Q4 2022

THE POTENTIAL IMPACT OF RISING INTEREST RATES ON MULTIFAMILY INVESTMENTS

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CONTENTS

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INTRODUCTION

Interest rates have increased for the first time in four years, but multifamily assets may still be positioned to thrive.

Before this year, the Federal Reserve ("the Fed") had not increased interest rates since 2018. Then, in March 2022, the Fed bumped up interest rates by 25 basis points, followed by another increase of 50 basis points in May.[1] In its self-proclaimed "unconditional war on inflation", the Fed then increased its benchmark interest rate by another 75 basis points in June, July and September, the highest increases since 1994.[1] With the Fed indicating additional hikes are on the horizon, some turbulence in the market may be expected. We believe certain investors, however, who are able to take advantage of the market's opportunities may still achieve significant growth this year.

THE GOAL OF FED RATE HIKES IS TO CURB DEMAND BY INCREASING BORROWING COSTS

AFTER THE LARGEST RATE INCREASE IN ALMOST 30 YEARS, THE FED HAS INDICATED MORE HIKES ARE LIKELY

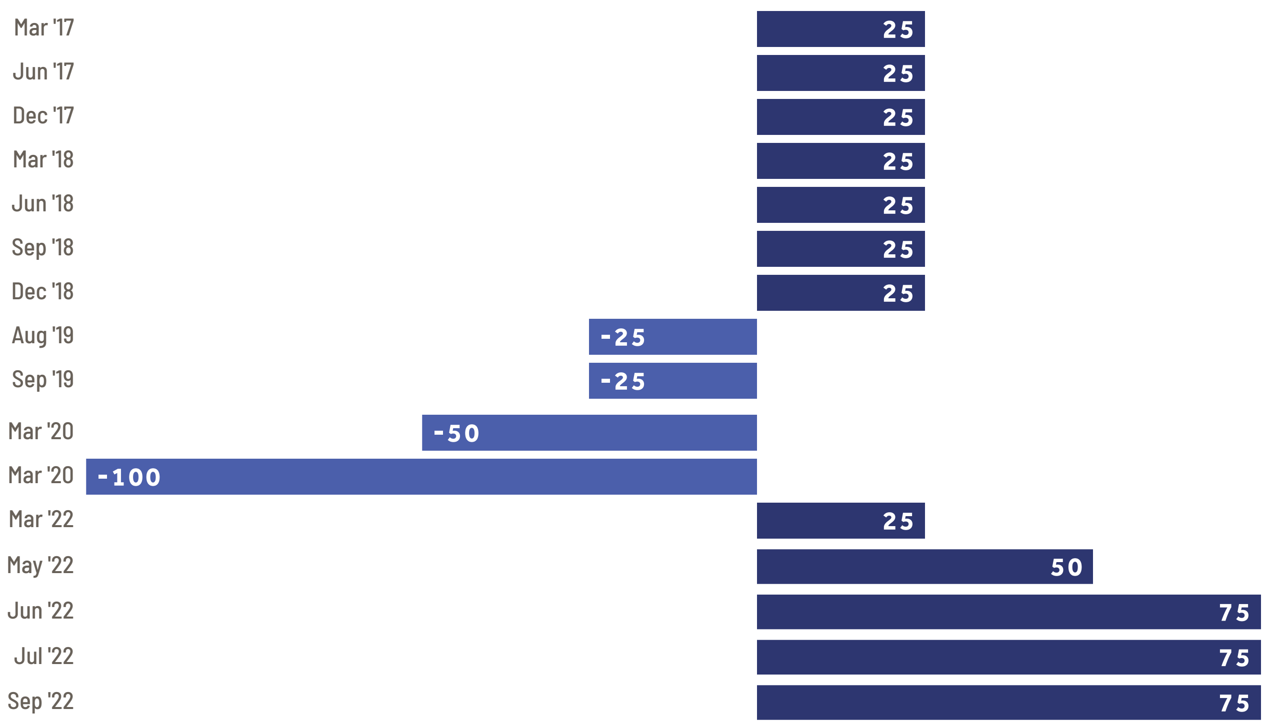
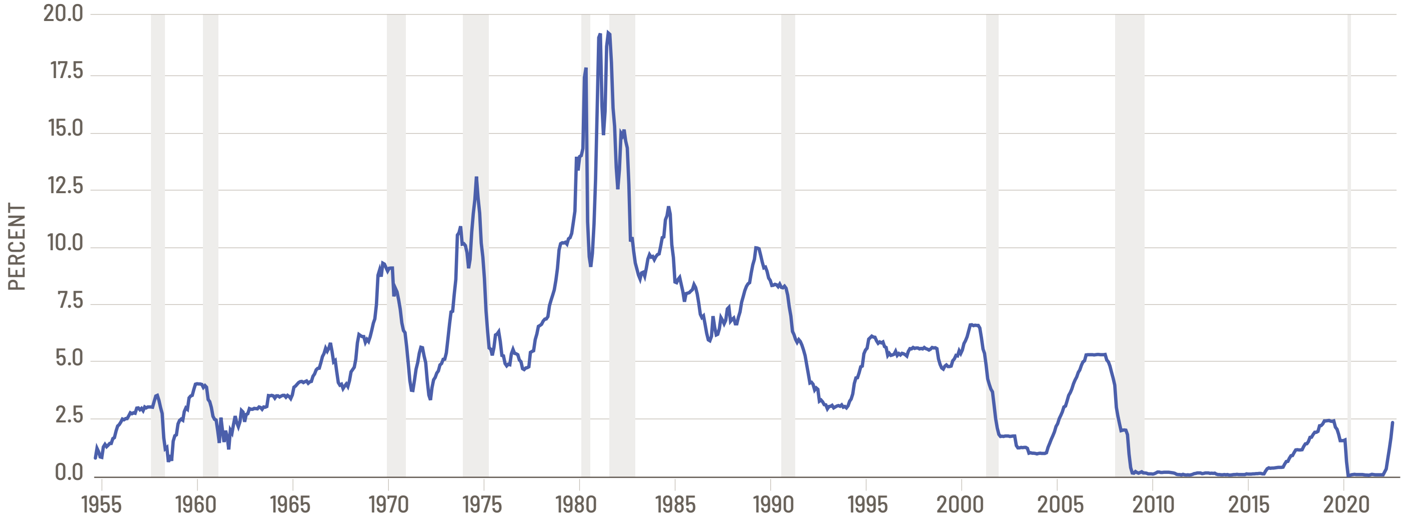


