

Navigating the Commercial Real Estate Landscape

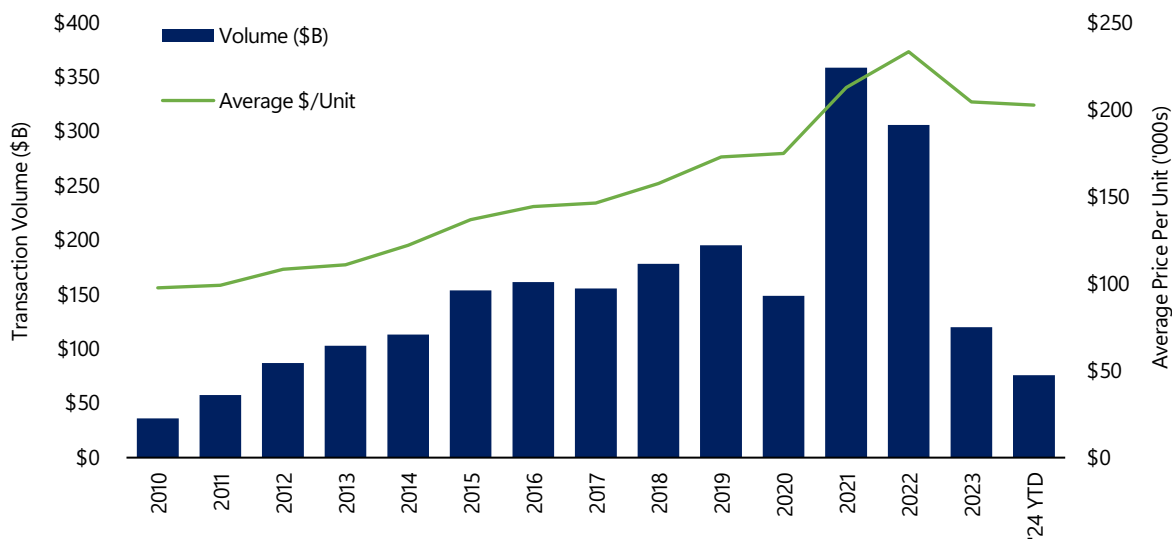


Executive Summary

Since 2019, the U.S. commercial real estate market has undergone significant changes, driven by the COVID-19 pandemic, which accelerated remote work and MSA-specific domestic migration. The Federal Reserve's accommodative interest rate policies spurred multifamily investment and ground-up development, particularly across the Sun Belt markets. The ensuing surge in inflation, however, led the Fed to reverse course and embark on a series of interest rate hikes that drove a repricing of real assets down from peak levels witnessed in 2021-2022⁽¹⁾.

Elevated interest rates suppressed transaction volume in 2023 and YTD 2024, as owners have been reluctant to trade at a loss and have struggled to refinance out of over-levered assets (Exhibit 1). In Q2 2024, multifamily sales volume fell to a four-year low, representing a 28% year-over-year decline and an 88% decline from the peak of transaction volume in Q4 2021⁽¹⁾.

