HOUSING

A MARKET UPDATE

PRIME MERIDIAN CAPITAL MANAGEMENT ir@pmifunds.com

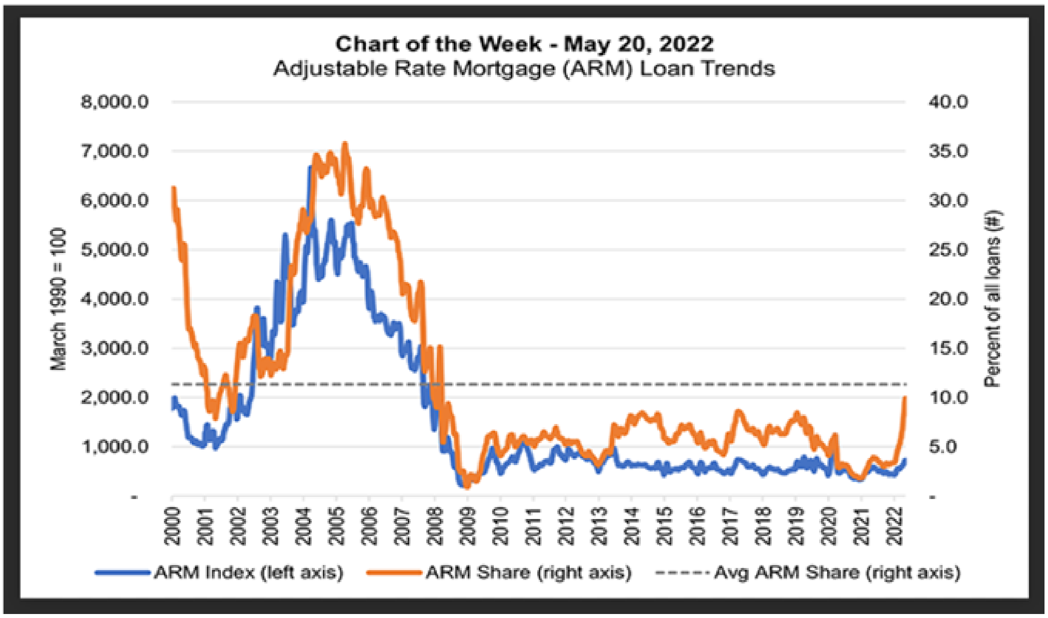
RESIDENTIAL REAL ESTATE

If you watch the news or read the local paper, you would think that we are on the cusp of a massive correction in residential real estate. If we look at the run-up in housing prices and the increases in mortgage rates in isolation, then yes, you could make a strong case that we are due for a correction.

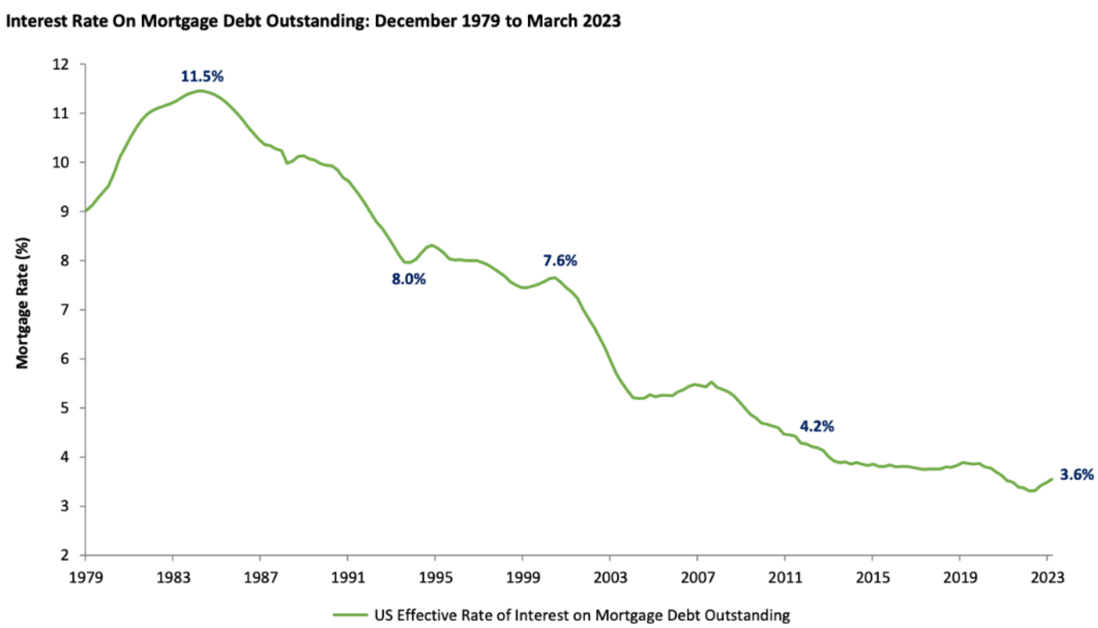
However, in our October 2022 letter to our investors we outlined why Prime Meridian did not think the housing market was vulnerable to a significant correction in price, which turned out to be correct. There were a lot of great charts in that letter which we think are still relevant today, below are a few of those charts with some updated data.

