EPISODE 293

[INTRODUCTION]

Neal Bawa (NB): The biggest part of your mindset today is to tell the truth to your investors. But tell them about the opportunity that's coming up. If you're not engaging your investors, twice as often as you were engaging them a year and a half ago, you're doing the wrong thing. That's the mindset you need to have - engagement, engagement, more engagement. In about an hour, I'm going to have what is known as a fireside chat, with about 1700 of my investors going over the events of the last nine days. I'm just doing this because I know that they want to know more about it. And I know that they're very interested because usually I don't get 1700 people signed up for one night. Right now, they want to hear from us. They want to hear from you. They don't want sugarcoating. There's been plenty of that. Right now, they just want the truth. And that's where you come out stronger at the end of this.

Announcer: Welcome to Elevate, the masterclass where we dissect the elements of exceptional achievement and lifestyle design with a focus on personal growth and real estate investing. Now, here's your host, Tyler Chesser.

Tyler Chesser (TC): Elevate nation, welcome back. This is Tyler Chesser. I'm so thankful to have you here and I'm blessed and grateful to be sitting with Neal Bawa. Today, we are going to be talking about the state of the financial system, concerns with the financial system where Neal sees things going in terms of the economy, and also really, really going deep in terms of the state of the multifamily real estate investment market, what that looks like today, what that looks like for the second half of 2023, what that looks like for the next three to five years, how you can survive, how you can thrive as an investor with all the volatility and all the choppiness in today's real estate market. And you know, even larger, really, we're talking about the economics of the global economy, the national economy, the regional economy, in terms of the United States, how that impacts your investments, how that impacts your money, your financial freedom. And as you continue forward to protect yourself and your partners, I think you're gonna find a lot of value in today's episode. I know I did. And there's a tremendous amount of

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action-packed advice and considerations for you to absorb in today's episode. So, I want to encourage you to go ahead and plan on listening to this episode a couple of times, because there's a lot of moving parts, there's a lot of crosswinds. There's a lot of challenges. There's also a lot of opportunities. As we move forward, you're going to learn about those opportunities today.

TC: As you know, Elevate Podcast is all about mindset, mind expansion and personal development for high-performing real estate investors. Today is really all about mind expansion in your understanding of the challenges, the risks, and the opportunities in terms of today's market. And as we move forward, understanding the probabilities of what the likelihood of certain circumstances are, as we continue to move forward. So, you're going to find a tremendous amount of value today. I want to invite you to pay the fee. The fee is to pay it forward and share this episode with a friend, someone that you care about, someone that you want to know, hey, you have got to listen to this because there's a tremendous amount of insights that can help us adapt, pivot, grow and capture opportunities as we move forward. Because you know, today's market is nowhere near what the market was six months ago, or 12 months ago or 18 months ago. Today's market is unique. Tomorrow's market will be tremendously unique as well. As we move forward, things will continue to change and perhaps rapidly. So, let's be prepared, let's be ready to anticipate, let's be ready to adapt. Losers react, leaders anticipate.

TC: And that's what today's episode is all about. It's about anticipating what's coming. It's about understanding where we are so that you do not have your head in the sand so that you are making the right decisions so that you're not making tremendous missteps, which can put you in a very precarious position. Of course, we all love real estate, and we're going to continue to love real estate, but it can be very dangerous. If you don't know what you're doing. Today is about getting you more clear on knowing exactly what you're doing and exactly what you're getting yourself into and putting yourself in a position to understand contingency plans to develop and to design and to implement as things continue to develop. So get your head out of this. And that's what today's episode is all about.

TC: I want to encourage you to give us a rating review, subscribe or follow elevate podcast on wherever it is that you listen or watch podcasts. That means the world to us. And I want to introduce you to Neal Bawa who has been on the podcast previously. And you know, he is the "mad scientist" of multifamily real estate. But he's also the CEO and founder at Grocapitus Commercial Real Estate Investment Companies. His companies use cutting-edge real estate analytics technology to source and acquire or build large commercial properties across the United States. They have collaborated with over 800 investors. Their current portfolio is over 4800 units with assets under management value upon completion of over $1 billion. Neal is one of those guys who is sharing his insights across the country on a daily basis. He speaks at some of the biggest conferences across the United States and he's somebody that is highly respected and someone that I think you're going to derive a tremendous amount of wisdom from and insights from today. So I want to encourage you to buckle up and enjoy this phenomenal, this extremely valuable conversation with Neal Bawa.

[INTERVIEW]

Tyler Chesser (TC): Neal Bawa, welcome back to Elevate, my friend. How you doing?

Neal Bawa (NB): Fantastic. So much has changed since the last time we talked, right? It's fascinating the times we live in.

TC: I was reflecting on that as we were about to sit down for the discussion. Obviously, you know, we talked about, I guess, it was probably about a year ago. I mean, in many regards a lot of things have accelerated, you know, and in positive directions. And there's been a lot of challenging set of circumstances in the economy, in the markets that we operate in. So I think it'd be fascinating to get your take on all of those different factors, obviously, being the mad scientist of multifamily, we'll talk about that stuff. But let's start with the higher level, you know, thinking about the financial system. I mean, over the past couple of weeks, you know, as we sit here in late March, there's been some tremendous set of circumstances that have started to cascade throughout the economy. So, let's talk about, you know, are we seeing some cracks in the financial system? We're seeing even larger concerns. What do you make of the recent

banking collapses? Do you think these are isolated? Or do you have larger concerns with what's what you've seen?