Exhibit 1: Multifamily Transaction Volume⁽¹⁾

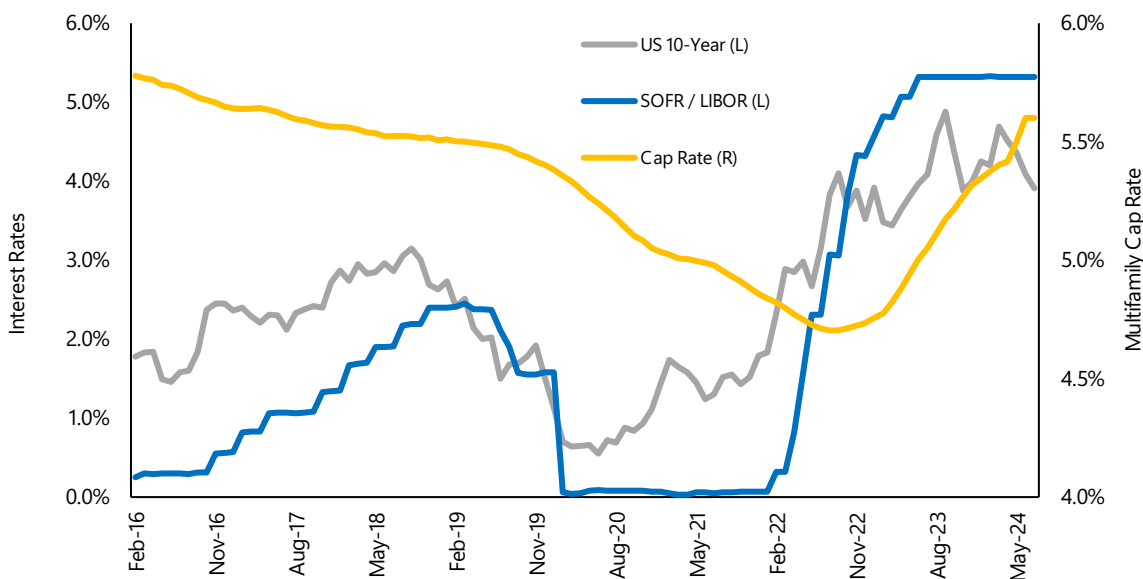


The U.S. multifamily market was not immune to these pressures, which were exacerbated by record deliveries of new apartments. Lenders who originated short-term, floating rate loans prior to the Fed's interest rate hikes have been facing mounting defaults on properties no longer covering debt service. However, many qualified sponsors, dealing with elevated borrowing costs and COVID-era eviction moratoriums, were able to negotiate "amend and extend" loan modifications, which in turn, allowed lenders to avoid confronting these risks head on.

Executive Summary

Prospect Capital Management (“PCM” or “we”) believes that there will be a meaningful rise in commercial real estate transaction activity over the next 18-24 months, as rates decline and markets stabilize. Facing a wave of upcoming loan maturities, banks, mortgage REITs and debt funds continue to retract from the market, as they administer a growing book of non-performing loans (Exhibit 4). Retrenchment from lenders was further exacerbated by the regional banking crisis, following the collapse of Silicon Valley Bank, as higher prevailing rates adversely affected the value of assets on bank balance sheets (Exhibit 2).

Exhibit 2: Cap Rates Have Widened with Rising Interest Rates⁽¹⁾⁽²⁾



These financial conditions left many sponsors facing material funding shortfalls at contractual maturity dates, requiring an injection of additional equity to extend or refinance existing loans on otherwise well-performing multifamily assets. We predict this ongoing dislocation will persist as \$5.7 trillion in commercial mortgages mature through 2029⁽³⁾, but will begin to mend as the Fed embarks on its long-awaited rate cutting cycle.

We believe improving real estate performance will allow the market to find its footing on valuations, narrowing the gap between buyer and seller expectations, and facilitating transaction activity. We believe an opportunity lies in providing gap financing into funding shortfalls on strong multifamily properties, at a defensible basis with equity subordination.

Market Opportunity

Banks have traditionally held the dominant position in the commercial real estate lending market (Exhibit 3), but exposure to troubled office loans, devalued Treasury holdings, depositor liquidity concerns, and regulatory scrutiny has diminished their lending capacity⁽¹⁾. Ongoing uncertainty in an elevated interest rate environment relegated many lenders and buyers to the sidelines, across asset classes, aggravating the refinancing challenge in the U.S. real estate market today (Exhibit 4).

