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"Predicting rain doesn't count. Building Arks does."

-- *Warren Buffett, The Oracle of Omaha*

Economy Still Humming, But Interest Rate Risks Grow

Economy Strong, But High Asset Prices and Rising Interest Rates Cause Risk to Grow. On Wednesday June 13, The Federal Open Market Committee (FOMC) raised the Federal Funds interest rate for the 7th time (their initial raise was December 2015). Commentary suggests we should expect four rate hikes this year, up one raise from previous expectations of three hikes, and with two more hikes this year left to go. While overall interest rates are still low by historical measures, and the economy is humming right along, four hikes in a year and nine hikes off the bottom (current expectations) is a lot of hikes!! It may be too much, or it may be appropriate, but certainly raising the Federal Funds rate this much this fast, while slowly selling off its balance sheet assets, does increase risks to equities, bond prices, commercial real estate, and pretty much all (currently very expensive-to-overpriced) asset classes.

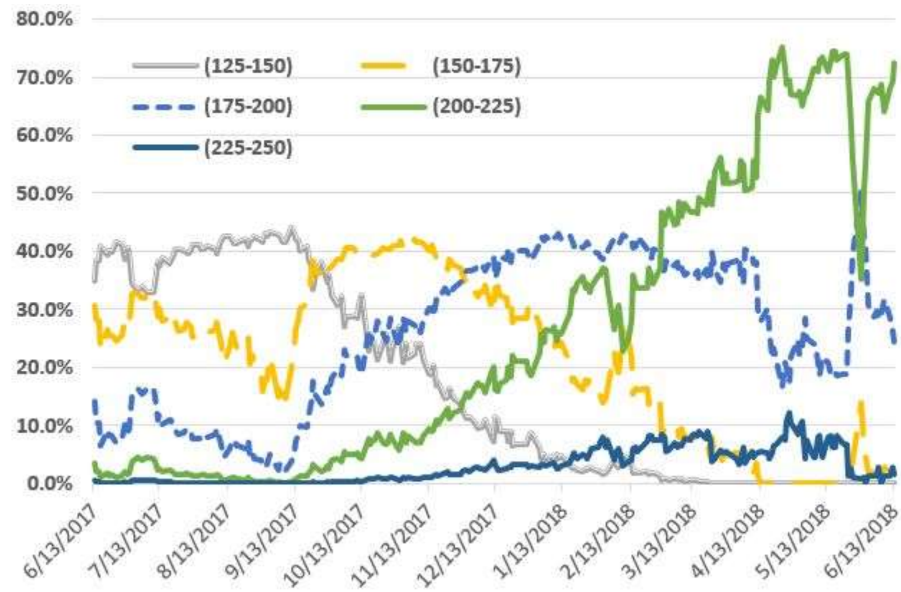
Higher Interest Rates Coming. Looking below we see that market expectations for more interest rate hikes continue to grow. Most of this data is today versus one month ago, but if you look at expectations for the first meeting (September 26, 2018), I am showing expectations versus seven months ago in mid-November 2017. This is quite telling. Today, the market is pricing in an 84.3% probability that Fed Fund rates will be 200-225 bps or higher for September 2018, whereas in November 2017 there was only a 9.2% chance that interest rates would be at this level. Back then, there was a full 62.6% probability that rates would be lower than they are right now! Market expectations for Fed Fund rates have moved up by 50bps-75bps in just seven months! When I see this I can't help but ask myself why multifamily and hotel cap-rates haven't moved up in lockstep?

Figure 1. Fed Fund Market Expectations Have Grown Materially in 7 Months

	Sep 26, 2018 Meeting			Nov 8, 2018 Meeting		Dec 19, 2018 Meeting		Jan 30, 2019 Meeting	
	Today	One Month Ago	11/12/2017	Today	One Month Ago	Today	One Month Ago	Today	One Month Ago
< 175-200 bps			62.6%						
175-200 bps (current)	15.7%	20.7%	28.2%	12.6%	18.6%	4.6%	9.0%	4.0%	8.0%
200-225 bps	82.6%	71.0%	8.2%	81.2%	65.7%	37.5%	41.4%	33.6%	37.9%
225-250 bps	1.7%	8.1%	1.0%	6.1%	5.4%	53.9%	41.0%	52.0%	41.1%
250-275 bps		0.2%	0.0%	0.1%	0.0%	3.9%	8.1%	9.8%	11.6%
275-300 bps						0.1%	0.6%	0.5%	1.4%
	There is an 84.3% probability of at least one rate hike versus a 79.3% probability one month ago; **Note in Nov'17 there was a 63% probability that Fed Fund Rates would less than they are today, and there was only a 9.2% probability that rates would be at 225-250 bps or higher (versus a full 84.3% probability of this now). Net, rate expectations have climbed 50 bps in 7 months.**			There is an 87.4% probability of at least one rate hike versus a 71.1% probability one month ago.		There is a 57.9% probability of at least TWO rate hikes versus a 49.7% probability one month ago.		There is a 62.3% probability of at least TWO rate hikes versus a 54.1% probability one month ago.	

