TWO CREEKS
DEVELOPMENT

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Our Approach to Investing in Real Estate

Fellow Investors,

Next month you will receive your regular quarterly performance updates for specific investments you have made in our projects. In addition, I was prompted by some overlapping conversations with fellow investors to write out a longer letter describing both our general and current thinking about investments and positioning.

There are many ways to make money in real estate, with appropriate risk/rewards to different approaches (development, NNN properties, flipping homes). Someone once said that the best investment strategy is one that allows you to sleep at night (an alignment of style with personality). Our approach outlined below reflects this same concept- we look for properties that fit a particular profile and risks that we believe we can tolerate. When we go through economic rough weather, we want to have confidence that we can make it to the other side because we understand the features and limitations of our ship.

How we think about our properties

Many of our investors are generally positioned in equities and bond assets with limited exposure to real estate. If they do have real estate exposure, the comparison often made by the typical financial advisor is that real estate is like holding a bond or a dividend stocks. The expectation is that an investment in real estate is to "park" capital in a tax-advantaged investment with regular cashflow but limited upside. This comparison works in many instances- this describes most stabilized properties, especially when bought on the open market, which can be a solid and steady complement to a portfolio of other investments (equities, bonds, etc).

For our portfolio, this comparison is a bit misleading. We are searching for properties that are better compared to discounted value stocks, where we believe there are multiple catalysts to unlock value that is not reflected in the property's purchase price.

The catalysts we look for are:

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- **Neighborhood "tailwind"**- acquiring in an area where rental growth is outstripping the city's growth rate, where a rising tide will float all boats
- **Rehab-** unlocking existing property potential by rehabbing tired units
- **Poor existing management**- unlocking existing potential by replacing management that is not maximizing rents, investing capital for long-term ownership, and controlling routine expenses
- **Altering property**- adding units and/or amenities, repositioning branding

The discounts we look for are:

- **Off-market**- mispricings that occur when the seller decides that our closing ability exceeds their advantage of putting a property on the market for price discovery. Most of our properties have been acquired off-market because of our reputation as a strong closer and our partnership with Calvin Griffith and Peyton Cox giving us early looks at properties.
- **Seller timing challenges**- more than half of our properties have been bought at a discount because a seller needed a strong buyer due to their own limitations and cashflow challenges
- **Legacy or out of market ownership**- often we purchase from owners who are not recognizing current value from proper management (let alone unlocking potential further value). This is reflected by under-market rents and/or above-market expenses.
- **Fishing in smaller pools**- we target property sizes where we have less competition. These are larger than properties that retail investors tend to look for and smaller than institutional investors target. Sometimes this allows us to get a discount when other similarly sized buyers have capital tied up. There are some impacts to this particular discount on our ability to exit, which are outlined further below.

Once we acquire a property, we work on unlocking those catalysts within our control and repositioning the property. This may mean major rehab, rebranding, or rolling over a poor tenant base. The first couple years of ownership tends to be capital intensive without a lot of cash coming back out. These are the years we are sowing seeds for future value realization. As we begin to stabilize, cash starts to trickle out, but the major value is not recognized until there is a refinance or sale. With an equity, you can log into your Schwab account and see that your stock has increased in value, but you don't recognize that value until you sell. In our properties, you can recognize some of the value in a refinance, or you can see it more steadily as the cashflow improves. But just as with a value stock, market value generally follows balance sheet improvement, which front runs dividends. In some of our investments you may see limited cashflow in the first couple years, but that does not equate to a lack of value being created. You can see evidence of that value creation as rent rolls improve and routine expenses decrease, even though in some cases we will wait to recognize that value (refinancing or selling) because the prevailing market conditions are unfriendly (higher interest rates, lower buyer liquidity).

There are major advantages to owning real estate for the long term, both because of its (again general) historic stability and because of the tax advantages. We attempt to maximize these tax advantages with cost segregation studies in the first year or two of ownership, another investment up front that pays off for years with accelerated depreciation.