Exhibit 3: Banks Represent the Majority of Maturities⁽¹⁾

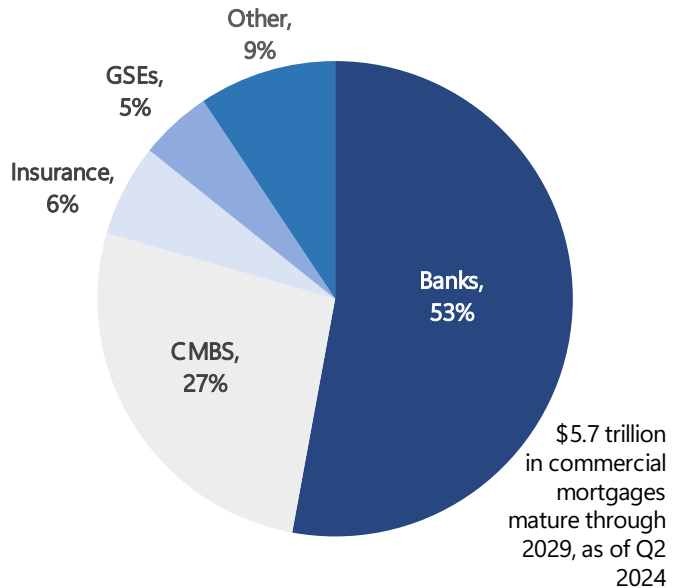
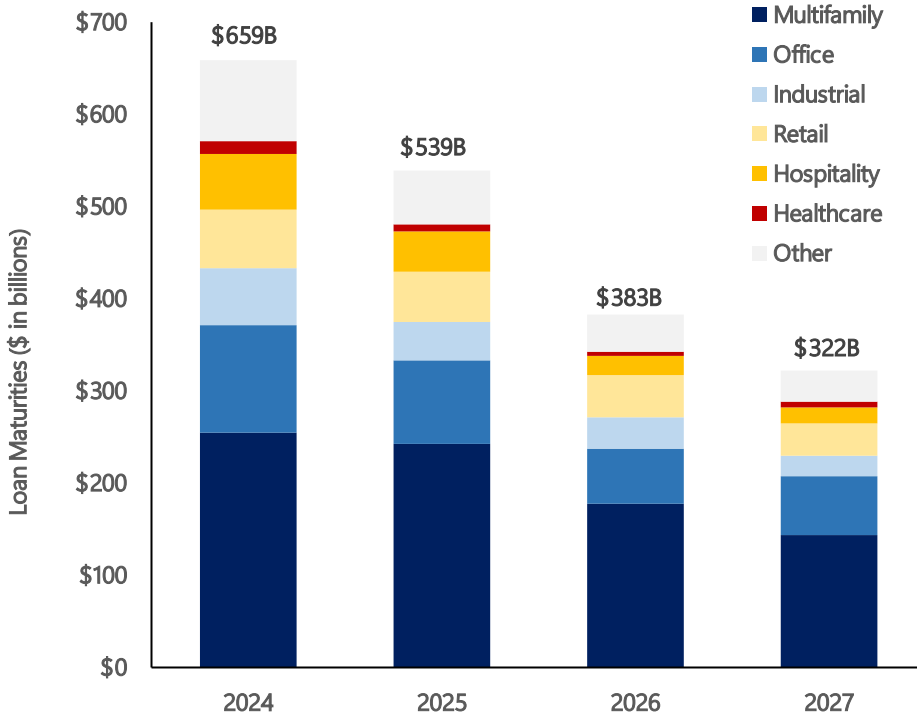


Exhibit 4: Mortgage Maturities by CRE Asset Class⁽²⁾

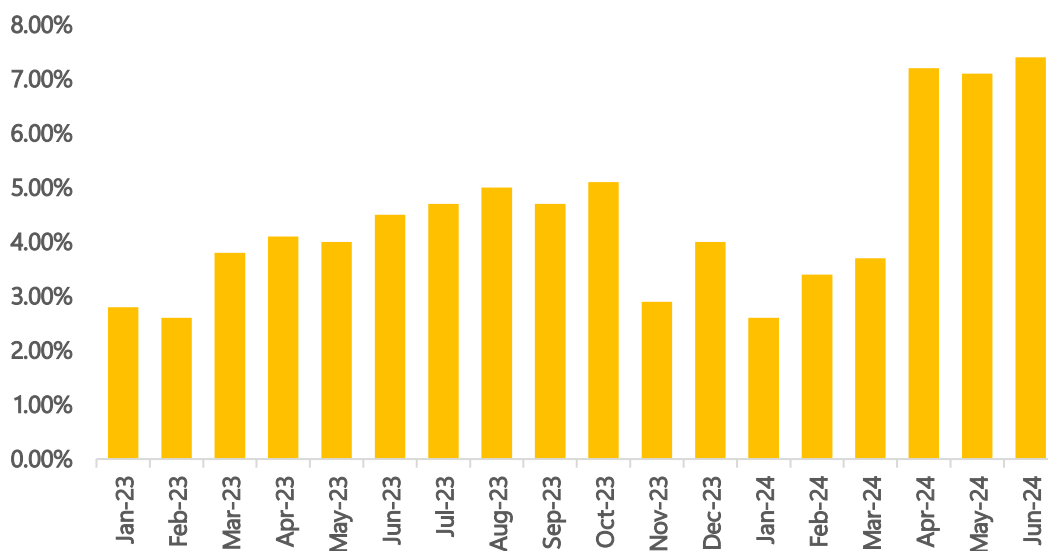


Announcing “the time has come for policy to adjust,” Chairman of the Federal Reserve Jerome Powell marked an end to the Fed’s historic inflation-fighting campaign in August 2024, paving the way for rate cuts to begin. In September, the Fed delivered a 0.50% rate cut, a largely anticipated but welcomed measure by property owners.