Chart source: bankrate.com/banking/federal-reserve/history-of-federal-funds-rate/

1. CNBC, "Fed Hikes Its Benchmark Interest Rate by 0.75 Percentage Point, the Biggest Increase Since 1994." June 16, 2022.

UNDERSTANDING INTEREST RATES

FEDERAL FUNDS EFFECTIVE RATE



Shaded areas indicate U.S. recessions. Chart source: https://fred.stlouisfed.org/series/FEDFUNDS#

Generally, when people speak of the Fed raising interest rates, they mean the federal funds rate. The federal funds rate refers to the target interest rate set by the Federal Open Markets Committee (FOMC), the policymaking body of the Federal Reserve System. This target interest rate is the rate at which commercial banks lend and borrow excess reserves to each other on an overnight basis.

The FOMC meets eight times a year to determine the federal funds rate as part of its monetary policy and makes adjustments based on key economic indicators which may show signs of inflation, recession or other potential issues. The federal funds rate has varied throughout the years, from 0% during the recent pandemic to 20% in the early 1980s.

Additionally, the Fed also establishes the discount rate, which is the interest rate the Fed charges other banks to borrow from it directly. In order to encourage banks to borrow from each other, the discount rate is usually higher than the federal funds rate. Based on these rates, each bank decides the annual percentage rate (APR) range that it will offer.