When we buy a property that is discounted because it is a "tweener" size with few rival buyers, flexibility becomes critical. Again, the equity comparison is valuable. Let's say you find a stock that is super cheap compared to its balance sheet. You're buying it for $1 but it has $2 of cash on hand. Obviously you are getting immediate value, but you can only realize it if the company liquidates or if the rest of the market recognizes that the price is does not reflect the balance sheet. The latter requires there to be a market of other potential buyers. Similarly, when we take advantage of a mispricing from size (limiting the number of rival buyers), that can work against us if we aren't flexible in our timing to sell. When the broader real estate market is hot, there is plenty of liquidity and plenty of buyers in the pool (often investors who are moving up-stream from smaller to larger properties as they have success). When the broader real estate market is cold, there are not many buyers available. So when we purchase these types of properties, we need to be able to protect ourselves through tough markets and take advantage in good markets. Since last June (2022), the market has been challenging. Rates have increased, many smaller buyers are finding out they are overstretched and stressed. It would be unfortunate to have to sell right now (and thankfully we are have positioned ourselves to be able to sidestep the current market conditions). At some point in the future things will open up again and we want to ensure our loans give us the ability to take advantage.

Finally, we believe that **the best returns are made by layering the above concepts together- patience, flexibility, and multiple catalysts**. The ideal property has multiple short and long-term catalysts (rehabbing units in a neighborhood that is continuing to grow), without the pressure of needing to return cash immediately (allowing us to invest now for future payoff), and with a loan that is flexible (preferably a fixed rate with the ability to prepay if we get an overly hot market). If we position ourselves this way, we can afford to wait out a poor interest rate environment or cap rate uncertainty.

There are two quotes that I like from a book by Antii Ilmanen which I strive to keep front of mind.

- *"Investment success requires good strategies and good investors. Good investors understand which matters they control and focus on these."*
- *"I prefer holding portfolios that are resilient across many different macro scenarios instead of portfolios that perform well when my investment view turns out to be right."*

I believe our approach of layering patience, flexibility, and catalysts gives us the opportunity for resilience when we face tough economic conditions.

<u>How our properties are positioned against "macro" headwinds</u>

Our big macro challenges are inflation and rising rates, with the added variable of uncertain liquidity among buyers.

Generally, inflation is a positive for real estate with fixed long-term debt. Rents go up, expenses go up, but the biggest expense (debt service) is stable. Across our portfolio, rental rates are exceeding pro forma expectations.

Generally, increasing rates are a drag on the market value of real estate. Buyers demand a higher cap rate if they have to place higher debt. The added variable to this is liquidity of buyers. Right now, cap rates have increased but not to the extent expected because there is still a lot of liquidity among buyers trying to place money.

Most of our properties have fixed long-term debt unless we are in the midst of major construction. The explosion of rates in the last 13 months has had a limited impact to our business plans (again, with the exception of one property with major construction). However, these higher rates do have an effect on our timing of refinancing or selling properties where we have created value. Presently, rates are up and banks are very cautious (reflected in diminished loan to value). Though there is still liquidity among buyers, but we do not believe we could maximize returns by selling right now.

For those properties where we have already created significant value (Forest Hill Apartments, Ghent Apartments), we are waiting until the market settles down to recognize that value. Both of these properties are on fixed rates- the former has an earnout that we can get but we will need to "blend in" current rates to our fixed rate and I would rather wait versus taking what is out there presently. We have other properties in the midst of construction and we will continue to monitor refinance opportunities as we stabilize. Finally, we have several properties that have such fantastic debt that refinancing would be burdensome- we will recognize value with stabilizing cashflow after the first couple years and if/when rates ever drop again we will consider recognizing larger chunks of that value by refinancing.

It is hard to say what the effect will be from the recent collapse of Silicon Valley Bank and Signature Bank. Most of our loans are placed with regional banks and credit unions. Our assumption, in part because of some of the communication coming from those banks, is that those institutions are extremely nervous, regardless of their credit worthiness. Given that we do not have massive deposits and our loans are already in place, we do not see a major risk to our portfolio even if one of our banks should fail. But I would imagine that it will be extremely difficult to place a new loan with one of these institutions until things settle down.

<u>How our properties are positioned within their neighborhoods</u>

As mentioned exhaustively in this and prior communication, we are very excited about the tailwinds in the neighborhoods that we have invested in. We continue to see growth in Manchester, the North Side, Shockoe Slip, Forest Hill, and Ghent. In some instances (Manchester and Forest Hill) this growth takes the form of continued new development. In the others, it takes the form of new restaurants in vacant buildings and continued construction of neighborhood amenities.

Across our portfolio, the last year has been one of continuing to plant seeds that will bear fruit in the future as the macro environment stabilizes. We cannot predict when the proper time will be to harvest, but we are happy with continued progress and improvements to pro forma expectations.

I appreciate the faith shown by your investment with us and I hope this is helpful to understand our thought process. Those thoughts continue evolving and I hope to always have the humility and curiosity to continue learning, so I welcome any feedback or challenges to the approach outlined above.

Thanks,

Alex Griffith