranking just behind location on their list of priorities when selecting a place to live.

Apartment owners use various strategies to maintain a safe environment, including gated entrances, security cameras, alarms, patrolling guards and on-site security officers. Each of these measures provides a degree of security and can prevent incidents from occurring; however, all have limitations and drawbacks, and the costs can be quite high.

Controlled gated entrances, if not already in place, can be extremely expensive to install and do not guarantee that trespassers will be kept out. Bad actors can gain access by following behind residents' vehicles or simply climbing over walls or gates. Standard security cameras capture footage of incidents, but this footage is typically only reviewed after the fact and does not prevent the incident from occurring. Alarms are also reactive, requiring a break-in before the alarm company or police are alerted. Patrolling guards conduct property walk-throughs for a few minutes every few hours but miss incidents that occur outside of patrol windows. While 24-hour, on-site security officers can be highly effective, this is rarely economically feasible.

Last year, we identified a new video surveillance service which combines artificial intelligence (AI) with human intervention to offer proactive, real-time security for apartment communities, businesses and homeowners.

AI-Powered Cameras: The system uses AI-powered cameras equipped with night vision, motion detection and object recognition capabilities. These cameras

continuously monitor the property, looking for unusual activity and potential security threats.

Immediate Threat Detection: When the AI detects suspicious activity, such as someone attempting to break into or vandalize a property, it sends an alert to a monitoring center.

Live Intervention: The monitoring center is staffed with trained security agents on standby 24/7. When an alert is triggered, the agents immediately view the live camera feed of the suspicious event.

Two-Way Audio Communication: The agents, many of whom have military or law enforcement backgrounds, can use two-way audio communication through the camera's speaker and microphone to interact with the potential intruder. They can issue warnings, ask questions, sound alarms or notify the intruder that law enforcement has been contacted.

Emergency Response: If a situation escalates, and the intruder doesn't leave or respond to warnings (most incidents are averted once an agent engages verbally with the trespasser), the agent can contact the property manager and local law enforcement to report the incident and provide real-time updates.

Over the past year, we have successfully deployed AI cameras at eight of our properties and are pleased with

the outcome. Our property managers have reported enhanced security, resulting in fewer crimes, and we've received positive feedback from our residents.

Pathfinder staff can also observe the results since the system provides real-time alerts when a guard intervention occurs, and we can also monitor the interaction on our phones. To date, we've observed scores of instances where guard interventions have prevented trespassing, loitering, vandalism or potential intrusions.

We believe that improved security enhances the quality of life at our communities. When tenants feel secure, they are more likely to interact with their neighbors, actively participate in community events and build meaningful social connections. This translates into higher tenant satisfaction and increased retention.

NOTABLES AND QUOTABLES

"Fortitude"

"Patience and fortitude conquer all things."

- Ralph Waldo Emerson, *American Philosopher*

"It's not life that counts but the fortitude you bring into it."

- John Galsworthy, *British Author*

"Success is the sum of small efforts, repeated day in and day out."

- Robert Collier, *American Author*

"The longer I live, the more I think of the quality of fortitude… men who fall, pick themselves up and stumble on, fall again, and are trying to get back up when they die."

- Theodore Roosevelt, *American President*

"Continuous effort – not strength or intelligence – is the key to unlocking our potential."

- Winston Churchill, *Former British Prime Minister*

"Fortitude is the marshal of thought, the armor of the will, and the fort of reason."

- Francis Bacon, *Former British Chancellor*

"The key of persistence opens all doors closed by resistance."

- John Di Lemme, *American Author*

"The man who moves a mountain begins by carrying away small stones."

- Confucius, *Chinese Philosopher*

"I try to view the challenges in my life not as annoyances, but as confirmations of fortitude."

- Oprah Winfrey, *American Businesswoman*

"Fortitude is the guard and support of the other virtues."

- John Locke, *British Philosopher*

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Investing involves risk of loss and you should be prepared to bear investment loss, including loss of original investment. Real estate investments are subject to the risks generally inherent to the ownership of real property and loans, including: uncertainty of cash flow to meet fixed and other obligations; uncertainty in capital markets as it relates to both procurements of equity and debt; adverse changes in local market conditions, population trends, neighborhood values, community conditions, general economic conditions, local employment conditions, interest rates, and real estate tax rates; changes in fiscal policies; changes in applicable laws and regulations (including tax laws); uninsured losses; delays in foreclosure; borrower bankruptcy and related legal expenses; and other risks that are beyond the control of Pathfinder or the General Partner. There can be no assurance of profitable operations because the cost of owning the properties may exceed the income produced, particularly since certain expenses related to real estate and its ownership, such as property taxes, utility costs, maintenance costs and insurance, tend to increase over time and are largely beyond the control of the owner. Moreover, although insurance is expected to be obtained to cover most casualty losses and general liability arising from the properties, no insurance will be available to cover cash deficits from ongoing operations.

Please add msiegler@pathfinderfunds.com to your address book to ensure you keep receiving our notifications.