CRE Beyond the Gateway: Surveying Opportunity in Non-Major Markets

Sound Point and Sound Point Commercial Real Estate ("SPCRE"): Sound Point Capital manages ~$45+ Bn across performing and private credit investment strategies, including $3.5 Bn of commercial mortgages.[1] SPCRE is comprised of 22 investment professionals led by senior members who have on average 30 years of experience. The team pursues an investment strategy focused on originating light-transitional mortgages backed by U.S. middle market commercial real estate. SPCRE partners with sponsors having asset type / location expertise in the multi-family and industrial sectors in secondary, higher growth U.S. markets.

Pivot Toward Non-Major Markets

Following the Great Financial Crisis ("GFC"), much of U.S. commercial real estate ("CRE") investment (debt and equity) understandably centered on the relative safety and quality of gateway cities, a.k.a., Major Markets,[2] such as New York, Los Angeles, Washington DC, and Chicago. This strategy proved fruitful as property price appreciation in such cities outpaced secondary cities, a.k.a. Non-Major Markets,[3] like Provo, Austin, and Raleigh, for many years, as illustrated in this table:

Property Price Index	2009-2019	2019-2024	2009-2024
Major Markets	6.8%	0.1%	4.5%
Non-Major Markets	6.1%	3.6%	5.2%
National All-Property	6.3%	2.5%	5.0%

*Compound Annual Growth Rates
Source: Real Capital Analytics, RCA CPPI Indices Major Markets (All Property), RCA CPPI Indices Non-Major Markets (All Property), RCA CPPI Indices National All Property

In 2019, a decade after prices bottomed, our analysis detected signs of a reversal in pricing trends between Major and Non-Major markets. Our data-driven approach incorporates factors including population and job growth rates, net operating income ("NOI") growth, and relative capitalization rates ("cap rates") which we believe are reliable predictors of property prices. We leaned into our conviction that values in Non-Major Markets were set to accelerate and between 2019 and 2024 we originated $3.5 Bn of first mortgages, $2.9 Bn (~82%) of which were on properties in Non-Major Markets.[4]

Furthermore, we expressed our preference for multi-family residential and industrial properties which we discussed in our prior *Insights* report titled, *An Emerging Opportunity for Fresh Capital*, with nearly 80% of properties in these two sectors. The accelerated migration to Non-Major Markets that has resulted from COVID-19 lock-downs, adoption of remote work and cost of living inflation following the 2022-2023 rate hikes has buoyed our positioning and resulted in property price growth in Non-Majors that is nearly 4x the rate in Major Markets between 2019 and 2024. As a result of their recent surge, Non-Major Markets' property prices have now outpaced the Majors over the past 15 years.[5]

Key Data Sets

When taken together and properly interpreted, we believe these three factors are reliable indicators of CRE pricing trends and assessing relative value.

(I) Population and Job Growth

An influx of people into a market translates into sustained demand for housing and retail needs while concurrent job growth places money into the pockets of people for rent payments, retail shopping experiences, and other expenditures that directly and indirectly benefit CRE values. Population and job migration to Non-Major Markets for financial and lifestyle motivations, more pronounced post-COVID, has provided foundational support for CRE as evident in the tables below. The top-ten markets experiencing the highest population growth from 2009 to 2019 and 2019 to 2024 are Non-Major Markets, accelerating from an average of 1.7% to 2.3% CAGR, respectively. This compares with 0.25% growth and a (0.59%) decline in Major Markets like New York, Chicago and Los Angeles during the same periods.[6]

The information provided and discussed herein is reflective of Sound Point's subjective opinion and beliefs, is provided for illustrative purposes only, is subject to change without notice and should not be relied upon as a promise or representation of future performance. Please see the endnotes and important disclaimers at the end of this paper.

