CAPITAL SQUARE

DST DISTRIBUTION ANALYSIS

September 2023

Capital Square plans to remain focused on acquiring the highest quality properties in the best markets and therefore will need to stay highly selective in our acquisitions in the near term.

ASSESSMENT OF CAPITAL SQUARE'S DST DISTRIBUTION & INTEREST RATES

Capital Square recently assessed our DST distribution rates and their relationship to cap rates and interest rates in the current market environment. The bottom line to our findings is that current market cap rates and interest rates make it extremely difficult for high quality, Class A multifamily to offer 4.0% starting distributions. Offerings that have greater than a 4% starting distribution require either unrealistic growth projections or a shift to lesser quality assets in weaker markets. We will not pursue either of these strategies, and so we expect to remain highly selective in our acquisition activities.

To look at the relationship between cap rates, interest rates and DST distributions, we put together data from our multifamily acquisitions going back to 2021. We ran a regression analysis on the data, which provided a predictive model to answer the question, "Given an entry cap rate of X% and an interest rate of Y%, what do we expect the starting distribution to be for a multifamily DST?" The regression provided the following equation:

Year 1 DST Distribution = 3.53% + .60288*(Entry Cap) - .5971*(Int Rate)

The statistical outputs of the regression indicate that approximately 62% of the year one distribution can be explained by the cap rate and the interest rate. That generally means that the predictive power is important but that there are also other variables at play. (This makes sense as rental growth rates, operating margins, the timing of tax assessments, etc. all impact distributions on any given deal.)

To look at the predicted distribution rate based upon a range of entry cap rates and interest rates using our regression analysis, see the table below:

PREDICTED YEAR 1 DISTRIBUTION - SENSITIVITY ANALYSIS: ENTRY CAP RATE AND INTEREST RATE

		Entry Cap Rate								
		5.00%	5.25%	5.50%	5.75%	6.00%	6.25%	6.50%	6.75%	7.00%
Int. Rate	7.00%	2.36%	2.51%	2.66%	2.81%	2.96%	3.11%	3.26%	3.41%	3.56%
	6.80%	2.48%	2.63%	2.78%	2.93%	3.08%	3.23%	3.38%	3.53%	3.68%
	6.60%	2.60%	2.75%	2.90%	3.05%	3.20%	3.35%	3.50%	3.65%	3.80%
	6.40%	2.72%	2.87%	3.02%	3.17%	3.32%	3.47%	3.62%	3.77%	3.92%
	6.20%	2.84%	2.99%	3.14%	3.29%	3.44%	3.59%	3.74%	3.89%	4.04%
	6.00%	2.95%	3.11%	3.26%	3.41%	3.56%	3.71%	3.86%	4.01%	4.16%
	5.80%	3.07%	3.23%	3.38%	3.53%	3.68%	3.83%	3.98%	4.13%	4.28%
	5.60%	3.19%	3.34%	3.50%	3.65%	3.80%	3.95%	4.10%	4.25%	4.40%
	5.40%	3.31%	3.46%	3.61%	3.77%	3.92%	4.07%	4.22%	4.37%	4.52%
	5.20%	3.43%	3.58%	3.73%	3.88%	4.04%	4.19%	4.34%	4.49%	4.64%
	5.00%	3.55%	3.70%	3.85%	4.00%	4.15%	4.31%	4.46%	4.61%	4.76%

Notice from the table, the combination of cap rate and interest rate required to predict that the year one distribution will be greater than 4.0% (highlighted in blue). For instance, at a 6.0% interest rate, we would need to acquire a property at a 6.75% cap rate in order to generate a 4% starting distribution.