NB: Larger concerns? Definitely in that bucket of people that have larger concerns. I think that over the last 12 months, as I've been interviewed on podcasts, one of the things that I've often pointed out as people would say things like, I don't think the Fed would go so far because they would break something. And I would say, yeah, but look, nothing's broken yet. And then people, two months later, would challenge me again and say, you know, I think the Fed is gonna break something. And I'd say, well, it might take longer than you think. And so a year ago, people were betting on the top rate being 3.25%, the Fed funds rate. Then people started betting for it to be 3.75, then 4.25. Now we're at 4.75. But that's where the rate is today. Tomorrow morning, March 22, is when the Federal Reserve will announce what they're going to do with their next rate hikes, because they're meeting today. So, they'll announce tomorrow at noon time, Eastern Standard Time. So, it'll be fascinating to see what that number comes out to be. I don't think it's going to be zero. But we're at basically close to 5% at this point.

NB: And all along, I've been saying the Fed hasn't broken anything. The market expected that stuff would start breaking when the Fed got into the fours. Well, now they're up to five, nothing broke, the economy didn't break. Unemployment rates are still extraordinarily low. In Jan and Feb together, the US economy created 800,000 jobs, that's 400,000 a month. Well, anytime you're creating 400,000 jobs a month, your GDP level is not going to be at 1% or 2%. Isn't certainly not going to be zero, which is recession level. It's going to be more like 3%. I think Q1 GDP is going to come in around 3%, which is rockin' right, it's extremely high. And that's what the Fed is trying to cool.

NB: But here we are today. Finally, I cannot say that in this podcast. I cannot say the Fed hasn't broken anything because they've broken something. And what they've broken is pretty substantial. I can't say I saw it coming. I didn't understand that the banks which were being flooded with massive amounts of cash in 2021 and also in the first half of 2022, they'd have to put that cash somewhere. And I think that some of the banks the choices that they made on where they wanted to put that cash were the exact wrong choice given the massive increase in

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interest rates. So I think that there's potential for severe distress in the banking system. And we can talk more about that.

TC: Why don't we start with what exactly happened? Because I think there's obviously a lot of headlines out there, there's a lot of spin out there. There's been some rescue since we've seen some of these collapses, you know, to sort of at least attempt to contain what we've seen in the banking system. But why don't you sort of recap a little bit of what you've seen and what actually happened?

NB: I think the place to start is Silicon Valley Bank. So, as we, I live in Silicon Valley. So they're right down the street from me, very well-recognized bank, total deposits in the $200 billion range, which doesn't put them in like the top 20 or top 15 in the US, but right after that, maybe the 18th largest, 17th largest in the US. So, a midsize bank on the larger size, not systemically important, but midsize. And so this bank made some fundamental mistakes. One of the key things that they did was as they entered into 2021, and late into 2021, their deposits went up from $90 billion in 2020, all the way to $200 billion. There's $110 billion that flows into this bank, a lot of it is startup cash. They are startups, were cash rich at that point in time. They were getting huge amounts of money from VCs. And that money's flowing in. The bank made the assumption that a year later, they will be at $300 billion. And that was a false assumption. Because once the Fed started raising interest rates, and even a little bit before that, as the tech bubble started to not burst, but deflate, well, they went in other direction, their deposits went from $200 billion down to $170 billion, which doesn't seem like much.

NB: But the bets that they were making with the money, the deposits that were coming in was that they would keep going upwards. So they expect it to be at $250 billion, they end up down at $170 billion. And there's this gap that they weren't able to get around because they had invested their money into long-term treasury bonds. And those treasury bonds were purchased when treasuries were incredibly cheap. The yield was, you know, 1%, one and a half, 2%, whatever it is. Today it’s four, four and a half. So nobody wants to buy those bonds. Those bonds, I wouldn't say that there's anything wrong with those bonds but it's not something that people want to do because they can buy bonds today that have 4% interest rates. And these

bonds are only about a year or two old. So they're if the bond was seven or eight years old, that would be different. But if it's one or two years old, nobody wants to buy them. So, the bank basically was getting into a situation where you know, they were going from $200 billion to $180 billion to $170 billion.

NB: And as more and more depositors started to pull their money out, the bank needed cash, and so they ended up having to sell a lot of these bonds, these treasury bond at discount prices, and they declared a $2 billion loss. One of the people that read their document where they declared this $2 billion loss was the granddaddy of Silicon Valley. His name is Peter Thiel. He is part of the PayPal Mafia and is a big VC. He wrote a letter to all of the startups that he was funding, that letter ended up on Twitter, and a few hours later, a run started on Silicon Valley Bank. And the bank was unfortunately not in a good liquid position because of the fact that they were losing deposits already. And now they're losing tens of billions of dollars in hours. And so the bank never had a shot. They never had a chance to go find alternate financing, they never had chance to get sold. And so basically, within days, the bank has closed because when you get to the point where you can't fund depositor money, the FDIC, which controls banks has to take over.

NB: So now the bank is called the Bank of Santa Clara, it's reopened. And because the contagion was so quick, I mean, this is why Twitter is so dangerous when it comes to bank runs. Because it used to be that it used to take a week for a bank run now it takes hours, thanks to Twitter. And so the news spreads very closely and accelerates the bank run, reducing the options for the banking industry. And the Treasury understands this, the FDIC understands this. So over that weekend, you know, the bank closed on Friday, they already decided that they were going to make all the depositors hold, the FDIC is only supposed to make the first $250,000 of each account hold and most of the bank's money was above $250,000. All those startups with $10 million, $50 million and $100 million, that was all uninsured cash. So the chances of contagion in the banking system was so high that the Treasury on a Sunday brought in all the banks and said we're just going to give all of the depositors' money back.