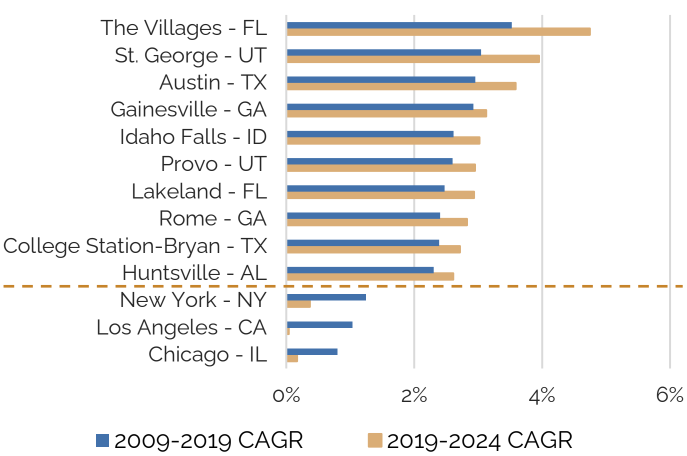
Population Growth Rates (CAGR)

Rank	Market	2009-2019 CAGR	2019-2024 CAGR
1	The Villages - FL	2.24%	3.57%
2	Austin - TX	1.90%	2.12%
3	Greeley - CO	1.76%	2.29%
4	Myrtle Beach - SC	1.70%	3.25%
5	St. George - UT	1.70%	2.90%
6	Provo - UT	1.64%	2.16%
7	Daphne-Fairhope-Foley - AL	1.59%	2.21%
8	Raleigh - NC	1.51%	1.68%
9	Orlando - FL	1.51%	1.38%
10	Bend - OR	1.47%	1.35%
162	New York - NY	0.48%	-0.60%
279	Chicago - IL	0.13%	-0.43%
265	Los Angeles - CA	0.16%	-0.76%

Source: CoStar Historical Data, Multifamily, 2024 Q2

Notably, the top-ten markets (including four from the list above) with the highest employment growth are also all Non-Major Markets. These ten averaged 2.7% between 2009 and 2019 accelerating to 3.3% between 2019 and 2024. This compares to employment growth in New York, Los Angeles and Chicago that is barely positive in the last five years.[7]

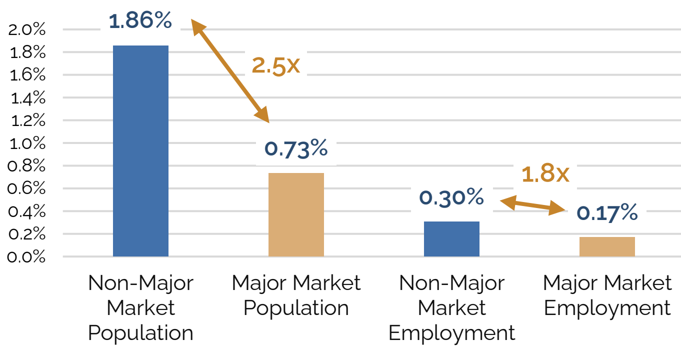
Employment Growth Rates (CAGR)



Source: CoStar Forecast Data, Multifamily, 2024 Q2. CoStar's property sector models are based on inputs from Oxford Economics' macroeconomic models in its North American Cities and Regions service published in March 2024

Fundamentally, we believe the momentum behind population and job growth in secondary markets will persist, driven by some combination of no-to-lower state income taxes, greater affordability and perhaps more relaxed lifestyles that appeal to the aging U.S. population, with rotation around markets based on local CRE supply and demand trends. This view is supported by projections from CoStar, a leading real estate industry analytics firm. CoStar forecasts population growth rates in Non-Major Markets to be two and a half times those of Major Markets between 2024 and 2027 and employment growth nearly twice the rate.

Projected Population & Employment Growth
2024 to 2027

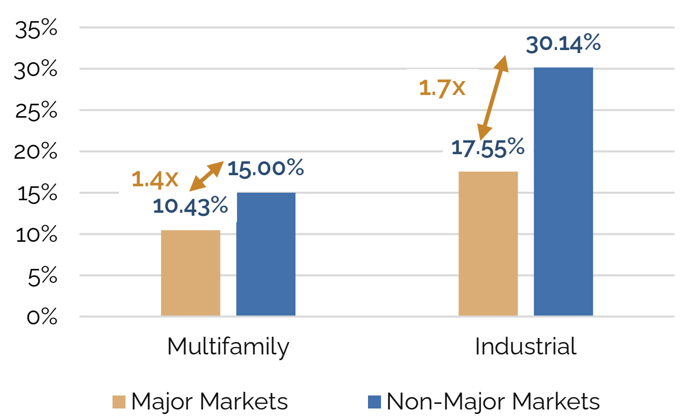


Source: CoStar Forecast Data, Multifamily, 2024 Q2. CoStar's property sector models are based on inputs from Oxford Economics' macroeconomic models in its North American Cities and Regions service published in March 2024