RECESSIONS HAVE OCCURRED 75% OF THE TIME FOLLOWING RISING INTEREST RATE CYCLES

THE POTENTIAL EFFECT OF RISING INTEREST RATES
ON COMMERCIAL REAL ESTATE INVESTORS

How might rising interest rates affect commercial real estate investors?

When interest rates increase, the cost of debt rises, discouraging borrowing and slowing consumer demand, as consumers generally see their purchasing power decrease. The flip side is that savers are often rewarded, as interest-bearing accounts may potentially earn higher interest payments.

Higher interest rates affect asset classes in different ways: Stocks and bonds are generally negatively affected, due in part to a decrease in demand, while certificates of deposit (CDs) and money market accounts may earn higher annual percentage yields (APYs). One asset class, however, that may be particularly impacted in several different ways is commercial real estate and, specifically, multifamily properties.

Equity investors and private lenders may benefit from increased interest rates

Like many other goods, real estate values are generally affected by supply and demand, but interest rates especially can affect these drivers. For commercial real estate investors, it is likely that the supply of debt capital will be reduced. Counter-intuitive as it may seem, as interest rates increase, banks often take a more conservative approach to lending and loan-to-value (LTV) ratios, which may provide equity investors with greater opportunity to participate in the market by supplying more capital to purchase a property.

With banks pulling back, private lenders may be able to step in and make loans at attractive terms.

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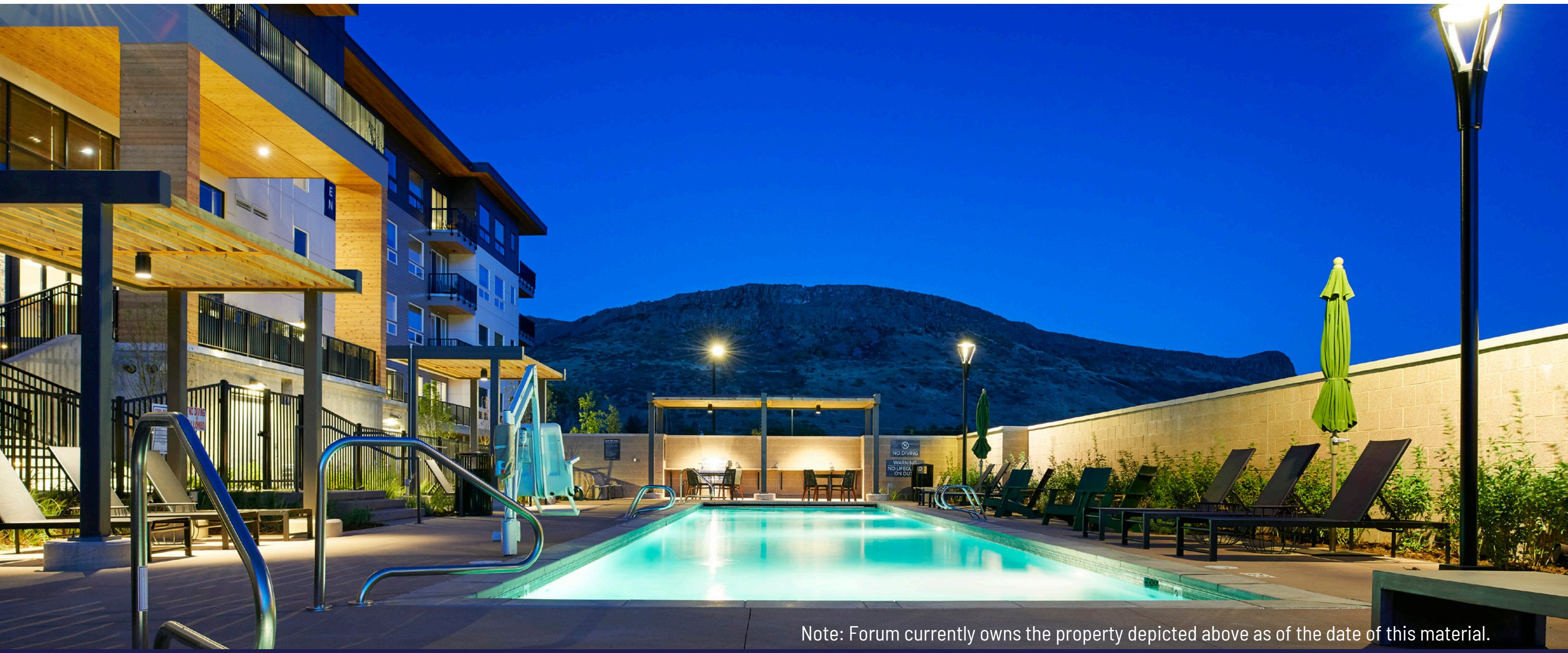
Cap rates may increase