NB: And they thought that they had, at that point controlled the contagion by doing something so unusual. But in the meantime, there were other banks that were closing Signature Bank was closing and you know, Signature had exposure to crypto, same kind of problems. But, now you substitute 10-year treasury bonds for SBB with crypto for Signature, so they closed. Then there was another small bank that closed. And so what happened is that the stock market started to react and share prices of the banks started to fall. Now these mid-sized banks have two different problems. On the one side, depositors are starting to pull their money out. And on the other hand, their share price is falling, so they can't go out and get fresh equity. And so one of the banks that got caught in that was First Republic Bank, it's about 30, or 40 miles away from SBB. And First Republic has a much, much higher quality bank than SBB. They haven't really fundamentally done anything wrong. You know, they're a little heavy on uninsured deposits, which are the ones that tend to be mostly at risk. But I really haven't seen this bank put a foot wrong in the last couple of years. And so their stock got driven from over $100 a share and yesterday it was at $9 a share. It's gone up to $20 today, so that's good. That's good news.

NB: So now you have a situation where every bank in the US that is not one of the systemic banks is now looking at all of their deposits. They're looking at everything that they're doing, and they're saying, okay, we got to stop lending at this point, because the Fed is great, basically going to come in and do liquidity tests on us. The Fed gonna do something known as *mark to market*, a technical thing, which will hurt our ability to lend. So everyone's frightened right now, everyone's a little bit freaked out. And so we're in this weird in-between situation where the market changes each day. And each day, the direction of the market changes. Unfortunately, we also extended our contagion to a European bank, much larger European bank called Credit Suisse, which was sold for pennies yesterday. So this whole thing now, they know, obviously, we're not talking about real estate yet. But this is all in the last nine days. So it's moving at the speed of lightning.

TC: Yeah, it really is. And, you know, when this episode comes out, maybe a lot of this is gonna be ancient history. And we're gonna have a total sort of new understanding of where things are shaking out. But each and every day, there's a new set of headlines and a new sort of understanding of how far is this going. And how wide is this going? I mean, I do want to talk

about and dive into sort of what you're seeing and what you're projecting with regard to the credit markets, because in general, what we could be sort of looking at as perhaps, a seizing of credit markets. So let's maybe let's talk about that. But let's recap a little bit. Because when we talk about SVB, I mean, ultimately, that was the 18th largest bank in the United States. The second largest collapse in US history. And, you know, sort of 15 years ago, we saw the first largest. And so going back to that example, and perhaps Signature with regard to exposure to crypto and some of the challenges in that market. I mean, would you sort of look at those two examples of recklessness and a lack of a hedge in understanding where the market could go or what the Fed could do in sort of leading to those collapses? And perhaps, you know, First Republican may be different, but would you sort of categorize those first two examples as a bit of recklessness and a lack of foresight in terms of what could happen as the Fed fought inflation?

NB: I think it was a combination of recklessness and a lack of foresight. So they're, you know, SVB buying these long term bonds not fully understanding what was happening with inflation was definitely a lack of foresight. They are not the only one. So the challenge is this, there may not be a lot of other examples in US banks that are on the reckless side, but the lack of foresight appears to be fairly widespread. So in my mind, there are a significant number of other banks, let's just call them a couple hundred banks in the US that have up to $600 billion of exposure to long-term treasuries and other such instruments, right, where these instruments have lost value for the moment. If you let them mature, they haven't lost any value. But the problem is, if your depositors ask you for money now, you can't let something mature. So at this point, you have to sell it at a discount.

NB: So it appears that there's hundreds of billions of dollars of potential risks. And so there's a lot of conversation going on with the Treasury saying, you know, you may be able to use the discount window, which is how the Treasury interacts with the banks to simply give those treasury bonds back to us, and we'll give you dollars. And that would be radical, but could fix the problem. I'm sure Congress would have a conniption if the Fed tried to do that. Because what the Fed is now saying is, okay, you bought treasury bonds, and when you bought them, the bonds were worth $100 million. Now they're worth $70 million. If you have to sell them

today, well, instead of selling them for $70 million, why don't you give it back to me to the Fed, and I'll give you $100 million, and you can meet your liquidity requirements. And whenever you're ready, you come back and you give me $100 million and I'll give you this money back, right, I'll give you these treasury bonds back. So it's a swap where the Treasury is taking on the risk instead of the banks. I think we may end up needing to do that if banks continue to fail. And I think that that has significant consequences for liquidity because the only way for the banks to then get their treasuries back would be to tighten lending.

NB: So their ability to lend, you know, not just to multifamily, but lend in general become significantly restricted. So in the short term, I think regional banks are going to have a very hard time lending, they're gonna have a very hard time. It may not impact the super large, you know, ones because those the super large banks, we call them systemically important banks, like Wells Fargo, Citi, and Chase, Bank of America, those guys, they actually have higher liquidity requirements. So they're not as much affected. Also the money that is coming out of these regional banks, guess where it's going? To the big boys. So, the big boys are right now flush with cash. I mean, Bank of America has gained $18 billion, I think Citi has gained over $25 billion, so has Chase. They are now flush with new deposits. So they actually are in a better position to lend out. But with the exception of the Big Five, I think you're going to see credit drying up over the next three months. And that's the short term, the medium term, the picture is completely different. In fact, it's the opposite. But in the short term, I think you're going to see a drying up in the credit markets.

TC: So what do you see in the medium term?

NB: Well, today's the 21st of March, tomorrow morning, the Federal Reserve will announce what happens with their next rate hikes. So far, they've been hiking at incredible speeds. But we expect that because in January, they dropped to 25 basis points, they are going to announce a 25 basis point hike, even though on March 7, when Jerome Powell was talking to Congress, he opened the door to, hey, I think we need to go back to 50 basis point, 25 is not working, inflation is too high.

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TC: Well, that was before we saw some of these contagion, right?

