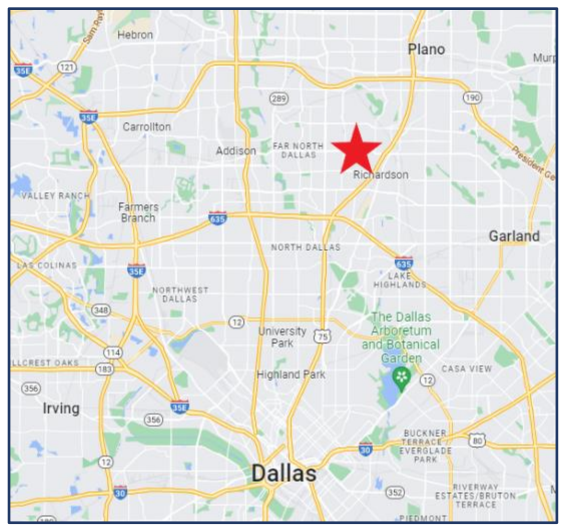
ClearWorth Capital

Q4 2024 Investment Update

Lockwood Heights (formerly Belle Grove at Custer)

800 Custer Rd, Richardson, TX 75080



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Q4 2024 Investment Update
(Prepared on February 18, 2025)

Property Description: Lockwood Heights, formerly known as Belle Grove at Custer, is a 202-unit Class 'B' garden-style apartment community in Richardson, TX, an inner suburb of Dallas with solid demographics and a well-established employment base. The asset offers a well-balanced mix of floor plans, including 88 one-bedrooms, 98 two-bedrooms, and 16 three-bedrooms, each averaging 959 square feet of living space. Community amenities include a pool with outdoor grilling stations, a fitness center, a leasing office, and two laundry facilities.

The plan for this asset is to renovate, reposition, stabilize, and sell it within 3 to 5 years. The total renovation budget is $2.4 million, with only $0.2 million allocated for exterior improvements and $2.2 million earmarked for interior upgrades.

Asset Type:	Conventional Multifamily	**Acquisition Date**:	10/06/2022
Units:	202	**Equity Contributions:**	$13,070,000
Vintage:	1969	**Equity Distributions** (through 12/31/24)**:**	($400,269)
Land Acres:	8.5 (24 units/acre)	**Debt Balance** (as of 12/31/24)**:**	$20,556,000

CURRENT UPDATES

Key Comments for the Quarter

- We are using some concessions to achieve higher rents, but have had strong renewal rates (without concessions) to improve occupancy.
- We bound insurance in Q1 2025 resulting in 55% saving from 2024!
- We are still hopeful rates will come down into 2025, though they have bumped up recently.
- Overall, we are a "hold" on this asset as we continue to build value and work through relatively unhealthy market conditions for sellers. We will assess our options closely as we move to the initial maturity of the loan in October of 2025.

Property Operations

Revenue in Q4 2024 decreased by 5% and expenses increased by 11% compared to Q3 2024, resulting in a decrease in NOI. Quarter-over-quarter income has decreased due to increased concessions, and we had a tax true up in December as we underestimated property tax expense. We will file a suit with the county to decrease our tax basis.

During the quarter, 21 new tenants moved in, 18 former tenants moved out, and 33 leases were renewed, keeping occupancy flat at 93.5% from the end of Q3. The average rental rates for move-ins and renewals, including all supplemental recurring charges, were $1,566 and $1,532, respectively, bringing the property's overall rental average to $1,463, reflecting a strong 6% quarter-over-quarter increase.

Year-to-date, NOI is 14% below budget compared to 8% last quarter. This was due to a tax true-up in December.

Interior Upgrades

In Q4, we completed upgrades on 0 units. A total of 71 units or 3% of the property has been renovated. As of September 2024, these renovated units generate a modest rent premium of $88 per month compared to non-renovated ones.