Primary drivers

We believe that there are three primary drivers supporting the outlook for the residential real estate market. First, homeowners have fixed rate mortgages and are not exposed to the financial risk of mortgage rates resetting at higher levels as interest rates increase. In 2005, 35% of outstanding mortgages were adjustable-rate loans, that compares to 10% as of 2022, according to the *Mortgage Bankers Association* (see chart below / orange line). As rates increase adjustable-rate mortgages will gain market share, but vast majority of mortgages outstanding have a fixed-rate.



Second, homeowners have locked in extremely low mortgage rates. The average mortgage rate in the United States is currently 3.60%, up from 3.30% when we first wrote about this in October of 2022. We expect that number will continue to drift higher as new buyers enter the housing market, but having locked in generational low interest rates, existing homeowners have a very strong incentive to stay put.

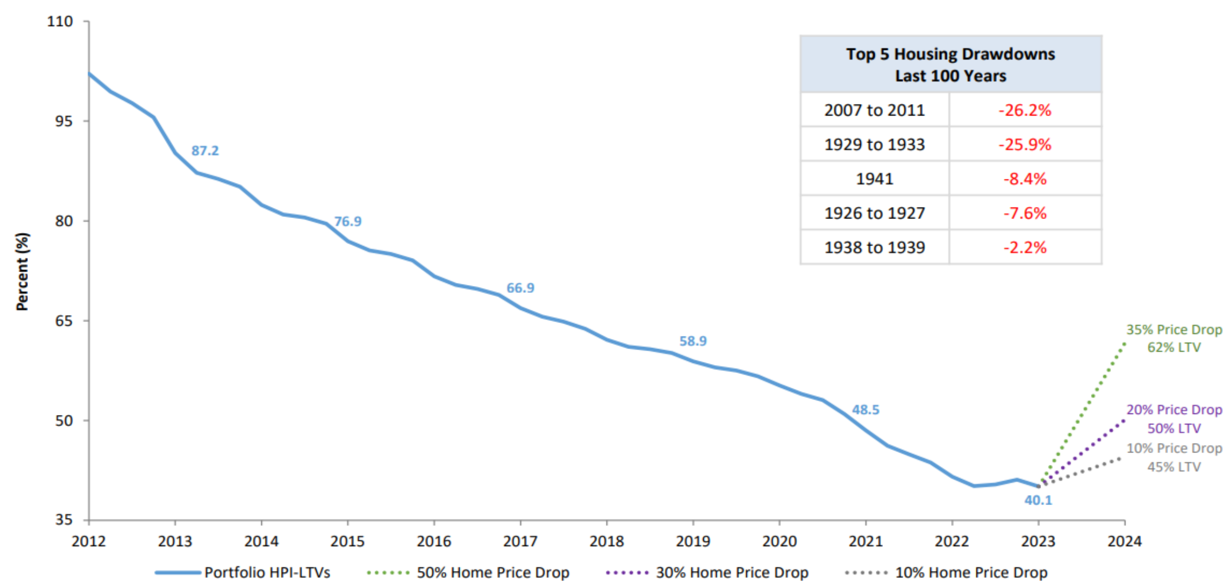


Source: Bloomberg. US Effective Rate of Interest on Mortgage Debt Outstanding uses ticker "USMIRATE Index." Data as of 3/31/23.

