2023 **Annual Letter**

HUMPHREYS

Dear valued investor,

After enduring over eighteen months of headwinds and disruption in the real estate market, we began this year with a steady confidence in the future of real estate and the performance of our funds. In many ways, it feels like the worst of the real estate down cycle is behind us: markets are trending up, inflation is trending down, rate cuts are ostensibly imminent, and deals are beginning to pencil again. We kicked off 2024 with two new deal commitments after only committing to one new deal in all of 2023. Beyond the current sentiment of the market, our confidence remains firmly rooted in our investment principles, the fundamental long-term growth in demand for real estate, and in the competency and character of the people we call "partners."

This past year demonstrated the importance of staying power. Real estate is a cyclical industry for reasons that are fairly apparent. The cycle goes something like this: rising rents increase profits, making buildings more valuable to owners. This incentivizes new construction by developers—the buildings are more profitable, and, as a result, investors are willing to pay more for them. As long as growing demand keeps up with the new supply, rents will hold or even continue to increase. Inevitably, though, something gets out of balance. On the one hand, various participants on the development side experience their own supply constraints, and we see increased costs driven by the frenzy: land prices increase, construction labor ticks up, and material costs jump. On the other hand, even once it becomes obvious to everyone that the values of the buildings being developed is no longer increasing, projects that have already launched will continue to be delivered for 18-24 months past the point when the "soft market" began. This further increases supply, thereby reducing rents and ultimately exacerbating the long-since obvious negative valuation trend.

One fascinating aspect about this current cycle, at least within the multifamily sector, is that even while property values have declined, rents were generally stable in most of our markets and, in some instances, have continued to increase. In fact, multifamily rents nationwide have outpaced the historical trend of growing 3.5%[1] per year and are now up over 10%[2] since the "down cycle" began in mid-2022. So, from a rent perspective, apartment buildings should be increasing in value, and yet the opposite is true. Why? First, increased rents have only marginally increased profits because inflating expenses (e.g., insurance premiums) have cut into the bottom line. Still—even if profits are only up slightly—shouldn't building values hold? In a normal environment, yes. However, real estate as an asset class typically incorporates leverage. While building-level fundamentals remain broadly healthy across the multifamily and industrial sectors, the rapid change in interest rates has certainly not been normal. The cost of new debt has soared. Increased borrowing costs have reduced cash flow available to real estate investors, while the correlated effect of increased fixed-income yields (e.g., T-bills, money markets) have created competition for investment capital. As a result, fewer investors are interested in owning real estate, thus decreasing valuations.

This is the real estate cycle we are in, and it is just that—a cycle. Cycles are a short-term component of a long-term trend, and in the long-term trend, real estate has a long history as an appreciating asset that outpaces inflation. However, when cycles happen and values momentarily decrease, things get interesting fast. On a typical deal, a $50 million building that decreases in value by ten percent to $45 million will require investors to pony up $3 million of new equity to refinance the loan. If they don't have the capital, the only alternative is to sell into the down market, thereby locking in their decline in value and missing out on an ensuing recovery. Staying power is the ability to right-size the loan, ride through the storm, and ultimately decide to hold or sell an asset based on your own strategy and timing.

1. According to the Federal Reserve Bank of St. Louis' Consumer Price Index for All Urban Consumers: Rent of Primary Residence in U.S. City Average, the median annual rent growth rate from January 1947 to January 2023 is 3.5%.

2. According to the Federal Reserve Bank of St. Louis' Consumer Price Index for All Urban Consumers: Rent of Primary Residence in U.S. City Average, from July 2022 to December 2023 multifamily rents increased 10.84% (July 2022 Index Value: 370.448, December 2023 Index Value: 410.606).

Over the past eighteen months, our staying power approach to real estate investing has been on display. We have allocated capital for all loan refinancing. In our income fund, we have managed liquidity to maintain consistent monthly distributions for 140+ months and counting. And we have fulfilled 100% of investor redemption requests. Just as important, we have maintained key relationships with partners and continue to attract and retain an exceptionally talented team. Partners always matter, but they matter even more in a challenging market. We make it our mission to align ourselves with great partners. Behind the bricks-and-mortar is a team of people making decisions and executing operations that directly impact investment outcomes. When we join forces with people of competency and character, we increase the likelihood of success and mitigate a broad range of risks. In his book *Essentialism*, author Greg McKeown suggests that one well-made decision can automate one thousand follow-on decisions. We apply this approach when selecting partners, where that single decision makes one thousand decisions for the investment.

Long-term partnerships thrive when there is both performance and alignment. We align ourselves with our employees through compensation and ownership grants that make each of our thirty team members true partners, incentivized to act in the long-term interest of the company and our investors. We align ourselves with development partners through deal structures designed to mitigate downside risk to our investors while sharing in upside performance. While absolute alignment will never be attained, our directional aim for better alignment has led to flourishing, long-term partnerships that have endured through the ups and downs of the market.

These past few years brought us both ups and downs, primarily driven by the initial impact of the pandemic and the ensuing shockwave effects of the market and federal monetary response. Our efforts to navigate the dynamic shifts have yielded mixed results: some impressive wins, a few real misses, and a list of lessons learned and garnered wisdom that enhance our prospects for the future. Overall, this season of challenge has made us better, sharpening our capabilities and resolve. As we look forward to 2024, we are optimistic about the market and confident in the readiness of our team and partners to capitalize on the opportunities that emerge.

Thank you for the trust you place in us and our team. We are grateful for your partnership.

Sincerely,

Kirk Humphreys
Founder

Grant Humphreys
President

Blair Humphreys
CEO