Source: Avid Realty Partners, www.CMEGroup.com

Figure 2. Probability Trends for Sep'18 Fed Meeting Show Rising Rate Expectations



Source: Avid Realty Partners, www.CMEGroup.com

Higher Interest Rates Directly Impact Cap-Rates and Asset Prices. In the chart below we see that multifamily cap-rates generally track with 10-year treasury rates, give or take, and thus higher interest rates should eventually lead to higher cap-rates and lower asset prices. What we also see below is that the spread between multifamily cap-rates and 10-year treasuries are essentially at a 10-year low, tied with a couple quarters of lows seen in 2011 and 2008. Thus, multifamily apartment cash flow yields are essentially at 10-year lows as slightly higher mortgage rates combined with higher asset prices squeeze cash-on-cash equity yields.

Figure 3. Multifamily Cap-Rate versus Treasury Rate Spreads are at 10-Year Lows

Source: Avid Realty Partners, NKF Research, Real Capital Analytics

Deal IRRs Depend on Getting a Good and Predictable Sales Price (Cap-Rate) at Exit. Below, we see that Multifamily (or any CRE asset) deal level IRRs are impacted dramatically by assumed sales prices, as measured by exit cap-rate. I typically underwrite apartment deal exits higher than today's entry prices by 50-100 bps, but is that enough? Are others planning this way as well? Assuming a six-year hold period on a multifamily asset, per below, a 6.0-cap rate at exit drives a 19.8% internal rate of return, while 200bps of bad news versus this assumption -- an 8.0-cap rate at exit -- would drive IRRs down to only 9.0%. This is barely enough to cover most investors' preferred interest rate and surely would drive some disappointment among both sponsors and investors. Net, interest rates drive cap-rates, and a mis-assumed exit price can and will have big impacts on deal level returns.

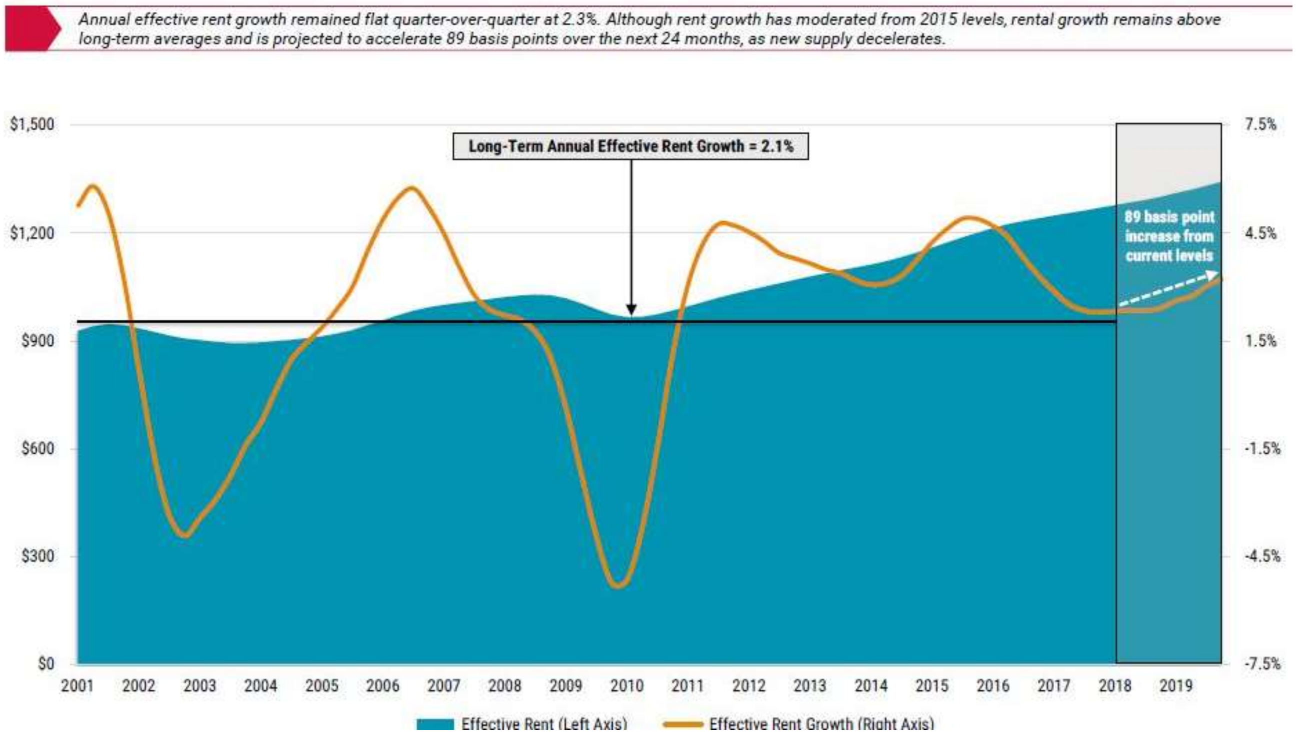
Figure 4. Multifamily Exit Cap-Rate Moves Have a Big Impact on Deal Level IRRs