Additionally, as interest rates rise, a similar increase in capitalization (cap) rates is likely to be triggered, leading to a decline in property values and a possible damper on returns, as the increased cost of capital would require a lower going-in price in order to generate similar pre-rate-increase returns. This could affect certain areas of commercial real estate, such as retail or industrial, because those areas typically have longer lease times. They may hold leases up to 20 years. Multifamily, however, is different. Most multifamily leases last one year or less. Given this short time frame, multifamily property owners may simply reprice their rents to offset the impact felt by the higher interest rate.

Refinancing could become more costly

Another side effect of higher interest rates is the possibility of refinancing becoming more expensive. This could possibly force owners who are over-leveraged and were relying on refinancing to sell, presenting another opportunity for investors. Supplemental loans may also be an option and could be attractive, from a weighted cost of capital view, if the existing debt is cheaper than today's rates.

MULTIFAMILY'S SUSTAINED DEMAND AND SHORTER LEASE TERMS MAY ALLOW RENTS TO BE REPRICED TO OFFSET THE IMPACT FELT BY HIGHER INTEREST RATES



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Renting may become more attractive

While rising interest rates may certainly affect commercial real estate investors, multifamily properties have the exceptional opportunity to potentially benefit from these higher rates.

The unfortunate truth is that rising interest rates make buying a home more expensive. According to the National Association of Home Builders ("NAHB"), 87.5 million households (roughly 69% of all U.S. households) are already unable to afford the median priced home of $412,505.[2]

The NAHB goes on to share that just a quarter-point increase on a 30-year fixed-rate mortgage eliminates an additional 1.1 million U.S. households from buying a median-priced home.

Regardless of market conditions, individuals will need a place to live, and the lion's share of these 1.1 million households will likely look to multifamily rental options.

Additionally, multifamily has shown stable market rate occupancies over time.[3] In more than 20 years, multifamily occupancies have not fallen below 92%. In the first quarter of 2022, the occupancy rate was 97.6%.[4]

FOR EVERY QUARTER-POINT INCREASE IN INTEREST RATES, DEMAND FOR MULTIFAMILY COULD GROW BY 1.1 MILLION HOUSEHOLDS[2]

