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Multifamily Mid-Year Outlook

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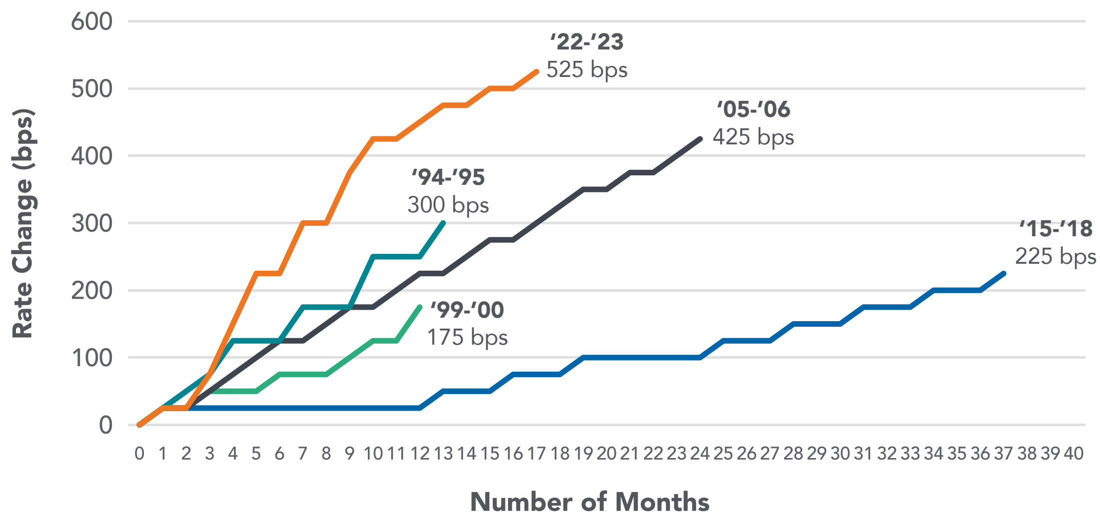
In periods of low interest rates, real estate investors can ride the leveraged beta escalator to strong returns, often rewarding the most aggressive and least disciplined investors the most. When the cost of capital rises, and does so abruptly and acutely, the difference between a positive and negative outcome becomes increasingly attributable to what you invest in, where you invest and the structure of that investment. As a result of a broad and complex confluence of events, we have entered a part of the economic cycle where the cost of capital is elevated, credit has tightened, and underlying fundamentals and the associated demand drivers differ vastly across property sectors.

As unemployment stays low and inflation appears to be moderating, overall economic conditions seem to be improving. This has led to increased optimism among most market participants that have been hoping for a proverbial "soft landing" scenario. However, we must acknowledge that inflationary pressures persist due to factors such as a historically tight labor market, reshoring, and government expenditures. Consequently, the Fed's ongoing efforts to curb demand and control inflation are likely to result in a prolonged period of elevated interest rates. As a function of this dynamic, we see a strengthening counter-cyclical case for a resilient multifamily sector anchored by strong demand from a deep and sticky pool of tenants.

The increase in yields on risk-free assets (i.e. U.S. Treasuries) has led to a coinciding increase in the required return for other assets as investors demand additional compensation for the incremental risk of their investment and leveraged buyers seek to offset higher financing costs. However, the increase in required returns across assets has varied significantly as the additional risk premium investors require is predicated upon their view of an asset's short, intermediate, and long-term performance. With respect to multifamily real estate, the required return is reflected in cap rates, which are defined as a property's 12-month forward net operating income as a percentage of its value. While multifamily cap rates have expanded over the past several months, the degree of expansion has lagged the change in the risk-free rate and thus reflects continued optimism about the sector's performance and a significant expansion of risk premium. We have observed cap rate expansion of 100 to 125 bps since the beginning of 2022 compared to the over 225 bps shift in the 10-year treasury. The relatively modest decline in values, which we believe to be between 10% to 20% depending on location, quality and vintage, follows a period of outsized growth that was the byproduct of historically strong demand. As the market digests these changes and impacts, specifically the disconnect between the increase in debt rates relative to the increase in cap rates, transaction volume has declined 64% year-over-year with only $75 billion of transactions in the second quarter of 2023[1] as a standoff between buyers and sellers persists with the