Assumed Multifamily Deal Exit Cap-Rate							
Exit Cap-Rate	5.5%	6.0%	6.5%	7.0%	7.5%	8.0%	8.5%
Project IRR	22.7%	19.8%	17.0%	14.3%	11.7%	9.0%	6.4%

Source: Avid Realty Partners

But, Apartment and Hotel Fundamentals Remain Strong. As a buyer of commercial realty assets like multifamily apartments and hotels, it gets frustrating that interest rates keep going up, cap-rates *should* increase in lock-step (but haven't yet), and asset prices *should* decline to levels where project-level IRRs make sense to buy at. But, it seems the overall economy, and underlying trends in apartment and hotel assets, remain too strong to yet deter buyers off of current price levels. In apartments, vacancy rates remain below long-term averages, even as new construction driven supply grows. One major driver here is that more people are choosing a 'renting' lifestyle (mobile, not tied down, flexible, sharing economy, and/or affordability reasons) versus a stodgier old-world 'owning' lifestyle. This is confirmed with the substantial drop on home ownership rates over the past 10-15 years (though this drop appears to be bottoming out now). Rental rates have largely absorbed increases in supply and, in strong growth markets like Dallas, continue to rise meaningfully. In the graph below, we see that national average rental rates have grown from about $925 in the recession-driven lows of 2010 to about $1300 now, an almost 50% rise in eight years! No wonder REITs and other institutional buyers haven't stopped buying yet...their returns have been too good to quit!

Figure 5. Even with New Construction Supply, Multifamily Rents are Still +2.3% YOY