NB: Right. So already, the benefit that we've received is, I think there was a high chance that we were going to be 50 basis points tomorrow. I think there's almost a zero chance of being at 50 basis points, there's a pretty high chance, let's say two-thirds that we're gonna get a 25 basis point increase to match with Jan's 25 basis point increase. There's a 38% chance that the market is pricing in that there's no rate hike tomorrow which I don't believe by the way. The fact that the market is thinking that where they were thinking 50 basis points 10 days ago, is in itself dramatic. Now, what does that mean for short term? Nothing, it means nothing. It still means that the Fed is raising rates, it still means the Fed is withdrawing liquidity from the marketplace. But what that means is I have seen dramatic changes to the curve. There's a curve that the market provides and it's a new one every day, which is the market's expectation of how much further will the Fed go up? How long will they stay there? And then when will they come down? And how sharply will they come down?

NB: The curve shows these four things. Well, I can tell you the curve from 13 days ago and the curve from yesterday are dramatically different, where the curve from 13 days ago was still showing the Fed to be at 5% Fed funds rate on December 31st. Today it is showing the Fed to be at three and a half percent on December 31st. So that is a 150 basis point difference. There is a very large difference in liquidity. There is a very large difference in lending. I don't think it happens by the way - the market seems to be they swing back and forth in extremely dizzying ways that we don't do in real estate because we don't live on a daily basis. And we're not reading articles 17 times a day and you know, reading tweets on our phones 35 times a day. But I do think that it's likely that the feds hiking is going to be less aggressive, their plateau is going to be for shorter time and their rate cuts are going to come faster. I think all three of those things are true. It may not be as aggressive as Wall Street wants it to be. Wall Street always wants free money. But I think that all three of those are affected. None of that affects what happens in the next 90 days. But I think beyond the next 90 days, we start to see the numbers get better. Now, this doesn't change the fact that 90 days from now, regionals might still not be lending to us. That's bad for us, but whoever is lending might have better rates.

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TC: Yeah, you know, it is really interesting. And to your point, we're not day traders in real estate. So, you know, all of this, you know, in many respects, will be water under the bridge at some point. But I think many of the experts that are out there sort of giving their analysis or their expert opinion on what has happened, what they're talking about is saying they're saying, look, what is happening now is based on what happens three to four quarters ago. And so what we're seeing is a lagging indicator of some tremors across the system. And that could be larger tremors as we move forward because of the fact that we had such rapid increases in interest rates over the past 12 months. And so moving forward, what we could be looking at are some even further unforeseen circumstances.

NB: We have to. So one of the statements that I like to talk about that, the Fed says this until they're blue in the face, but nobody ever actually listens to them. The Fed says, once we hike a rate on a given day, it takes nine months for that rate hike to wind its way into the economy for its full impact to be felt. There's going to be an initial impact the day you raise rates, but for the full impact, it takes nine months. Here's the scary part, Tyler. If you go back nine months ago, from this week, that was only the first 75 basis point hike, the second, the third, the fourth and the 50 basis point hike could not have possibly wound its way through the economy, only the first one has, that's what you're feeling now, with the first one having felt, you know, full impact. There's four more of those suckers that are after that. They're still winding their way through the economy. And we're not feeling that impact yet. And so that's why that's the statement that I keep repeating, nine months, nine months delayed impact, they only started nine months ago.

TC: Exactly. And if you really take another step back and look around and realize that our economy is built on historically low-interest rates for a prolonged period of time. And what you just described shows how sort of dangerous and how fragile this system can be. And so let's kind of get tactical here, let's serve the listeners. What can investors do to protect themselves with all of this instability? I mean, what are you doing? What are you suggesting? What are you seeing, as you kind of look out on the horizon? You see all of these concerns, right? Which can, you know, create opportunity? I mean, at the same time, yes, there's a lot of concerns, a lot of risk out there. Let's be aware, let's protect ourselves. But let's also position ourselves to optimize the opportunities on the horizon.

NB: Oh, absolutely. Honestly, today, after what happened in the last 90 days, which is a little mind boggling is actually a great time to be an investor. It's an absolutely phenomenal time to be an investor. And I think it'll be an even more phenomenal times in the second half of this year. I think the second half of this year is the biggest investment opportunity since, you know, maybe seven or eight years ago. So I'm very, very bullish. I'm not buying anything right now. Because right now multifamily is a falling knife. Single-family is a knife that's falling but in slow motion. So it's actually much safer. Why, but the reason single family is safer is simply because almost everybody that owns a single family property has a 30-year fixed loan at 3% right? So if every one that needs to sell has a 3% fixed loan, their incentive to sell is very strongly reduced. Right? So that's why you notice that single families have only fallen to date about six and a half percent. And there's obviously markets like Phoenix and Austin that have fallen faster. But even though the markets are only at 10 or 11%, there's no panic anywhere in the single family industry that I can see anywhere in the United States, right.

NB: Californians are panicking, but California has panic all the time. They're either boom or bust. Maybe that's their nature, right? Either they're the greatest market in America or the sky is falling and there's nothing in between for California, so sort of ignore that one market. But in general, there's no distress that I can see in the single-family market. That is not true in the multifamily space. There is unquestionable distress building up while actually I would say Tyler is the precursor to distress, but there are very clear signs of precursor to distress. And I want to for a moment get technical and I'll explain what what I'm about to say. So the CBRE US cap rates survey for the second half of last year came out and it is the most interesting cap rate survey I have ever seen in my life. Okay, by far the most interesting because it tells me what is moving, where are the markets moving and some of it is absolutely stunning because the markets are not reacting to these rate hikes the same way. Some markets are reacting very strongly, some markets are reacting with almost very little momentum.