Market Opportunity

Property owners who took on floating rate loans when SOFR hovered just above zero percent not only acquired properties at peak valuations, but were tied to short duration, 3-year initial loan maturities. As the Fed raised interest rates, SOFR climbed from 0.05% to 5.30% in the 18 months leading up to August 2023 (Exhibit 2), depressing valuations and constraining debt service coverage ratios. Floating rate loans typically require borrowers to purchase interest rate caps that limit exposure to rising rates. To save on costs, however, many borrowers purchased rate caps for shorter durations than the initial 3-year loan terms and at strike prices that did not afford them sufficient protection⁽¹⁾.

Exhibit 5: Multifamily CMBS Distress Rates⁽²⁾

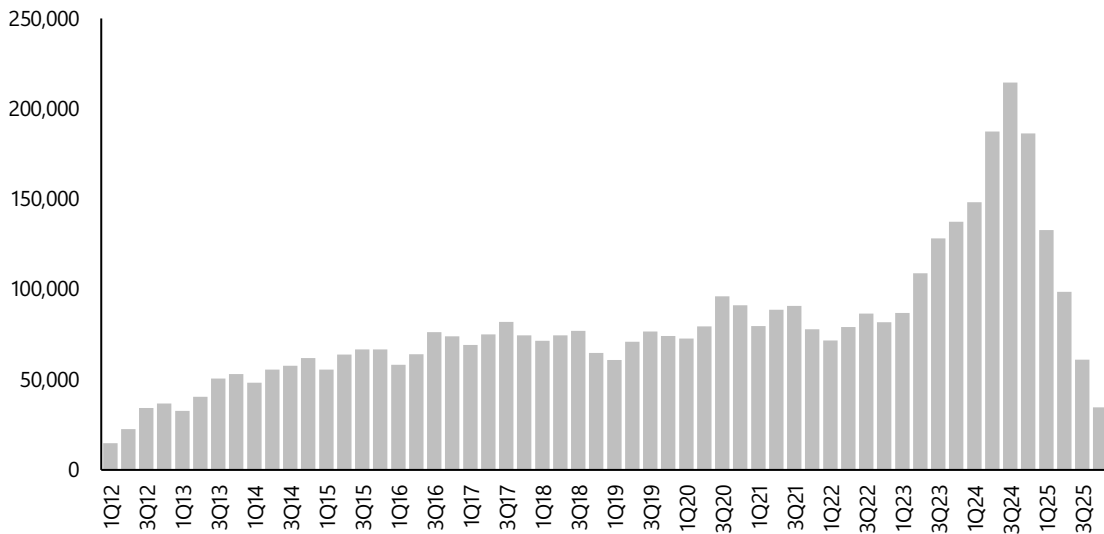


Facing deteriorating debt serviceability, declining valuations, diminished capital markets liquidity and a shortfall in refinancing proceeds, an increasing number of borrowers have been forced into monetary defaults (Exhibit 5), despite strong property-level fundamentals. Lenders have been taking back properties from under-capitalized borrowers while providing well-positioned sponsors with extensions, allowing the latter group to execute a sale or refinancing in a more favorable environment. Although “extend and pretend” continues to pervade the market, we view the Fed’s inauguration of its rate cutting cycle as the primary condition precedent for unlocking transaction activity in the market.

Improving Multifamily Fundamentals

We believe that fundamentals across the U.S. multifamily market are showing signs of improvement, providing additional support for valuations to begin to reverse course. With property values down from peak levels and above trough cap rates⁽¹⁾, we believe there is an opportunity to invest in multifamily assets at a cyclical low.