MULTIFAMILY OCCUPANCY RATES HAVE BEEN HISTORICALLY STABLE REGARDLESS OF ECONOMIC BACKDROP

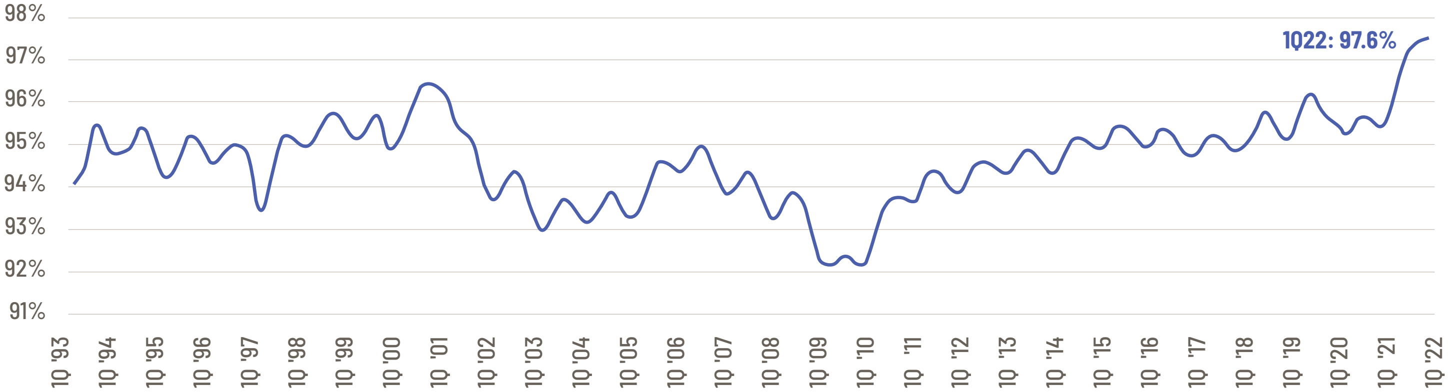

Chart source up to 1Q '20: Willet, Greg and Couch, Adam. "2021 U.S. Apartment Market Outlook." RealPage Inc. 2021. https://on24static.akamaized.net/event/28/73/51/5/rt/1/documents/resourceList1610997573508/2021outlookdeckfinal1610997570788.pdf. Chart source for 1Q '21 and 1Q '22:"Spring 2022 Apartment Market Pulse." National Apartment Association. April 27, 2022. https://www.naahq.org/spring-2022-apartment-market-pulse

2. NAHB.org, "Households Priced-out by Higher House Prices and Interest Rates," August 18, 2022
3. Past performance is not indicative of future results.
4. RealPage.com, "Apartment Demand, Occupancy and Rents Jump to New Highs Again in 1st Quarter," April 4, 2022

THE POTENTIAL EFFECT OF RISING INTEREST RATES
ON COMMERCIAL REAL ESTATE INVESTORS

MORTGAGE RATES AS OF SEPTEMBER 1, 2022

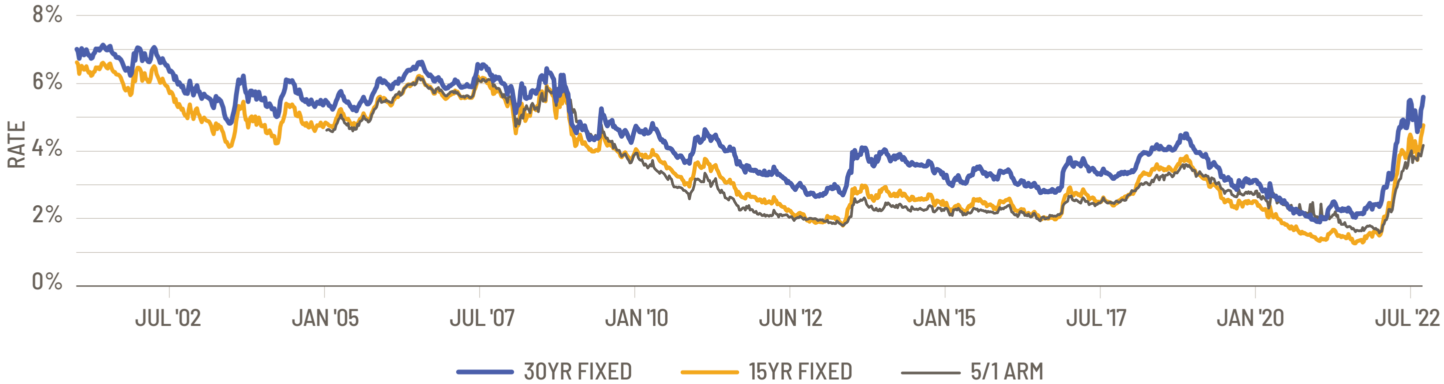

Chart source: Freddie MacChart source: https://time.com/nextadvisor/mortgages/mortgage-rates-history/