NB: I'll give you an example. So multifamily suburban, so suburban, not in fill not downtown stuff. Baltimore class A value adds, one year ago, that's H1 2022. Actually not one year. Yeah, one year ago, so the first half of last year versus the second half of last year. In H1, 4.75 cap. In

H2, 5 cap. Not much of a difference, a little bit, quarter point, right? The sky is not falling. But now, let me give you that number for Phoenix. This is a market that I like, it's the market that I'm invested in though I don't have any current value add properties in that marketplace. Phoenix has gone from 4.25 in the beginning of the year, the first half, to 5.75. That is 150 basis points. Now, because I've been technical, you're like, what the heck is he talking about? What does that 150 mean? Well, the answer is prices in Phoenix are down by 25% to 30%. That's what a 150 basis points means, right? That's what it means. That's a stunning number when you're comparing the first half of a year to the second half of the year, the same year, right? Not talking about two years, three years, four years.

NB: Usually, you don't see movements like that even over half a decade, well, you're seeing that in the same year. So there is clearly distress in Phoenix that is resulting in these cap rates changing so quickly. And I think that there's a bunch of markets that are right behind Phoenix that we are going to see distressed building up in the second half of this year. Note that this survey is for the second half of that last year versus the first half. Well, we're in March, now, three more months have passed, interest rates are still higher, there was a rate hike in January, there's going to be a rate hike tomorrow. So that distress is actually going to build up further. And while we've had one market in distress in the US, now, I think that there's going to be ten by the end of June.

NB: And so the opportunity for investors is that in the second half of this year, we will get to buy multifamily properties at 20% to 30% off peak prices. That's the opportunity. And opportunity is time-bound. Because I don't believe for a moment that a market as high great as Phoenix is going to just stay there, it's not going to stay at 5.75, you know, cap for a value add property, that's just not going to happen. It makes no sense. Those numbers are crazy. It's obviously just because of interest rates. The moment you get interest rates to come down to a reasonable level, let's say 12 to 18 months from now, you're gonna see these properties get better. And because that bounce back is going to be fairly rapid, just like the decline has been fairly rapid. Remember, first half of the year, second half of the year 150 basis points, it makes no sense unless it's interest rates. Well, a bounce back may not be 150 basis points, because I think Phoenix was too expensive, right? That bounced back might be 75 basis points.

And once again, a lot of people are like, what is that 75 basis point? Well, now, if you buy a property in the second half of this year in Phoenix, I'm just using this as an example, by the second half of the following year in a single year. If that property moves 75 basis points on a $30 million property, you've made 5 million bucks, you've made $5 million. Well, that's halfway to doubling your money on the equity side. Because you know that $30 million property probably had $10 million dollars in equity. You just made $5 million from cap rate movements in a single year. Well, that's a pretty awesome opportunity to have.

NB: We saw it once before in 2021. But in 2021 properties are going from four cap to three cap and obviously that was a bubble. Now properties are going from 5.75 to 4.75 less of a bubble, right that less bubbly. So, you have not only the opportunity to make gains, but Tyler you have the opportunity to keep those gains for the following two or three or four years. And so just that one cap rate report made me go wow, this is an incredible opportunity. Phoenix is a star market with amazing, you know, an inflow of migrants, amazing inflow from California, people are coming in from everywhere, jobs are coming in. Some of the most critical things that are happening with the globalization are happening in Phoenix. So, all of this just has to do with interest rates.

TC: Yeah, at the end of the day cap rates are just a derivative of interest rates. And I think what the earlier part of the conversation why that's so interesting and critical to projecting forward is it almost sort of gives you a little bit of Intel in terms of what the probabilities are that the Fed makes a certain pivot, perhaps at a certain point in time. Because late last year, I think most investors are like, I have no idea how far they're gonna go, because they went farther than most people expected. Ultimately, they were obviously committed to the fight against inflation. And now what we've seen is there have been some significant breaks in the system as a result, which then now could be getting larger, which at some point is going to be intolerable. And so to your point, if you're projecting forward, perhaps there is a sort of, you know, rounding the corner or light at the end of this tunnel. And so if you're projecting, you're speculating in terms of valuation. I think a lot of what you're saying makes a lot of sense. But talk to me about the underlying factors of the distress now and you were talking about a falling knife and multifamily.

So you're obviously what you're projecting is sort of through the second half of this year, you think you could see perhaps depending on the market, another perhaps another 10% sort of decline in valuation. So talk to me about the underlying factors of that distress. Is it lack of recaps on some of these deals? Is it lack of continued rent growth in the assumptions that are just not hitting? What else would you say about the underlying factors of the distress that you're seeing in the marketplace?

NB: It's March 2020, and COVID hits, everything stops, we can't go to our properties, we can't survey them, there's no funding available, everyone's office is closed. So from March to June, March to July, nothing happens. There's no transactions for multifamily. So what happens to all those properties that were in contract? Well, they close in the second half of 2020. So imagine a second half of 2020, where there's a lot of closes. Now, imagine that those properties had bridge loans, because most of them did. Well, those bridge loans are probably two years of bridge with a year's extension, while you've already exercised that extension, because that extension would have been exercised last year in the second half of the year. So now here we are in 2023, a lot of those properties are coming up for renewal.

NB: And the lenders are very, very clearly saying this is before what happened in the last nine days, we're not going to renew you the value of your property because the cap rate changes has fallen to the point where it makes no sense for us to give you additional extensions, we need you to go out and get a new loan, we don't want your loans on our books. That's what the lenders are saying. My guess is there's thousands of properties that meet the description that I just provided for either purchase in the second half of 2020, or all of 2021, there were even some that were purchased in 2022. It's just they're not going to come to market right now, because they still have some time left on their bridge loans. So those properties are the least affected. In the short run, though, I think that nine months from now, or 12 months from now we'll see them.