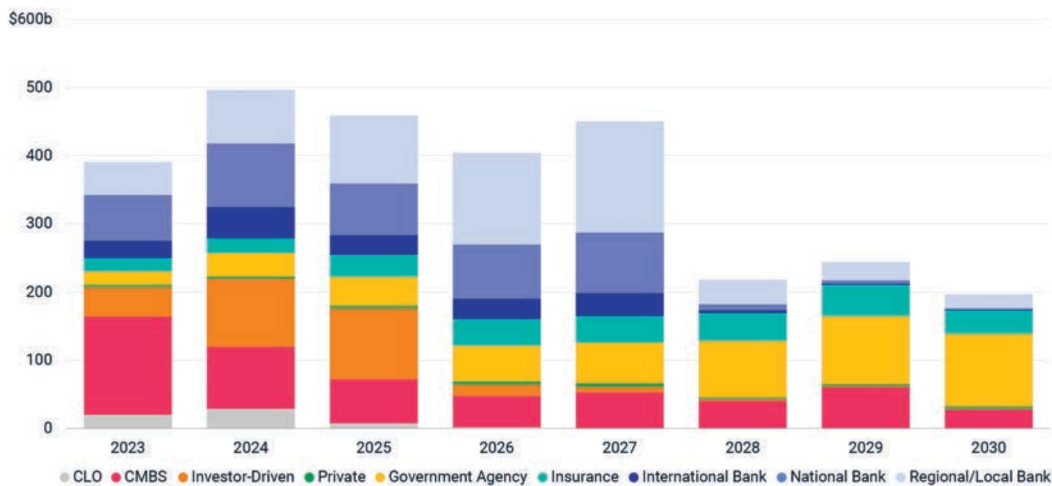
Source: Forbes, Federal Funds Rate History 1990 to 2023.

1. Source: CBRE Q2 2023 U.S. Capital Markets Figures, MSCI Real Assets.

number of buyers significantly outnumbering the willing sellers. While the year-over-year decline has been significant, the first half of 2022 was historically strong. As we have moved through 2023, there is increased activity from a price discovery perspective across various markets, which may signal a pending improvement in volume.

Due to the willingness of a subset of market participants to increase their risk appetite over the last couple of years, we saw an increase in high-leverage, short-duration borrowing at floating interest rates between the third quarter of 2020 and the middle of 2022.[2] This increase in floating rate exposure puts pressure on borrowers and lenders of these loans as a wave of commercial real estate debt matures over the next several years in a much tighter credit environment coupled with meaningfully higher interest rates. This pending maturity wall is causing lenders to pull back, limiting credit availability to the best borrowers and the most predictable assets. Capital structure-related issues will become increasingly prevalent as we move through 2023, creating opportunities for well-capitalized investors.

Volume of Maturing Commercial Property Loans by Lender Type



Source: Mortgage Bankers Association, Cohen & Steers. As of March 10, 2023.

The events of the last several years have created paradigm shifts in the use cases of certain property sectors, accelerating demand for some while eviscerating demand for others. The office sector has been particularly impacted due to a clear mismatch between demand and supply, impacting both owners and lenders with exposure to that asset class. It is important to recognize that all commercial real estate sectors are not homogeneous, and the underlying fundamentals relative to their performance differ vastly. Factors such as asset type, vintage, quality, and capital structure have the ability to materially impact investment outcomes. Consequently, this will undoubtedly be a period where there will be a broad dispersion of returns across sectors and participants.