Capital Improvements

We successfully completed our capital improvement plan during Q2 2024, finishing on schedule and within budget. Our comprehensive improvements included a full rebranding of the property to "Lockwood Height," featuring a new logo, color scheme, and signage. Additionally, we remodeled the leasing office, refreshed the resident fitness center, added new outdoor FF&E around the two swimming pools, updated the communal laundry facilities, addressed previously deferred brick and masonry repairs, and repaired the water line running underneath the parking lot. For photos of the impressive transformation, please visit lockwoodheights.com.

Loan Summary

Lockwood Heights is secured by a first mortgage from Southside Bank, with a total loan commitment of $21.9 million. As of December 2024, the outstanding principal is just under $20.5 million. The loan carries a fixed interest rate of 5.50% and allows for interest-only payments until its maturity in October 2025.

U.S. Apartment Sector Overview

Operating Fundamentals

The U.S. multifamily market continued a strong rebound in demand during the fourth quarter of 2024, with 110,000 units absorbed. That brings full-year demand for 2024 to 553,000 units, the strongest total since 2021. Additionally, that was a 68% increase over 2023's total. Demand was driven by stable economic growth, slowing inflation, and a continued slowing of renter households making the jump to ownership. And while supply additions have outpaced demand over the past 3 years, the gap has closed significantly in the second half of 2024. In the fourth quarter, the supply/demand gap only totaled 24,000 units, the smallest amount since the end of 2021. This shrinking of the supply/demand gap held the vacancy rate steady at 8.0%. It's the first time in three years that the vacancy has remained unchanged from quarter to quarter. Furthermore, it is projected that the vacancy rate has peaked and will begin to decline during the second half of 2025.

Additionally, overall rent growth has stabilized and may be on the cusp of expanding. Rent growth held steady at 1.0% during the fourth quarter and has remained close to that number for the past six quarters. Thus, with the vacancy rate's rise appearing over, conditions appear ripe for rent growth in 2025.

Nevertheless, rent conditions at different price points show unique outcomes. Most new supply additions are concentrated at the class A price point, contributing to the weakest rent growth observed at the market's upper echelon. In the fourth quarter, class A properties recorded rent growth of 0.2%, and this segment is projected to remain the weakest for the foreseeable future. At the same time, mid and lower-priced properties experienced rent growth that outpaced the overall average. During the fourth quarter, B class properties experienced steady rent growth at 1.3%, while C class buildings exhibited the highest growth of 1.9%. The outlook for 2025 indicates that accelerating rent growth will come first in the B and C class segments due to increasing demand and limited supply pressure in these price points. This trend is at the very heart of ClearWorth's value-add strategy. Our portfolio, which is primarily B class product, takes advantage of the supply economics that began during Covid: development of best-in-class properties hoping to achieve record-breaking rents. Being nestled just below these trophy assets and above C class product that can be difficult to operate, the portfolio is poised to take advantage of the growing working class renter base.

Market fundamentals are also highly varied depending on region. For the most part, Midwest and Northeast markets have experienced only moderate supply additions over the past two years, contributing to a more balanced multifamily sector in these regions. Consequently, they have exhibited the most favorable rent growth. At the same time, rent growth has been sluggish in the Sun Belt, with numerous markets reporting negative year-over-year rent growth.

2024 saw 677,000 completions for the year, the highest total since the mid-1980s. However, 2025 will experience a steep forecasted 50% decline in deliveries to 346,000 units. If absorption can maintain the strong pace set year to date, demand will finally overtake supply in 2025. In that case, the overall market will have the opportunity to begin recovering, and by the end of 2025, overall rent growth could approach the mid 3.0% range.