(II) Net Operating Income ("NOI") Growth

Given the population and job growth differentials between Non-Major and Major Markets, it stands to reason that growth of Net Operating Income (property revenues less necessary operating expenses) would follow a similar pattern. CoStar's NOI forecasts also strongly support this conclusion. In multifamily, they forecast Non-Major Markets to outgrow Major Markets by ~500 bps, or ~44%, and industrial by 1,200 bps, or 72%, as shown below.

Projected NOI Growth
2024 to 2027



Source: CoStar Forecast Data, Multifamily and Industrial, 2024 Q2

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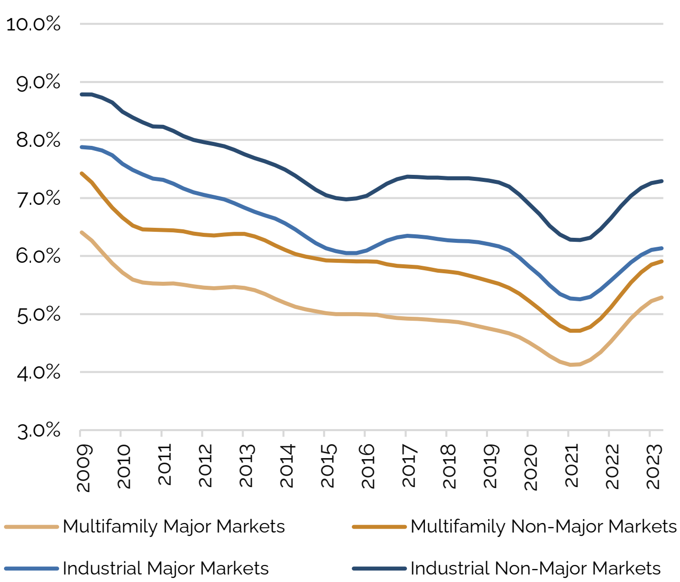
(III) Relative Capitalization Rates

An additional factor behind leaning into Non-Major Markets in 2019 was our view of relative cap rates. Cap Rates (calculated as NOI / current market value) are a metric of rate of return on property and drive valuations for a given NOI. They have historically been lower for Major Markets relative to Non-Majors, as investors trade lower property valuation for greater potential NOI stability and asset liquidity. For example, as shown below, until 2019, multifamily and industrial Major Markets cap rates were about 81 bps and 105 bps tighter, respectively, than Non-Major counterparts.[8]

As we like to say, "Cash flow, not value, makes mortgage payments!"

Cap rates tend to move in tandem with interest rates - as rates fall, Cap rates compress lifting asset values relative to the NOI produced. However, rising property prices not driven by NOI growth results in greater risk to mortgage lenders, like us, that depend on property cashflow to service debt. As value has been inflated by a decreasing cap rate on a constant NOI, the equivalent LTV on a lower cap rate asset has lower cash flow coverage of monthly mortgage payments than a loan on a higher cap rate asset. As we like to say, "value does not make mortgage payments, cash flow does!"