Despite the current state of the office sector, the property markets have experienced surprisingly resilient fundamentals. Excluding office, occupancy rates across all sectors have remained steady, providing landlords with stable and consistent income. As we move through the remainder of 2023 and anticipate that interest rates will remain higher for longer in an attempt to weaken demand, the more cyclical property types will likely experience headwinds.

Multifamily has long been a favored sector of property market investors due to its ability to deliver returns with a lower correlation to broader markets. In the pecking order of necessity, shelter is second only to food, which is a key reason why multifamily has empirically outperformed on a long-term, risk-adjusted basis relative to other property types. In addition, population demographics, housing supply and affordability challenges have further fueled outsized returns for multifamily investors over the last several years.

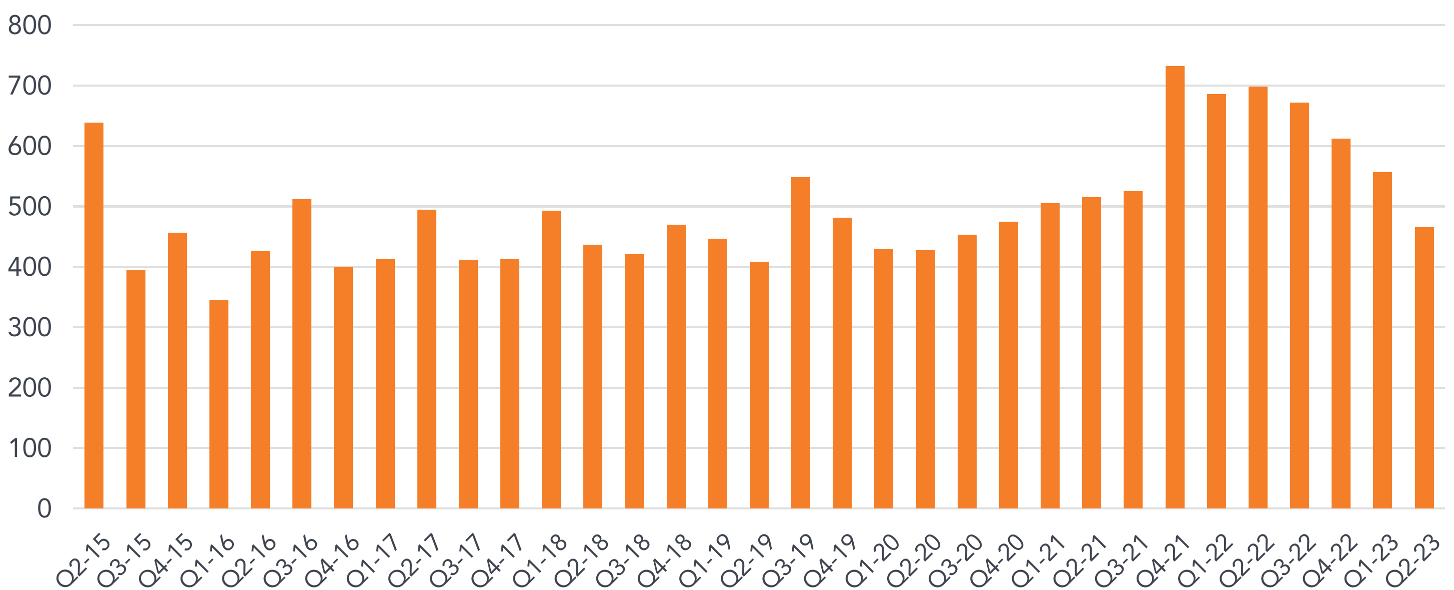
2. Source: https://www.wsj.com/articles/bonds-backed-by-apartments-are-under-stress-as-housing-market-cools-9717d617?mod=article_inline

As the U.S. economy added 1.67 million jobs through the first half of 2023,[3] historically strong job growth and a consequently tight labor market have been a catalyst for continued rental rate growth. In addition, higher mortgage rates have served to redirect demand from would-be homebuyers to the rental pool and keep them there longer. The average homebuyer is now 36 years old, up from 33 years old the year before.[4] These factors individually, and certainly collectively, would normally fuel elevated occupancy and rent growth relative to the long-term average; however, the effects of inflation on consumers and tempered household formation due to broader economic concerns coupled with new supply and a rent growth cycle that was outsized over the past several years have led to a more muted operating environment.