NB: So in the meantime, it's the 2020 stock, it's the early 2021 stock. And these properties, many of them either had no rate caps, and I know you're supposed to buy a rate cap but the bank doesn't really mandate it the appropriate way. So there are properties with no rate caps.

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Or there's properties with rate caps but those rate caps are pretty high. They're 8%, 9% sort of cap. So, you know, until the property is at 8.63 or nine, it's not hitting its rate cap, and because it's not hitting its rate cap, it's bleeding, right? So that rate caps not as as useful, right, somewhat useful, but not as useful to those properties. Bottom line, those properties are now bleeding. And an average $30 million property could easily be bleeding by $100,000 a month.

NB: Now the first few months of bleed can be covered using operating cash, the next few months using short-term loans and syndicator loans. But then after that, 6, 7, 8, 9 months into it and the bleed is increasing, because every time the Fed raises by a quarter point, the bleed goes up by seven or $8,000. In this example that we have of a $30 million property with $100,000 in bleed. Well, now the bleed is 106. They raise again by a quarter point, now it's 112. You're not seeing that much of a light at the end of the tunnel because each month that bleed is going up.

NB: And so there are only two choices for people for syndicators that are in that crunch. Number one, refinance your property. But because of cap rates, what if your property cannot be refinanced without wiping out your investor equity? Well, then you're stuck. The second option is to accept some kind of prep, accept a prep fund that comes in or a rescue fund that comes in that basically rescues your property. And the third option is keep eating the $100,000 or $250,000 a month of bleed. And I believe that because there were a lot of new syndicators in the last three or four years, they don't have the money to stem the bleed, they don't have the money to keep putting it up. Even the ones who now see the light at the end of the tunnel, because of the banking system breaking. They think that something good is gonna happen at the end of the year or by next year, even though it's couple of people, they don't have the money to get there.

NB: So, there's going to be a realignment, a lot of properties will go back to the bank part, I think most of them will actually end up getting sold, because even if they get sold some portion, some percentage of investor equity will get made back and syndicators will prefer to sell their properties rather than send them back to the banks and end their careers. So because effectively if you have a Fannie or a Freddie loan, you send it back, that's it, you can't ever get

a Fannie Freddie loan. Again, that's the end for you. And even if it was not Fannie or Freddie, now you have to disclose that you send a property back to the bank every time you sign on a new loan. And sometimes just that is enough for you not to get that loan, you can get denied. So a lot of these syndicators will sell properties, which is why I believe that in the second half of the year and this is really this was your question, right? What is causing this panic? Well, the second half of the year, there's got to be four or five, 6000 properties that have to be sold.

TC: *Hey, guys, I want to remind you to check out CF Capital. CF Capital is the premier boutique real estate investment firm in the Midwest and southeast region of the United States. We are a national real estate investment firm with a purpose. We provide property investment and asset management solutions to help passive investors maximize returns on high-value multifamily communities. But our investments go far beyond acquisitions, we invest in people. We are in the business of elevating communities and raising the bar for everyone within our ecosystem. CF Capital is a real estate investment firm focused on the acquisition and operation of multifamily assets. We confidently deliver tax-advantaged stable cash flow and capital appreciation with a margin of safety. By investing alongside our team, investors can preserve and grow their wealth without having to deal with tenants, termites, or toilets. Investors come and stay for the outsized returns we create in our deals while appreciating the ancillary opportunity to make a bigger impact that only CF Capital can provide. If you're an investor and want to invest with us, here's how to learn more about CF Capital at CFCapLLC.com or by simply clicking the link in the show notes of this episode. We will see you on the inside of this powerful community. So, let's elevate communities together.*

TC: So, how do investors make the right moves in the second half of the year or thereafter if there are, you know, there's cascading effects of this level of distress? You know, projecting forward is very challenging. I mean, thinking about what will the Fed actually do? Because you know, cap rates being a derivative of interest rates is an important function for investors to understand as we play this long game, you cannot project you can consider probabilities. There are no certainties or only probabilities as you move forward. But how can investors make the right decisions in terms of cleaning up this distress and taking advantage of the opportunities in this marketplace moving forward?

NB: I'll break that question up into two pieces. Because when you use the word investor, Tyler, it can apply to limited partners and general partners. So I'll go with the LPs first because it's much easier. As a limited partner, you're in an awesome position. Unfortunately, you're not going to use that awesome position well. You're going to chicken out because the five or six properties that you've invested in the last couple of years, they're going to have cash calls, and those cash calls are going to make you miss the opportunity today. You're gonna say I don't want to buy any more multifamily. I have cash calls coming on four or five of my properties. Biggest mistake ever. The cash calls are the reason why the opportunity is so massive today. They are the reason, they are the cause and the reason of the opportunity. So as a limited partner investor, your job becomes to be an investor that thinks like Warren Buffett. I'm sure Warren Buffett gets hit every time the market goes down. But guess what he does, he buys a lot more. He sits there buying nothing when the market is bullish. And he has all sorts of money at his disposal. And he doesn't do anything with all of that money.

NB: So right now, when there's distress in various markets, people like Warren Buffett become very aggressive even though some of their own assets are taking hits, which if you look at what Berkshire Hathaway is doing, they are marking down their assets they are taking hits, but they also know it's a great time to buy. So as a limited partner, you have to be logical, you cannot react because of what's happened in the marketplace. Those were past properties that were purchased over the last two years. Any property that today is being purchased for 25%, 30% off of its peak price from 18 months ago is probably a good one to buy.