Comparing these numbers with current market cap rates illustrates exactly how difficult it is right now to achieve 4%+ distributions. Below is a snapshot from CBRE's cap rate survey for H1 2023 showing Class A Suburban Multifamily cap rates:

CBRE'S CAP RATE SURVEY FOR H1 2023 - CLASS A SUBURBAN MULTIFAMILY CAP RATES IN THE SOUTH

MULTIFAMILY SUBURBAN

South

	Class A Stabilized		Class A Value-Add	
Market	**H2 2022**	**H1 2023**	**H2 2022**	**H1 2023**
Atlanta	4.75% - 5.25%	5% - 5.5%	5.25% - 5.75%	5.5% - 6%
Austin	4% - 4.5%	3.75% - 4.5%	4% - 4.5%	3.75% - 4.5%
Charlotte	4.25% - 4.75%	4.25% - 5%	4.25% - 4.75%	4.25% - 5%
Dallas	4% - 5%	4.5% - 5%	4% - 4.75%	4.5% - 5%
Houston	4.5% - 5%	4.5% - 5%	5% - 5.5%	5% - 5.5%
Jacksonville	4.5% - 5.25%	5% - 5.5%	5% - 6%	5% - 5.5%
Nashville	4.25% - 5%	4.5% - 5.5%	4.5% - 5.5%	4.25% - 5.25%
Orlando	4.25% - 5%	4.75% - 5.25%	4.25% - 5%	5% - 5.5%
Raleigh-Durham	4.25% - 4.75%	4.25% - 5%	4.75% - 5.25%	4.75% - 5.25%
Richmond	4.75% - 5.5%	5.25% - 5.75%	4.5% - 6%	5.5% - 6%
San Antonio	4% - 4.5%	4% - 4.75%	4.25% - 4.75%	4% - 4.75%
Tampa	4.5% - 5%	4.75% - 5.5%	5% - 5.5%	5.25% - 5.75%
Tulsa	5.25% - 6%	5.25% - 6%	5.25% - 6%	5.25% - 6%
West Palm Beach	-	4% - 4.75%	-	4.25% - 5%

Many of Capital Square's top markets, including Atlanta and Richmond, currently feature market cap rates ranging from roughly a high 4% cap to a high 5% cap. The survey results correspond with the Capital Square's actual experience as we gather real-time pricing information when bidding on assets.

Based on the current rate environment, new debt for multifamily deals would price with a +/- 6.0% interest rate. Returning to the above example, we would need a ~6.75% cap purchase in this scenario to achieve 4.0% distributions. Furthermore, following the data from the market cap rates in the presented survey, a 6.75% cap is not a reality for a Class A property in the current environment.

The above analysis demonstrates the difficulty of producing yield in the current environment. Multifamily interest rates have been quick in rising to reflect the increase in index rates, while limited sales activity has kept seller pricing expectations from allowing cap rates to increase. These factors combine to create neutral or negative leverage in most situations (interest rates are often greater than cap rates). The difficulties are made worse by declining rates of rent growth in many markets.

Overall, the analysis shows that for Class A multifamily acquisitions, a meaningful shift will need to occur before we can offer investors distributions of 4.0%+. To achieve this type of yield, we would need to either (a) underwrite unrealistic rental growth expectations that only set up investors for disappointment in the future or (b) look at acquiring older properties in weaker markets that will trade for much higher cap rates. We plan to remain focused on acquiring the highest quality properties in the best markets and therefore will need to stay highly selective in our acquisitions in the near term.

ABOUT CAPITAL SQUARE

Capital Square is a national real estate firm specializing in tax-advantaged real estate investments, including Delaware statutory trusts (DSTs) for Section 1031 exchanges, qualified opportunity zone funds, development funds and a real estate investment trust (REIT). As a vertically integrated company, Capital Square has also become an active developer of mixed-use multifamily and build-for-rent properties in the southeastern U.S. as well as a dedicated property manager through Capital Square Living, which launched in 2023. Since 2012, Capital Square has completed more than $7.5 billion in transaction volume. Capital Square's related entities provide a range of services, including due diligence, acquisition, loan sourcing, property/asset management and disposition, for a growing number of high-net-worth investors, private equity firms, family offices and institutional investors nationwide. Since 2017, Capital Square has been recognized every year by Inc. 5000 as one of the fastest growing companies in the nation. In 2017, 2018, 2020 and 2023 the company was also ranked on Richmond BizSense's list of fastest growing companies in central Virginia. In addition, Capital Square was named a "Top Workplace" by the Richmond Times in 2023. To learn more, visit www.CapitalSq.com.

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