Deliveries, particularly in high-growth Sunbelt markets, are scheduled to be significant through 2024. The increase in supply is a byproduct of starts that occurred two to three years ago when small and mid-sized developers were able to easily access both debt and equity, a dynamic that has since changed dramatically. In June, multifamily permits decreased 13.9% to an annualized pace of 465,000 units, down 33.4% compared to June 2022. The June pace for multifamily permits was at the lowest level since late 2020, a sign of future apartment construction slowing. While the supply chain issues in the wake of the Pandemic have largely been rectified, the lack of available construction financing is now the top reason for delays in new starts. New multifamily starts are down 15.3% year-over-year as of June 2023, which should lead to a meaningful drop in completions by 2025-2026, which will likely bode well for multifamily investors over the intermediate term.[5]

Much of the slowdown in new construction starts is attributable to banks pulling back on construction loans. The Federal Reserve's most recent senior loan officer survey showed roughly 73% of respondents reported tightening loan standards for commercial real estate construction and development (which includes multifamily).[6] This is critical because banks are traditionally the leading source of construction loans. Starts will likely drop off further in the second half of 2023, and we could end the year with approximately 50% of the starts we saw in 2022.

Multifamily Housing Permits Issued



Source: U.S. Census Bureau and U.S. Department of Housing and Urban Development, New Privately-Owned Housing Units Authorized in Permit-Issuing Places: Units in Buildings with 5 Units or More [PERMIT5], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/PERMIT5, August 16, 2023.

3. Source: U.S. Bureau of Labor Statistics
4. Source: https://www.nar.realtor/newsroom/nar-finds-share-of-first-time-home-buyers-smaller-older-than-ever-before
5. Source: U.S. Census Bureau and U.S. Department of Housing and Urban Development, New Privately-Owned Housing Units Started: Units in Buildings with 5 Units or More [HOUST5F], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/HOUST5F, August 16, 2023.
6. Source: Senior Loan Officer Opinion Survey on Bank Lending Practices at Selected Large Banks in the United States (Status of Policy as of July 2023)

Despite the new supply in Sunbelt markets, these markets have proven resilient to date as a result of strong population growth and housing supply and affordability challenges. Of the top 17 markets boasting the most net new renters through the first half of 2023, the Sunbelt and Mountain Regions represented 14 markets. In addition, the largest rent concessions on new construction, or average days of free rent landlords provide to attract a tenant, are concentrated in non-sunbelt markets.

Apartment Demand Leaders, 1H 2023

Rank	Market	Net Absorption (Units)
1	Houston, TX	6,877
2	Phoenix, AZ	6,635
3	Dallas/Fort Worth, TX	5,430
4	Chicago, IL	5,486
5	Charlotte, NC	5,257
6	Nashville, TN	5,163
7	Austin, TX	4,868
8	Atlanta, GA	4,704
9	Washington, DC	4,698
10	Orlando, FL	3,785
11	Denver, CO	3,711
12	Northern New Jersey	3,266
13	Raleigh/Durham, NC	2,826
14	Jacksonville, FL	2,724
15	Huntsville, AL	2,548

Source: RealPage Market Analytics, June 2023.

Largest Average Rent Discounts for New Apartments

Rank	Market	Average “Days Free”
1	Oakland	43
2	New York	40
3	San Francisco	36
4	Boston	34
5	Seattle	33
6	Minneapolis/St. Paul	32
7	Washington, DC	31
8	Northern New Jersey	31
9	Portland	30
10	San Diego	30

Data reflects average concession value in terms of “days free” offered by properties in lease up.