Exhibit 6: Multifamily Unit Deliveries Expected to Decline Through 2025⁽¹⁾

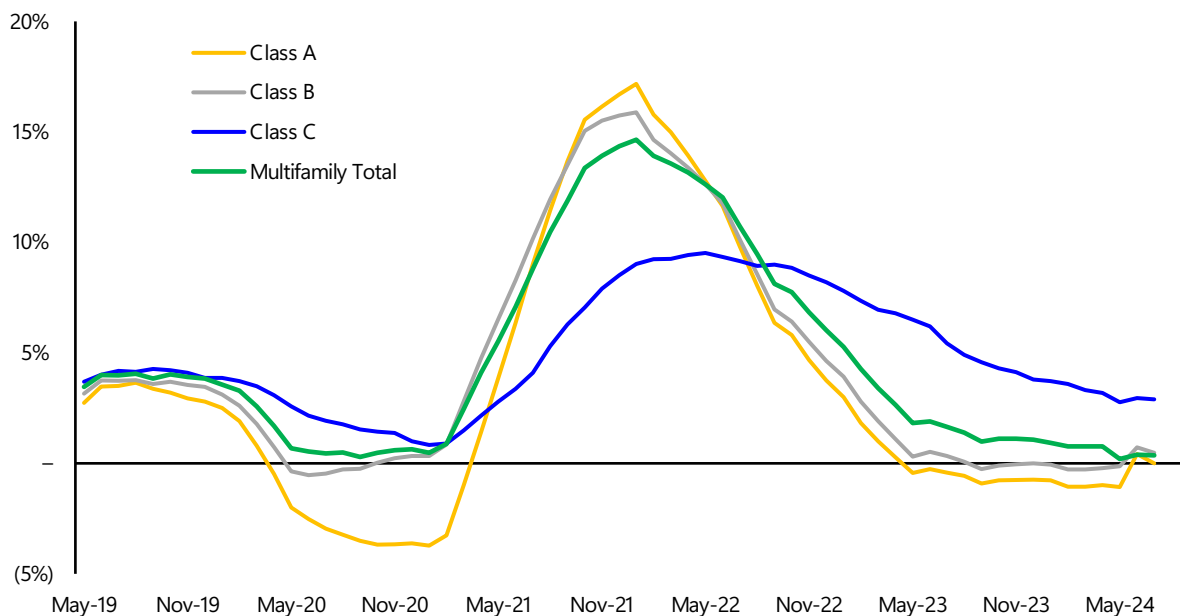


Despite record numbers of multifamily units delivered in 2023 and 2024, new supply is forecasted to decline significantly thereafter (Exhibit 6). We believe that increased borrowing costs, a retrenchment in activity from lenders, and elevated materials, labor and insurance costs have largely extinguished proposed development activity in the pipeline. Newly-constructed properties trading below replacement cost create a significant disincentive for developers to pursue new projects. We believe that this curtailment of supply will support the long-term strength of the multifamily market once existing units under construction are delivered and successfully stabilized.

Improving Multifamily Fundamentals

After declining rapidly from the peak witnessed during the pandemic, rental growth rates have been similarly finding a floor of support and appear to be approaching an inflection point (Exhibit 7). As deliveries of new multifamily properties are absorbed by the market, we expect rental growth rates will begin to improve, underpinned by the 5.5-million-unit structural housing undersupply in the U.S.⁽¹⁾

Exhibit 7: Multifamily Rent Growth Stabilizing⁽²⁾



A record number of Americans are priced out of homeownership. Home-buying affordability is at its lowest level since 1985 and the spread between the median monthly payment for homeownership vs. renting is currently \$994 a month⁽¹⁾, a 3.0x increase compared to pre-pandemic levels. In our view, disproportionate home price appreciation, lagging personal savings rates, and high student debt are burdening the next cohort of would-be home buyers.

Historical Multifamily Outperformance

Multifamily has traditionally outperformed other asset classes through economic cycles as shelter costs exhibit less elasticity versus discretionary spending⁽¹⁾. Additionally, multifamily rent growth has historically outpaced CPI, demonstrating the ability of the asset class to perform as a long-run hedge against inflation (Exhibit 8).