Third, homeowners have a significant equity cushion of approximately 60% of their home's current value. That equity cushion insulates homeowners from a price decline, even in an extreme event like 2007-2011 when home prices dropped 26.2%. Today a similar drop would return the market to 2019 levels.

❖ HPI-LTVs have decreased from 48.5% to 40.1% in two years, increasing equity ownership by 8.4%.

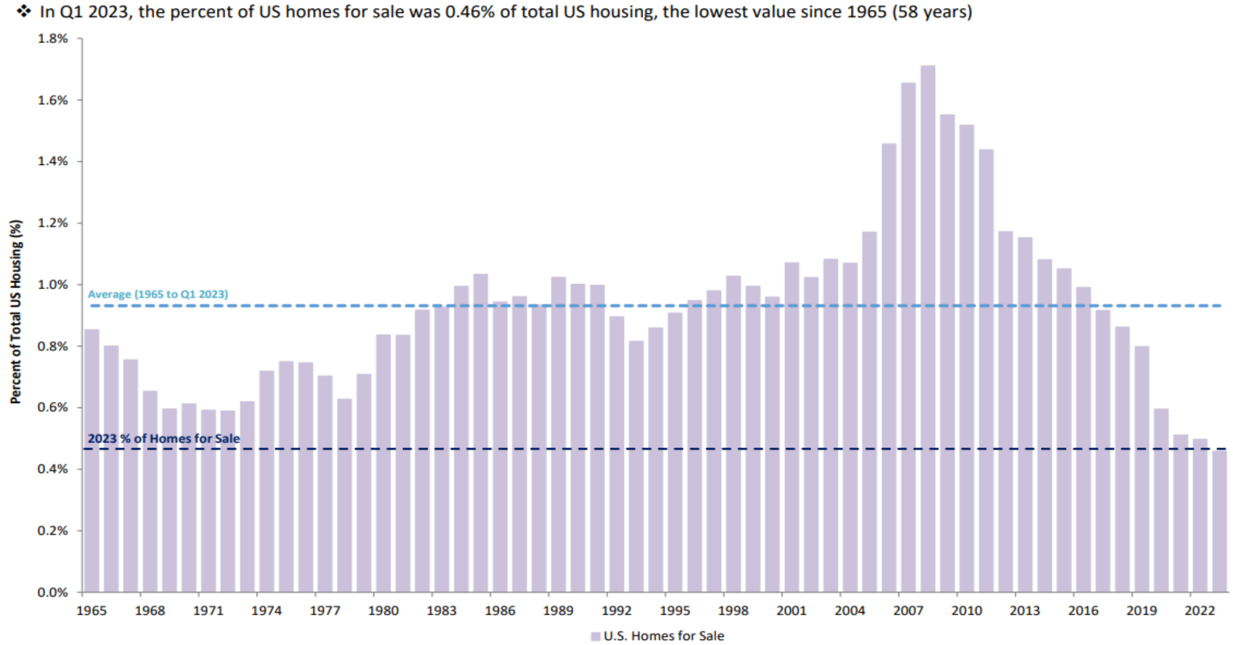
Portfolio HPI-LTVs: Last 11 Years



Source: Bloomberg, Robert J. Shiller, Irrational Exuberance, 3rd. Edition, Princeton University Press. Figures above shown for illustrative purposes only. Portfolio composition and investment characteristics are all estimated as of 6/30/23, may differ substantially over time, and should not be considered investment advice.

To summarize the above, homeowners have locked in low fixed rate mortgages and have built up significant equity in their homes. As a result, many homeowners are choosing to stay in their current home, which has resulted in existing home inventories declining to the lowest levels in 58 years. As a homeowner, why would you move if it means doubling your mortgage interest rate and potentially increasing your property taxes by 40% to replace your existing home for a similar house?