Capital Markets

Fourth quarter of 2024 was highlighted by the election of the 47th President of the United States, Donald Trump, who campaigned on a promise to streamline and maximize performance of the country's economy. Roughly 40% of votes said the economy was their top issue, which is interesting given the robust growth achieved so far this year: the Nasdaq rallied 30%, the S&P climbed over 24%, and the Dow Jones rose a more modest 13%. During the same period, however, interest rates remained roughly double their historic low – 3% – in 2021. The outcome of the election has been marked by continued volatility in both rate and transaction markets.

Whereas cost of borrowing was on the decline in 3Q2024, uncertainty regarding the new administration's inflationary policies, specifically its broadcasted tariff strategies have pushed bond yields to the upper end of their two-year range as investors have been dumping Treasurys in favor of higher-yielding alternatives. The 10-year Treasury note jumped up to 4.619% compared to 4.192% in November and 3.860% at the beginning of the year. While some economists have adopted the belief that the economy can handle higher rates and that inflation will persist as a threat, others are weighing relatively lofty stock valuations with the downward movement of bond prices. Robert Shiller has concluded that historically, when the stock market cap balloons amid falling bond prices, it has meant that the former struggles to outperform the latter over the following 10 years. This trend makes an argument for rate relief at some point in the future, however Trump's policy will remain a large factor in exactly when this relief will be felt.

The consumer price index reached 2.7% on an annual basis in November, up 10 bps from October, spurred primarily by shelter expenses such as rent. Comparatively, food costs rose 0.4% annually while energy costs fell 3.2% for the year. According to Oxford Economics, the labor market is balanced, and nominal wage growth is running consistently with the Federal Reserve's inflation target of 2%. Food and beverage services, healthcare and construction remain the top areas of job gains, which all added a combined 127,000 positions. While the labor market resiliency may not be enough for the Fed to continue its path of rate cuts, it is anticipated to bode well for property owners by way of occupancy and rent stabilization.

In combination with the rate environment, new supply deliveries have put upward pressure on cap rates, leading to an 8.3% decline in property values nationally. The pricing correction has been felt considerably by 11 of the top 25 metropolitan markets, which each saw a slide in transaction values north of 10%. Specifically, Dallas-Fort Worth and Houston are the two markets with the highest gross supply increase in the past 5 years vs. the prior 5-year period. The Sun Belt continues to lead the country in production, as Houston and DFW have added 100,000 and 150,000 units, respectively during that timeframe.

However, over the last several quarters, national multifamily prices have remained stable. The value-weighted repeat- sale index for multifamily properties from CoStar shows the deepest drop occurred in March 2024, with prices 27% below the all-time highs of 2022. Since the end of the first quarter, price declines have come in, suggesting that these losses may have been arrested. The U.S. multifamily picture appears to be turning a corner, as last year's transaction volume ticked higher compared to 2023. After consistently improving deal volume through each quarter, transaction volume was up 18% year-over-year to $102 billion in 2024. Transaction counts also showed improvement, with 10,516 deals in 2024, up 7% from the year prior.

Overall, the Apartment Investment Market Index, which is a measure of the financing conditions created by lending giant Freddie Mac, has grown on a yearly basis in four straight quarters for the first time in 2021; it topped out at 2.2% year-over-year growth in 2024. Despite being roughly 10% below the 10-year average, this continued growth signifies the endurance of the multifamily sector and relatively unwavering demand for property investment.

Looking ahead, the balance of risk for 2025 remains somewhat neutral. On the one hand, above-trend absorption is expected to overtake supply, holding vacancy rates in place. But, despite the recent efforts by the Federal Reserve to bring interest rates down, fixed- rate financing costs have risen in recent months and could act as a wet blanket smothering the market's recovery. This tug-of-war may be short-lived as new supply deliveries are expected to taper off substantially in late 2025 and 2026. Until then, price discovery remains caught between improving fundamentals and higher long- term interest rates.