NB: The only other caveat I would put in is this, the market is about to lose a lot of syndicators. I think 30% of syndicators will say goodbye to the world of syndication. Make sure that the people that you're investing with are rich. I know that sounds a little nasty. Invest with rich syndicators because right now is a time for syndicators to give back. Right now is the time for syndicators to invest in their properties. And you want affluent syndicators that have made huge amounts of money, you know, cash reserves. Ask questions about how much of their cash reserves are you willing to put in Mr. Syndicator, if all these forecasts that you've made don't turn out to be true. So this is actually a time to invest with rich people. That's my

feedback. So that's the LPs. I mean, your job is really just to think like Warren Buffett, and if you do it, you'll make plenty of money.

NB: On the general partner side, right? I mean, as a GP, in some ways, you have to be like that LP. You've got to shore up your existing properties, while not ignoring the fact that you can now buy properties 20-25%, you know, cheaper. I mean, come on, a year ago, you were like, oh, my God, I can't buy anything, everything's so expensive. Nothing makes sense, nothing pencils out. Well, in the second half of this year, you won't have that problem. Or if you have that problem. It won't pencil out for a short amount of time, and then it will. So, at least you're not paying a ridiculous amount of money for the property because remember, net operating incomes of multifamily properties haven't gone down in the last 12 months. NOI as a whole, if you look at every multifamily property, the US net operating income has increased over the last 12 months. It's gone up and it's gone up fairly substantially, even though not as much as the crazy 2021 increases, or that slightly less crazy 2022 increases. But in 2023, NOI is still blipping up a little bit because rent growth is positive. Should be higher because inflation is at 6%. So rent growth should be at seven or eight, but it's right now at one or two, but it's still higher. So from a dollar perspective, net operating income is going up. The only thing that's dragging the value of the property down is cap rates and interest rates. Those two things are tied together as you mentioned, Tyler.

NB: And that is a time-bound phenomenon. The rents are not. Because inflation is still staying high. So when you come out on the other side of this, you will still get higher rents. So you're basically buying a lot of NOI for a fairly small amount of money. So as syndicators you have to be basically be in this Jekyll and Hyde mode, where on the one side, you have to be extremely aggressive on selling your properties and not basically letting them go back to banks and convincing your investors that they should be buying new properties. That's hard because now your existing investors are gun-shy. But that's what you have to do. You have to do everything you can to tell your investors that there's a great opportunity coming, and that they should invest with you, even though your current properties might be bleeding or doing cash calls.

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TC: What do you think the likelihood of interest rates being prolonged at a much higher level really is from here? Because, you know, as I mentioned earlier, you know, a lot of what we're seeing across the economy, and some of these tremors are really telling us that our system is really built on a tremendous amount of historically low-interest rates. I mean, what is the likelihood that moving forward over the next 2, 3, 4 or five years? You know, we're surprised by the level of interest rates moving forward? Because if that were to happen, then obviously we're looking at a totally different outlook, what's your probability in terms of that sort of set of circumstances?

NB: Well, I'll do a short, mid and long term because I think that the answers are all different. In the short term, I still see interest rates going up. I see the Fed raising tomorrow, even though I don't know if they will. And I think they might raise again in May, before they plateau. But I think that that, because of what happened with the banking system, that plateau is going to be shorter, and that down curve is going to come quicker and be sharper downwards. So which means that in the midterm, let's call it 2024, I am fairly bullish about interest rates going downwards. Let's say they might be the Fed funds rate might be in the high threes by the beginning of 2024. And in the low threes by the end of 2024, maybe even at 3% by the end of 2024. So we'll see what happens there, which means that we'll see some life come back into the multifamily industry, especially in the second half of 2024.

NB: But also in the first half of 2024, there's going to be a light at the end of the tunnel, and that light's not going to look like it's too far, some properties will be able to kick the cans down the road, especially if they were purchased in 2022 and not 2021. If you purchased in 2021, that light may be a little bit too far for you. We'll see. But then in 2025 onwards, here's what I believe, very bluntly, low-interest rates are the norm. I do not think that changes. But if you're thinking zero or 1%, or 2% Fed funds rate that's gone for a long time, I think a Fed funds rate of two and a half, or three, which is similar to the conditions we saw in 2019 is what we are likely to see. Remember the Fed funds rate they have what is they call the benchmark Fed funds rate, right, or the equilibrium Fed funds rate, that rate is two to two and a quarter because at two to two and a quarter corresponds with 2% inflation since COVID, they've had it at zero, but even before COVID, they were struggling to make it go up to two because inflation

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was lower than 2%. I think they don't they won't have any of those struggles going forward for the next five years, they'll be struggling to keep it below three. So even at three, it puts some downward pressure on real estate values, but not the kind of outrageous pressure that it is putting today.

TC: No, this is really good stuff. And I'm gonna let you get out of here shortly. But I can't let you go without even zooming out further and talking about sort of the overall economy, the outlook, you know, when you think about where we're sitting now, we've been talking a lot about, obviously the banking system, the financial system, multifamily real estate in particular, but thinking about sort of the economy in general with regard to the United States, and of course, we're in a global economy. Are we looking at a recession or something worse here? Or do you have more of a rosy outlook here over the next year to three or so?

NB: My current outlook is there's a 100% chance of a recession happening. I think it happens in Q3, and Q4. Previously, I was saying Q4 and Q1 of next year but now I'm seeing I'm pulling it forward a quarter because of what just happened the last nine days as credit seizes up, businesses stop hiring, they start laying off people, and then that recession gets pulled forward. So it may happen in Q3 and Q4. I think it'll be a shallow recession. Most of these kinds of recessions tend to be shallow because they're artificially created recessions. The Fed is forcing the economy into recession and the economy clearly doesn't want to go there. And so once the Fed is convinced that inflation has moved back, expectations have moved down for salaries, then they let loose a little bit and things come back.