Mortgage payments have outpaced rent increases by 44% since the end of 2020.[5] With higher interest rates, these multifamily units may see even more demand. Recently, mortgage demand has dropped to a 22-year low.[6] Mortgage rates hit 6.38% on June 15th, the highest since 2008, and although they dropped to 5.22% in early August, mortgage rates rose again to a high of roughly 6.5% after the latest Fed rate hike.[7] While rates fluctuate constantly, each point added may mean the difference between purchasing and renting, especially for Millennials and other first-time homebuyers, many of whom are carrying historic levels of student loan debt (which could also see interest rates rise).[8,9]

For example, suppose a first-time homebuyer qualifies for a $400,000 loan at a 4% interest rate. At a 5% interest rate, however, the homebuyer may, based on their qualifications, only qualify for a $355,000 loan. The homebuyer's purchasing power has decreased by $45,000.

Furthermore, this interest rate increase affects affordability overall. If our homebuyer receives a 4% interest rate on a $400,000 30-year fixed rate mortgage, their monthly mortgage payment would be $1,900 per month. A 1% increase in the interest rate adds $238 a month to the payment. This means that the homebuyer's monthly payment has increased by more than 12.5%. In large metro areas, growing suburbs and other pricey markets, more people will be priced out and instead opt for renting, causing an increase in demand for multifamily rentals.

A 1% INCREASE IN MORTGAGE RATES RESULTS IN A 10-11% DECREASE ON BUYING POWER[10]

HYPOTHETICAL EXAMPLE*

$400,000 HOME LOAN

30 YR FIXED RATE MORTGAGE

INTEREST RATE	
4%	5%
MONTHLY PAYMENT	
$1,900	$2,138

*For illustrative purposes only. This information is estimated and subject to change.

5. Wall Street Journal, "Rising Mortgage Rates Complicate Decision on Buying Versus Renting," September 2, 2022
6. CNBC, "Mortgage Demand Drops to a 22-Year Low as Higher Interest Rates and Inflation Crush Homebuyers," July 20, 2022
7. https://www.forbes.com/advisor/mortgages/mortgage-rates-09-22-22/
8. Investopedia, "Today's Mortgage Rates & Trends June 15, 2022: Rates Continue Surge," June 15, 2022
9. As of August 11, 2022. https://themortgagereports.com
10. GMFSmortgage.com, "How Higher Interest Rates Can Affect Your Buying Power," January 28, 2022

Floating rates may offer an interest rate hedge

In addition to investment in multifamily equity, investors who are looking for a potential hedge against higher interest rates may want to focus on loans and investments made at a floating rate. Floating rates move in tandem with interest rates, so as interest rates increase, so does the income on the underlying investment. As a result, the loan's value may be able to keep pace with the changing market conditions and the investor is able to benefit from rising interest rates as the investment's income rises with higher rates.

Floating-rate loans also have a historically low correlation with traditional asset classes. This may help to provide diversification and reduce overall portfolio volatility.

INVESTMENTS IN FLOATING RATE LOANS COULD BENEFIT FROM RISING INTEREST RATES

Conclusion

The truth is that while rising interest rates may bring challenges, they also provide new opportunities. After more than a decade of cheap credit and an expansionary monetary policy, we believe the current era of rising interest rates may curb demand, slow the economy and place homeownership out of reach for many—further increasing demand for multifamily rentals. Whether it is on the debt or equity side of the equation, we believe investors working with management teams with experience in this type of market and the relationships necessary to access high-quality investments can ride the interest rate wave and potentially come out on top.

KEY TAKEAWAYS

1. The goal of Fed rate hikes is to curb demand by increasing borrowing costs
2. Recessions have occurred 75% of the time following rising interest rate cycles
3. Multifamily's sustained demand and shorter lease terms may allow rents to be repriced to offset the impact of higher interest rates
4. For every quarter-point increase in interest rates, demand for multifamily could grow substantially
5. Increases in mortgage rates reduces consumers purchasing power
6. Investment in floating rate loans may benefit from rising interest rates

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