❖ In Q1 2023, the percent of US homes for sale was 0.46% of total US housing, the lowest value since 1965 (58 years)

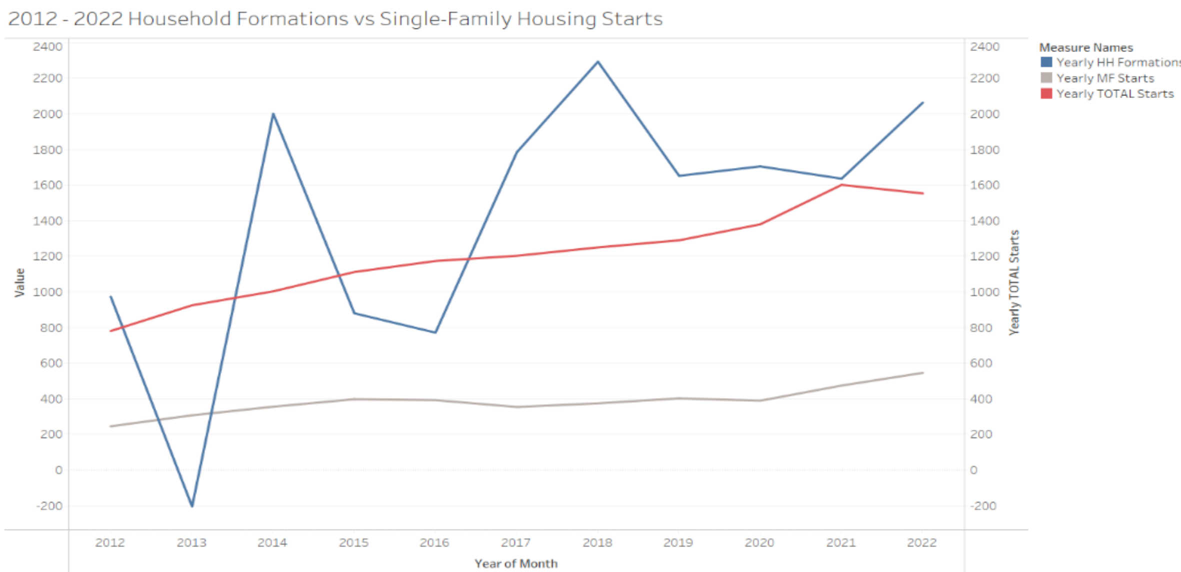


Source: US Census Bureau. Data is calculated using estimates of the housing units for sale only and the total housing inventory for the United States. Data as of 3/31/23.

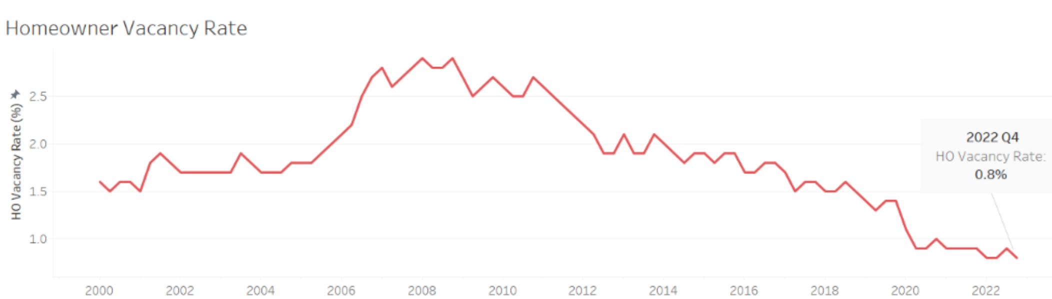
There is no assurance that the Fund will achieve its investment objective, generate positive returns, or avoid losses.

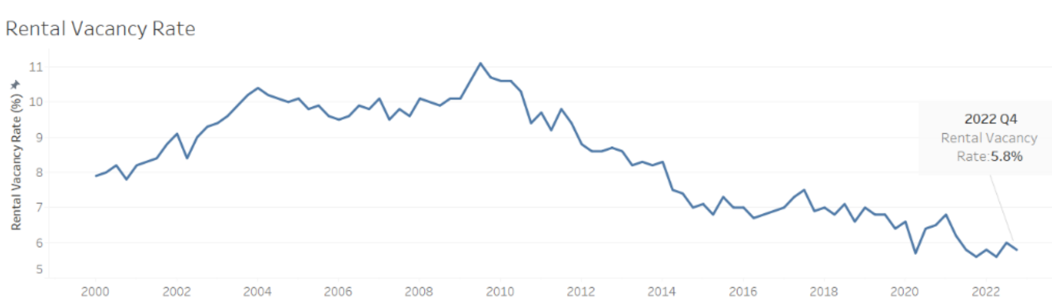
Structural Shortage

The U.S. housing markets continues to struggle with a sizable shortage of new homes, a result of more than a decade of under-building relative to population growth. In 2022, an additional 2.06 million new households were formed, resulting in a total of 15.6 million new households between 2012 and 2022. Homebuilders started construction on about 1 million single-family homes and 546,000 multi-family homes in 2022, bringing the 2012 to 2022 overall housing starts total to 13.3 million homes. As household formations continued to outpace housing starts in 2022, the gap between total housing starts and household formations widened in 2022 to 2.3 million units. See below chart courtesy of realtor.com.