NB: So I have a very strong feel that there is going to be a recession, In the long term, I see the world economy being extremely problematic over the next five to six years as the world order changes, Since the 80s, we've had very calm geopolitics, we've had very calm demographics, that calmness is now lost. I think this goes away. I think that the US could easily get into a shooting war with China over the next three years. And I think that makes for new problems that we don't have yet, And it's early to say whether we're actually going to get into a shooting war with them over Taiwan, but I wouldn't be surprised if it happened. I think both the Pentagon and the Chinese army is preparing and those preparations have really amped up in

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the last six months, So I think we are going to be in for a very problematic time in the next five to six years, I have an extreme belief in the works of Peter Zeihan, Z-E-I-H-A-N. And if you read his works, you will realize why the US comes out the strongest economy in the world at the end of that very difficult timeframe.

TC: Interesting. Is he's the author of The Rise and Fall of American Growth, is that correct?

NB: That's one of his older books. There's a few books about that. Peter Zeihan, zion or Z-han some people call him z-han, is absolutely brilliant at understanding why the world order is changing, and why it cannot stay where it is. And initially, we have a lot to lose when it starts to break. And then we have the most to gain of any country in the world. So in my 10-year outlook in the United States is the brightest it has been for the last 20 years. But my five-year outlook is very, very bumpy.

TC: 45:56
Yeah, a couple book recommendations that I would add would be the Fourth Turning, and then also The Changing World Order, Bridgewater & Associates. Anyway, those books are extremely sort of instructive in terms of what I think is really going on with regard to demographics with regard to geopolitics, and all the economics that we've really talked about today. But Neal, this has been a lot of fun. I've really value your input on this. I think that obviously, in many aspects, you're the mad scientist of multifamily. But you know, you are reading the data from a high level to understand sort of what is happening so that we can project forward. And I think it's important to anticipate and project and understand probabilities and be able and willing to adapt. But man, I think, you know, the other piece of this is the strong will survive, and the strong will thrive through this opportunity. So is there anything else that you would like to say about sort of the mindset and the positioning of those who are going to win over the next five to six years as we encounter those rocky circumstances?

NB: The biggest part of your mindset today is to tell the truth to your investors. But tell them about the opportunity that's coming up. If you're not engaging your investors, twice as often as you were engaging them a year and a half ago, you're doing the wrong thing. That's the

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mindset you need to have - engagement, engagement, more engagement. In about an hour, I'm going to have what is known as a fireside chat, with about 1700 of my investors going over the events of the last nine days. I'm just doing this because I know that they want to know more about it. And I know that they're very interested because usually I don't get 1700 people signed up for one night. Right now, they want to hear from us. They want to hear from you. They don't want sugarcoating. There's been plenty of that. Right now, they just want the truth. And that's where you come out stronger at the end of this.

TC: Great stuff. Great advice, Neal. Tell the listeners where they can learn more about you and what you do.

NB: I'm the only Neal Bawa on the world wide web. So simply type in my first and last name N-E-A-L B-A-W-A, anything good is about me anything bad is about me as well. There's several hundred articles there. We have a website multifamilyu.com, where data geeks like us gather. We have about 25,000 people that sign up for our webinars, we do a dozen of them, including the one that I'm doing tonight. So if you're interested in joining that data-driven community, we don't teach we don't have a educational program. There's no subscription. It's just where a bunch of people gather to talk. And so, you're welcome to multifamilyu.com.

TC: Neal, thank you, again, for being on the podcast for the second time, look forward to part three. We will come back and we'll review a lot of our projections here. We're not perfect, we cannot project perfectly into the future. But I guarantee that we can go back and we can say, look, here's what happened. And here's where we see things going forward. So, I really appreciate you taking the time, Neal, and we will see you again next time.

NB: I'll see you in part three.

[END OF INTERVIEW]

TC: Elevate nation, we are getting the best of the best insights from one of the greatest people in this business and one of the most insightful, intelligent individuals in this business. So I just

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hope that you saw how much value was brought today. And of course, we're discussing a lot of alarming things. But you cannot have your head in the sand, you've got to be awake, you've got to be aware of the set of circumstances so that you can survive so that you can thrive so that you can continue in this wealth creation journey of real estate investing, because you know what? It comes with risk. And so that risk is out of our control. But as you continue to get educated in terms of where things are moving in understanding the best moves to hedge yourself in the event of challenging circumstances. That's how you're going to position yourself to be successful in the long term, because again, it's not day trading, but it is about being successful in the long term. And to do that, you've got to last you've got to continue to press forward. And so obviously, there are a lot of challenges in today's economy in today's market, there are also a tremendous amount of opportunities. And as we look forward, I think I would agree in many aspects of what Neal was sharing today.

TC: I hope that you found tremendous value from this conversation. I want to encourage you to have a discussion with your partners, with your friends with your family members. What are you doing to position yourself for tremendous opportunity and what are you doing to protect yourself from the tremendous level of risk in the marketplace today and As we move forward here over the next year, two years, three years, maybe even five or six years of tremendous volatility that is really complex and many aspects, but what are you doing to ensure that you can continue to move forward successfully, you can capture those opportunities successfully as we move forward. So there's a lot of very complicated matters to understand and interact with. But I think the more that you're willing to have a conversation, the more that you're willing to make adjustments and adapt, the more likely you are to be successful as you move forward again, so I hope that you found tremendous value in this conversation. If you did, share this episode with a friend give us a rating review and subscribe to elevate podcast we're gonna continue to bring massive value to you throughout the time of tremendous volatility that we may be entering into or we may already be within now.

So I just want to thank you so much for listening to Elevate Podcast. Until next time, Elevate nation. We will see you next time.

[OUTRO]

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