Source: RealPage Market Analytics, June 2023.

As previously noted, the rate at which rents are growing has moderated as a function of a number of factors, including the sizeable number of recent deliveries. Nationally, rents grew every month so far in 2023, but not at the same pace as they did in the first half of 2022, which is why the year-over-year growth was modest at 1.1% as of the second quarter of 2023.[7] Of the nation's top 150 markets, 36 cut asking rents for new leases in the year-ending June. While most of the markets that experienced declines saw a negligible impact, there were five markets where cuts exceeded 3%. Of the top 150 markets in the country, 18 are experiencing rent growth of greater than 6%. The strongest markets are not the institutional favorites right now, as the list of leaders represents a mix of college towns, energy markets and cities in the Northeast and Midwest.

Asking Rent Growth Leaders

Rank	Market	Rent Growth
1	Midland/Odessa, TX	18.0%
2	Madison, WI	10.0%
3	Champaign-Urbana, IL	8.6%
4	Springfield, MA	8.3%
5	Knoxville, TN	8.2%
6	El Paso, TX	6.9%
7	Springfield, MO	6.7%
8	Youngstown, OH	6.6%
9	College Station, TX	6.6%
10	Fayetteville, AR	6.4%
11	Omaha, NE	6.4%
12	Trenton, NJ	6.4%
13	Portland, ME	6.3%
14	Fargo, ND	6.3%
15	Rochester, NY	6.2%
16	Albany, NY	6.2%
17	Northern New Jersey	6.0%
18	Cincinnati, OH	6.0%

Source: RealPage Market Analytics, Market-rate apartments, year-over-year through June 2023. New leases only.

7. Source: CBRE Q2 2023 U.S. Capital Markets Figures, MSCI Real Assets.

One of the most constructive factors for multifamily fundamentals in the current environment is that single-family home prices remain mostly the same relative to their peak in 2022. Empirical data shows that there continues to be a significant undersupply of single-family housing, and most homeowners have a mortgage rate well below the current average for a 30-year fixed-rate mortgage. Over 90% of owners have a mortgage rate below 6%, and nearly one-quarter have mortgage rates below 3%, impacting mobility within the single-family market.[8] As a result of existing homeowners locking in historically low interest rates, there has been little-to-no incentive to trade up, which has caused for sale inventory to remain low. This limited inventory has offset the negative impacts of elevated interest rates on values in most markets as demand has been able to match, if not exceed, supply.

According to an analysis by Freddie Mac, the U.S. was short 3.8 million housing units as of 2020, which represented a 52% increase in the housing shortage relative their assessment only two years prior.[9] Between 2020 and 2022, approximately 3.7 million new households were formed[10] but only 2.7 million new housing units were completed,[11] thereby further exacerbating the existing housing shortfall. If the average annual pace of 1.9 million new household formations over the past five years is maintained going forward, this would imply that the U.S. would need to deliver well north of 2 million new housing units per year for the next several years in order to address the existing shortfall, a threshold that hasn't been reached since 1973.

While we believe there will be idiosyncratic cases of distress due to capital structure-related issues, we expect the multifamily sector to manifest continued resiliency. Supply issues are short-term, we are reaching peak rates, but the housing supply and affordability issues will be sticky, as will inflation, underpinning secular demand for rental housing. Despite the oddities of the cross currents that exist, we believe the market will continue to reward investing in sectors with secular tailwinds with the most well capitalized investors.

8. Source: https://investors.redfin.com/news-events/press-releases/detail/930/nearly-everyone-with-a-mortgage-has-an-interest-rate-below
9. Source: https://www.freddiemac.com/research/insight/20210507-housing-supply
10. Source: U.S. Census Bureau, Household Estimates [TTLHHM156N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/TTLHHM156N, August 21, 2023.
11. Source: U.S. Census Bureau, Housing Units Completed, https://www.census.gov/construction/nrc/data/series.html

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