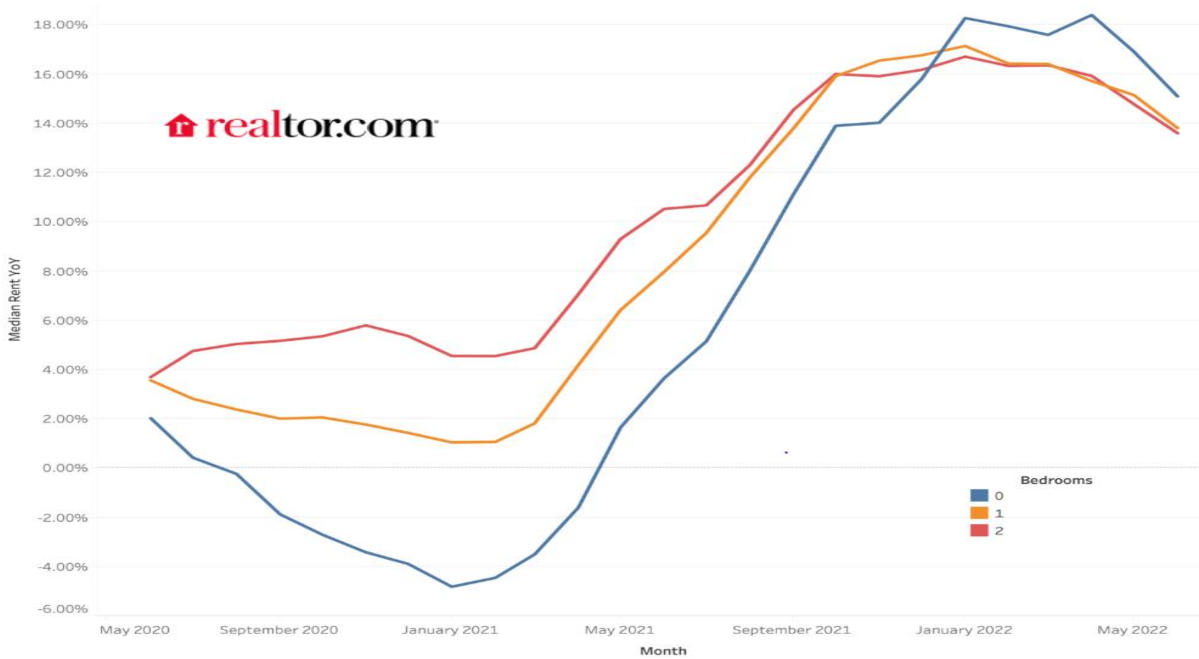


Vacancy rates for single family and multi-family homes remain exceptionally low and confirm the structural shortage. Homeowner vacancies dropped from 2% in 2012 to 0.8% by the end of 2022. Similarly, rental vacancy rates plummeted from over 9% in 2012, reaching a low of 5.6% in 2021 before rising slightly to 5.8% in 2022. Low vacancy rates in the multi-family sector, combined with record rents, has shifted the focus of builders away from single-family to multi-family new construction.