Source: Avid Realty Partners, NKF Research, Axiometrics

Figure 6. Hotel RevPAR Growing in 2018 (Despite Supply), and Should Grow in 2019

REVPAR FORECASTS

Luxury Growth
PwC Forecast as of May 2018

	2018	2019
Occ	1.0%	-0.8%
ADR	3.8%	4.0%
RevPAR	4.8%	3.1%

Upper Upscale Growth
PwC Forecast as of May 2018

	2018	2019
Occ	0.1%	-0.5%
ADR	1.4%	1.6%
RevPAR	1.4%	1.0%

Upscale Growth
PwC Forecast as of May 2018

	2018	2019
Occ	0.2%	-1.4%
ADR	1.7%	2.1%
RevPAR	1.9%	0.7%

Upper Midscale Growth
PwC Forecast as of May 2018

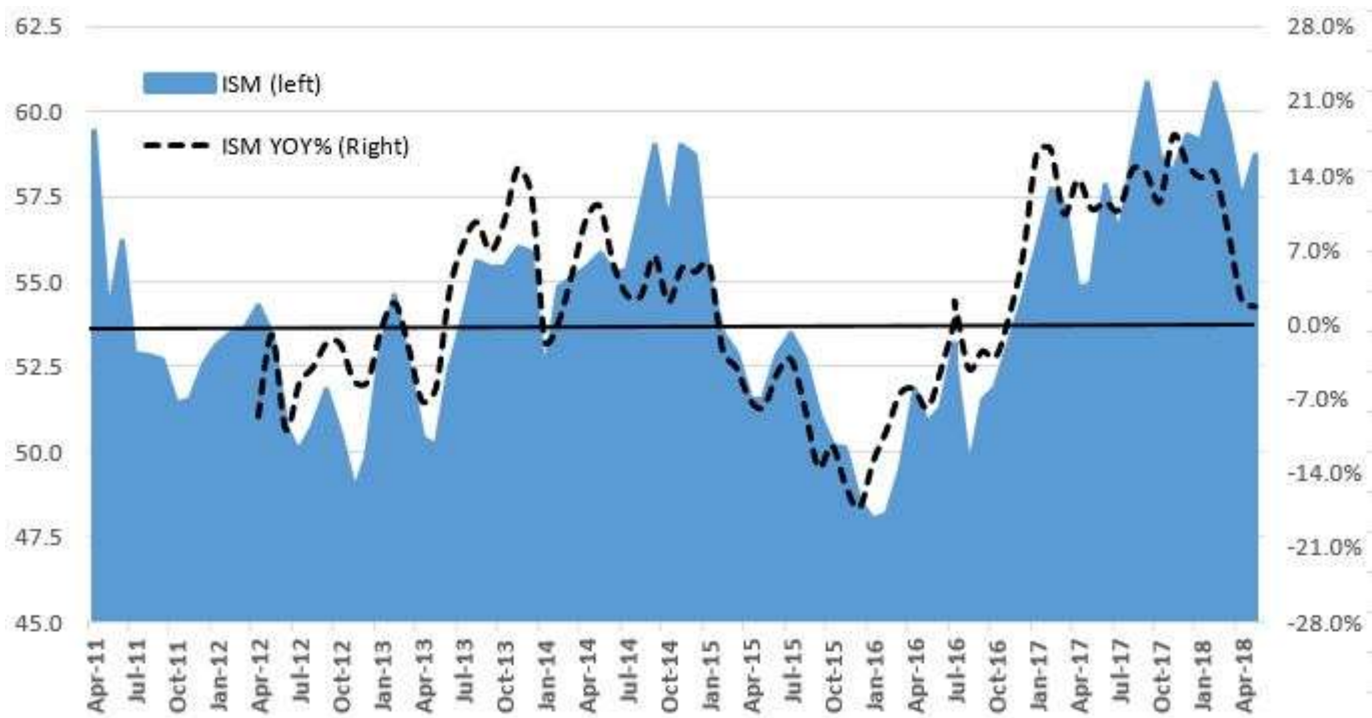
	2018	2019
Occ	0.7%	-0.5%
ADR	2.0%	2.3%
RevPAR	2.7%	1.8%

Source: PwC Hospitality Direction (May 2018)
https://www.pwc.com/us/en/hospitality-and-leisure/assets/pwc-hospitality-directions-us-june-2018.pdf

Source: Avid Realty Partners, PWC

And, the Economy is Robust, Employment Trends Strong, and ISM Report Suggest More Good Times Ahead. We have all seen reports that published US unemployment is essentially at all-time low levels and wages are rising solidly (just don't mention the under-employed workers and those that stop looking for jobs and fall out of the unemployment denominator all together). And ISM new orders data, one of the best leading indicators of future economic activity, is also very strong. These factors suggest continued economic expansion, at least for now.

Figure 7. ISM Data is Very Strong, Suggesting Continued Economic Strength Ahead



Source: Avid Realty Partners, Institute of Supply Management

Net, net, the Push/Pull of a Strong US Economy, Strong Asset Performance, and Rising Interest Rates makes Apartment and Hotel Assets Buyable, but with Growing Risks. So, our view is that the U.S. economy is humming right along and we have this push-pull dynamic of a strong economy, strong apartment & hotel fundamentals with rising rental rates, and yet rising interest rates that haven't yet cooled asset prices. So, we are still buying new properties at this time, but are doing so carefully, staying diligent on the prices we are willing to pay, and are underwriting exits at solidly higher cap-rate assumptions to guard against future rate moves and asset price declines.

We Seek Off-Market Deals

Let us know if you are looking to sell any of your Multifamily or Hospitality assets. We will underwrite the asset fairly quickly and can give you a fair price, while allowing for a quiet and easy exit.

Investors are Welcome to Reach Out

We are always working on our next deal, and continuously seek well-capitalized Equity partners to work with as Limited Partners, or even on a co-JV basis. We are open to deal structure and seek the most strategic partners that we can find as we carefully build and scale our portfolio further. We focus on creating tremendous Customer Experiences, realizing solid cash-on-cash yields, and managing risk at all levels of the Project and throughout our organization. Please Contact Us Here if you are interested in discussing this further.

About Avid Realty Partners

At Avid Realty Partners our passion is owning Multifamily Apartments and Hotels that deliver the best possible Customer Experience, while generating robust risk-managed returns to our investors. In Multifamily apartments, we focus on Class B/C value-add properties in growth markets around the country where we proudly bring enhanced unit upgrades and property renovations to our Residents, improving their Quality of Life metrics. In Hotels, we build or buy properties that deliver everything that our Guests deserve, and more than they expect. We are proud of the hard work and results that our Team delivers everyday on behalf of our Customers and our Investors.

Avid Realty Partners

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