Local Market Overview (Dallas-Fort Worth)

Entering 2025, the Dallas-Fort Worth multifamily market is on a path toward rebalancing after surging supply last year. Developers added 40,000 units in the past year, the highest level on record. Meanwhile, renter demand accelerated thanks to easing inflation and improving consumer confidence, but net absorption of 29,000 units fell short of deliveries, keeping vacancy elevated. At 11.4%, the vacancy rate is up 90 basis points year-over- year and holding near a 20-year high. Under the weight of new supply, rent growth remains negative at -1.2%.

While the supply-demand imbalance has prevailed, supply is downshifting with declining construction starts. Builders broke ground on just 21,500 units in the past year, the lowest level in a decade, setting the stage for the market to be more supply-constrained as the elevated cost of capital and softer property performances dissuade developers from pursuing new projects.

As the supply picture turns a corner, demand is led by fast-growing suburban submarkets, fueled by continued population gains in Collin and Denton Counties. Centered in both counties, Frisco/Prosper and Allen/McKinney account for a third of market demand in the past year and have helped stabilize the market during periods of heavy supply. Collin and Denton Counties have fueled population growth in Dallas-Fort Worth, expanding their resident bases by 50% since 2010.

Tracing new supply and submarkets with demographic tailwinds, demand is concentrated in the 4 & 5 Star segment, totaling 26,000. Meanwhile, demand is returning in mid-priced units after a pullback two years ago that led to expanding vacancy rates. Demand in the mid-tier 3 Star segment totaled 3,700 units in the past year, though the vacancy rate for 3 Star properties remains stubbornly high. At 11.5%, vacancies for 3 Star properties remain above the pre-pandemic average of 6% and reflect the residual impact of higher prices within mid-to-lower income renter households even as the pace of inflation has eased.

Rent growth remains negative as supply outstrips demand and performances are stratified by quality. High- end, 4 & 5 Star properties reported rent declines of -1.4%, reflecting greater sensitivity to pricing power among new competition. Meanwhile, mid-priced, 3-Star rents have slipped -1.2% in the past year for the first time since the end of the Great Financial Crisis.

Eroding rents have spread to submarkets adjacent to construction hot spots as owners and property managers compete for demand. Battling for residents, the share of properties offering concessions has risen above 50%, with six to eight weeks free as the norm, according to market participants.

In the near term, the outlook calls for vacancies to peak in 2025 as supply and demand shift closer to equilibrium with rents remaining mostly muted this year given the surge in deliveries in the past year. Even so, the sharp decline in construction starts is laying the foundation for vacancies to retighten and rents to rebound in 2026.

Partner Distributions

Distributions will be re-evaluated after real estate taxes and insurance payments are made in 1Q2025.

Rent Roll & Leasing Trends	4Q2023	1Q2024	2Q2024	3Q2024	4Q2024
Average In-Place Rent	$1,383	$1,382	$1,376	$1,374	$1,387
End of Quarter Occupancy	89.1%	89.6%	94.1%	90.1%	93.6%
Renovated Units	38	55	65	71	71
Occupied Renovated Units	30	43	59	61	65
Average In-Place Renovated Rent	$1,440	$1,626	$1,525	$1,534	$1,437
Move-Ins	19	20	20	16	21
Average Move-In Rent	$1,408	$1,365	$1,368	$1,450	$1,427
Signed Renewals	22	24	25	29	33
Average Renewal Rate	$1,371	$1,334	$1,301	$1,416	$1,393

Trailing Income Statement	4Q2023	1Q2024	2Q2024	3Q2024	4Q2024
Revenue	$905,455	$891,499	$902,642	$930,990	$887,066
Operating Expenses	$596,866	$572,694	$519,401	$557,142	$618,431
NOI	**$308,589**	**$318,805**	**$383,241**	**$373,848**	**$268,634**
Debt Service	$271,488	$283,300	$277,441	$281,387	$282,841
NOI less Debt Service	**$37,101**	**$35,505**	**$105,800**	**$92,461**	**-$14,206**
NOI Margin	34.08%	35.76%	42.46%	40.16%	30.28%