Multifamily has also historically outperformed other commercial real estate asset classes, generating a 9.6% annual return between March 1978 and June 2024⁽¹⁾. Multifamily also compares favorably from a long-run, risk-adjusted return standpoint as demonstrated by a Sharpe Ratio of 1.03x versus the Barclays US Aggregate Bond Index at 0.41x and the S&P 500 at 0.30x between December 1999 to June 2024 (Exhibit 9).

Exhibit 8: Multifamily Rent Growth vs. CPI (since 2005)⁽²⁾

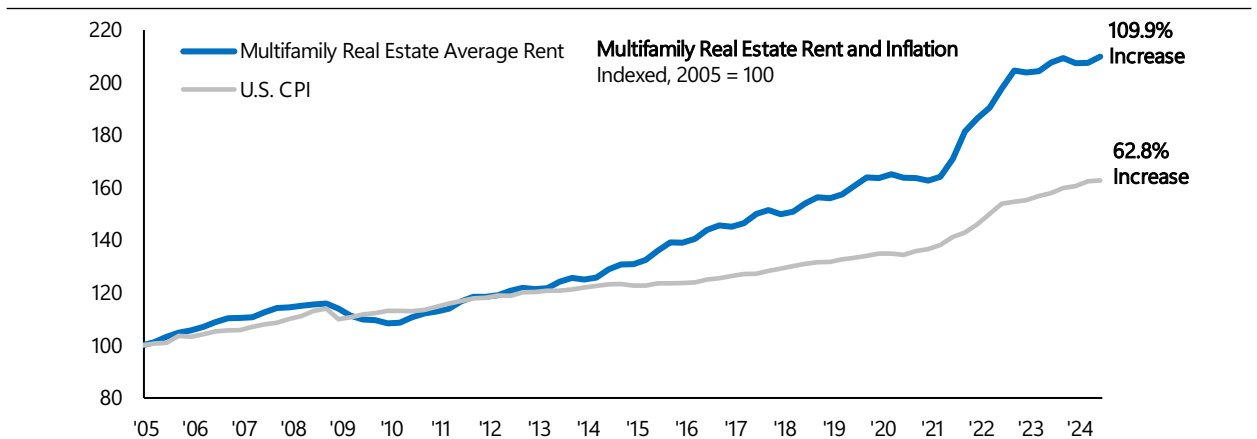
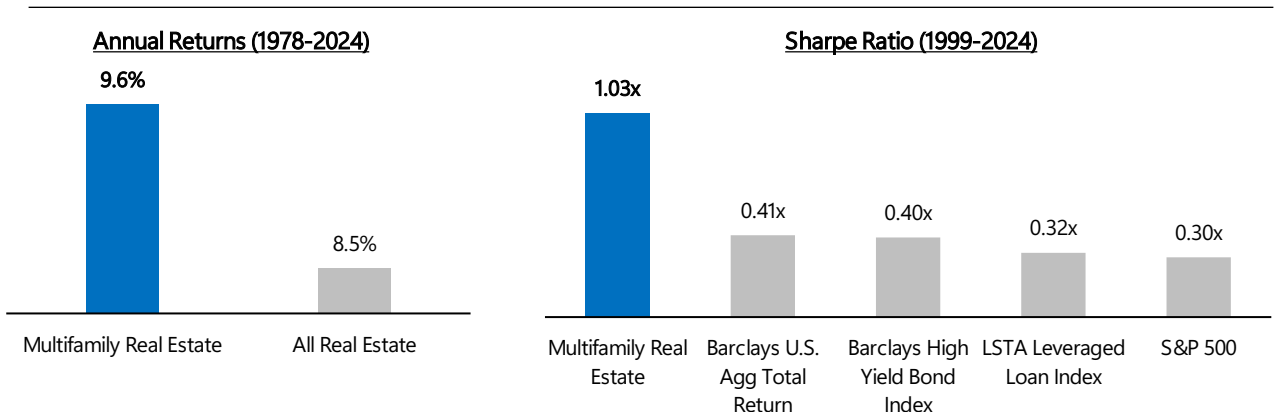