Capitalization Rates
2009 to 2024

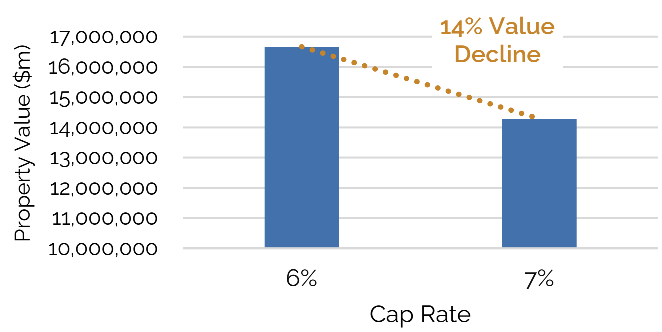


Source: CoStar Historical Data, Multifamily and Industrial, 2024 Q2

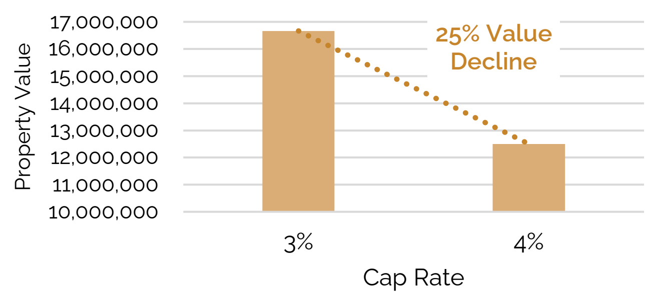
While cap rates would not bottom until 2022, we viewed Non-Major Markets as offering far more attractive risk-adjusted return than Major Markets given 1) greater cashflow coverage of debt service and 2) the far less negative impact of rising interest on CRE asset values (all else equal) due to cap rate decompression as shown below, due to the denominator effect.

Illustrative Impact on CRE Asset Value of a 100bps Increase in Interest and Cap Rates[9]

Non-Major Markets



Major Markets



Conclusion

CRE property price trends tend to be slow moving driven by demographic and societal trends and punctuated by major events (e.g., GFC, Covid-19) that can shape their trajectory. We believe the population and job growth shift from Major to Non-Major Markets was decades in the making and will persist for the foreseeable future. These powerful tailwinds will continue to propel the opportunity set for Sound Point's CRE strategy that is focused on originating first mortgages backing multi-family residential and industrial CRE in Non-Major Markets. That said, we will continue to monitor population and job growth, net operating income, and cap rates, and other data sets, for signals foretelling a future pivot.

Endnotes

[1] All Firm-wide and strategy level AUM figures provided are as of 12/31/2023. Firm-wide and strategy level AUM figures do not include redemptions received or liquidations that may be in effect after 12/31/2023. Firm-wide and strategy level AUM figures include (where relevant) committed capital to discretionary draw-down vehicles that have not yet been drawn, entities that are not open to new investors and/or are in the process of winding down and represents the closed total commitment of all loans managed by Sound Point Commercial Real Estate Credit as of 12/31/2023, including inherited portfolios managed that were originated by another manager. Please also note, that Firm-wide AUM and the Commercial Real Estate ("CRE") strategy AUM includes assets attributable to InPoint Commercial Real Estate Income, Inc., a real estate investment trust (the "REIT") sub-advised by SPCRE InPointAdvisors LLC, a subsidiary of Sound Point which is exempt from registration as an investment adviser with the SEC. The REIT portfolio, which represents a material portion of the CRE strategy's AUM, primarily consists of first mortgage loans, mezzanine loans, and any current or future real estate owned, does not meet the definition of a securities portfolio and as such, does not technically qualify as an advisory client. The REIT portfolio's size is calculated using financial data provided by the REIT's unaffiliated investment adviser, Inland InPoint Advisor, LLC, and includes the unpaid principal balance of debt investments, the fair value of any real estate owned, cash and cash equivalents and accounts for the current expected credit loss reserve. Additional information about the REIT is publicly available on its website at https://inland-investments.com/forms-literature/inpoint.

[2] Generally, the center of commerce and population that provides opportunities for large investments.

[3] Less populated than major cities and typically lacking the same level of amenities

[4] As of March 31, 2024

[5] Real Capital Analytics, RCA CPPI Indices Major Markets (All Property), RCA CPPI Indices Non-Major Markets (All Property), RCA CPPI Indices National All Property

[6] CoStar Historical Data, Multifamily, 2024 Q2

[7] CoStar Forecast Data, Multifamily, 2024 Q2. CoStar's property sector models are based on inputs from Oxford Economics' macroeconomic models in its North American Cities and Regions service published in March 2024.

[8] CoStar Historical Data, Multifamily and Industrial, 2024 Q2.

[9] Sound Point internal calculation utilizing capitalization rates from the following source: CoStar Historical Data, Multifamily and Industrial, 2024 Q2.