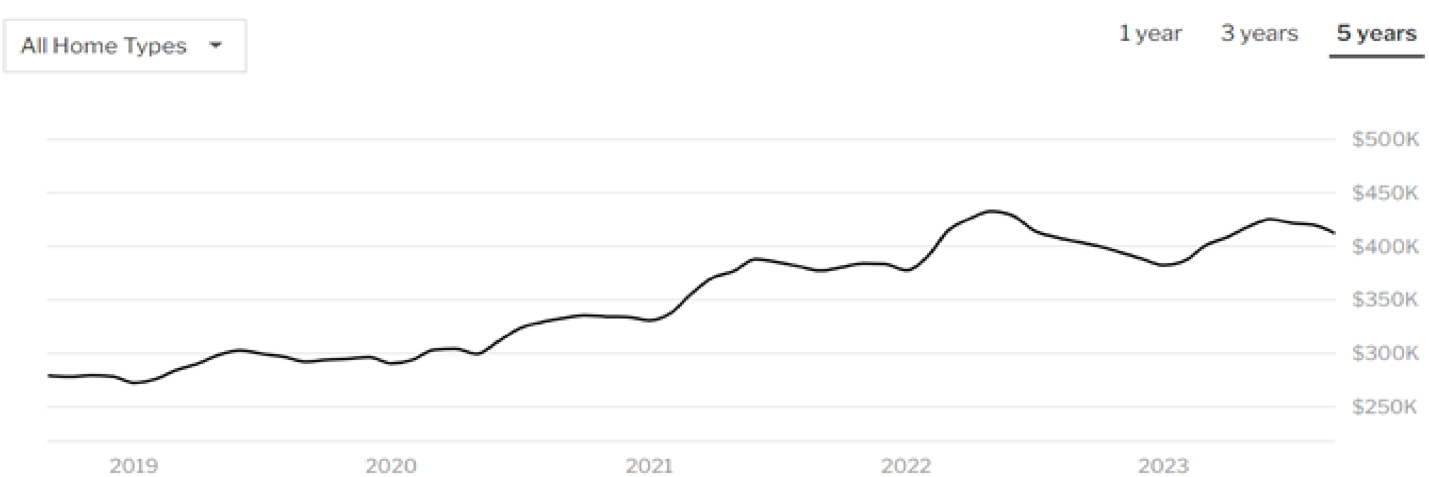


Renting remains more affordable than buying in most metro areas. In fact, in 38 of the 50 largest US metros, the monthly cost of renting a home is lower than buying a starter home, and renting has become relatively more affordable year-over-year. The median listed rent was $1,876 in the 50 largest US metropolitan areas as of June 2022, up 14.1% year-over-year. Metros with low unemployment continue to see the largest gains in the cost of rent.



All of the above leads to a steady to modestly positive housing market, in spite of the negative sentiment widely circulated in the media. According to Redfin, in September 2023 U.S. home prices were up **2.0%** year-over-year, selling for a median price of **$412,020**. While the number of homes sold was down 16.2% year over year with 419,968 homes sold in September of 2023.

Median Sale Price	# of Homes Sold	National Avg. 30-Year Fixed Mortgage Rate
$412,020	419,968	7.2%
+2.0% year-over-year	-16.2% year-over-year	+1.1 pt year-over-year



Based on Redfin calculations of home data from MLS and/or public records.

Outlook

The drop off in existing homes for sale and the tepid recovery in new home starts leads us to believe that the housing market will remain robust through 2024. In fact, we believe that the lack of existing homes for sale has opened the door for rehab specialist and new home builders to thrive.

There are several areas that we think are particularly attractive in the current environment. Direct first lien bridge loans to experienced micro developers in growing markets with a focus on single-family and multi-family rehab and new construction projects, with LTVs in the mid-60s and potential yields of 10-12% are particularly attractive.

We also like opportunities in the residential non-performing loan space, where banks and finance companies are seeking to repair their balance sheets often selling loans at steep discounts to their current market value. These deals require patience and expertise to evaluate, litigate and service, but offer the potential of excellent risk adjusted returns of 12-14%.[1]

While we remain positive on the outlook for residential real estate broadly, we do believe that going up in Seniority in the cap structure with a focus on debt as opposed to equity represents a better potential risk adjusted return for investors. We believe, this is driven by the technical dislocation in the banking and finance sectors, which we expect to continue through 2024.

Sean Bill
Chief Investment Officer

We believe the lack of existing homes for sale has opened the door for rehab specialist and new home builders to thrive.

Prime Meridian Capital Management offers direct exposure to both performing and non-performing real estate loans via the Prime Meridian Real Estate Lending Fund and the Prime Meridian Non-Performing Loan Fund. Please reach out to ir@pmifunds.com to learn more about our strategies.

[1] There can be no assurance that the assumptions made in connection with any Projections will prove accurate, and actual results may differ materially, including the possibility that an investor may lose some or all of any invested capital.

Disclosures

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