Exhibit 9: Historical Annual Returns & Sharpe Ratio⁽¹⁾



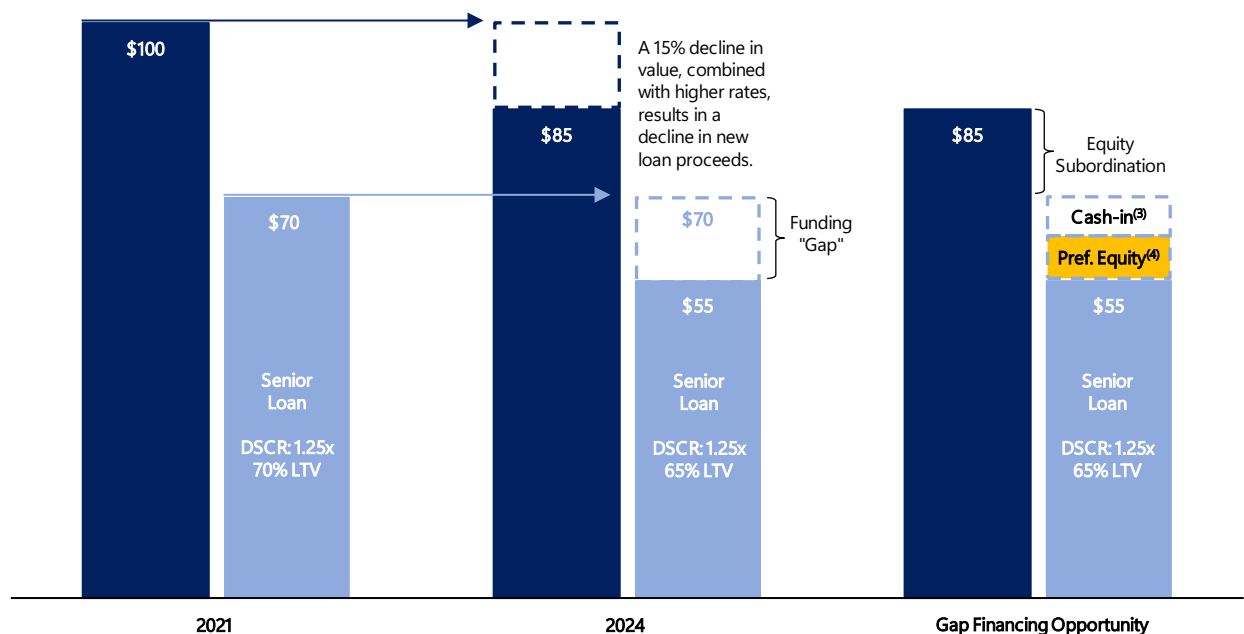
Sources: (1) Bloomberg & NCREIF Indices: Annual returns calculated using quarterly data since inception on Mar. 31, 1978, to June 30, 2024. Historical Sharpe ratio and portfolio return analysis calculated using quarterly data from Dec. 31, 1999, to June 30, 2024; (2) Bureau of Labor Statistics Economic Data and Axiometrics, as of Mar. 2024.

'Gap' Financing Opportunity

As property valuations have declined in tandem with interest rate hikes, property owners have been faced with the inability to refinance out of existing loans. Confronted by higher borrowing costs and lower refinancing proceeds, sponsors are faced with the need to contribute significant additional equity into "cash-in" refinancings.

Due to lower asset valuations, even the most well-positioned sponsors are forced to weigh the decision to contribute additional cash or sell in an unfavorable environment (Exhibit 10). We believe funding this "gap" in the form of a preferred equity investment or mezzanine loan on well-performing multifamily assets, in conjunction with a cash-in contribution from the sponsor, presents an attractive risk-adjusted opportunity for investors.

Exhibit 10: 'Gap' Financing Opportunity: Illustrative Capital Structure: 2021 vs. 2024



Notes:

- (1) 2021 assumes a 4.25% cap rate and 4.9% loan constant (interest + principal);
- (2) 2024 assumes a 5.75% cap rate and 7.1% loan constant (interest + principal), plus 15% cumulative NOI growth;
- (3) Incremental sponsor equity cash-in at closing;
- (4) Preferred equity investment at 80% loan-to-value (LTV) with 20% sponsor equity subordination at a reset valuation (down 15%).

Conclusion

With the announcement of the Fed's first rate cut of 0.50% in September 2024, we believe that commercial real estate transaction activity will rebound heading into 2025. The ability to lend on commercial properties at reset valuations with equity subordination presents a favorable investment opportunity, particularly in the multifamily sector in which fundamentals are strengthening.

Disclosures

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