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Macro Headwinds Potentially Lead to Tailwinds for Multifamily Development

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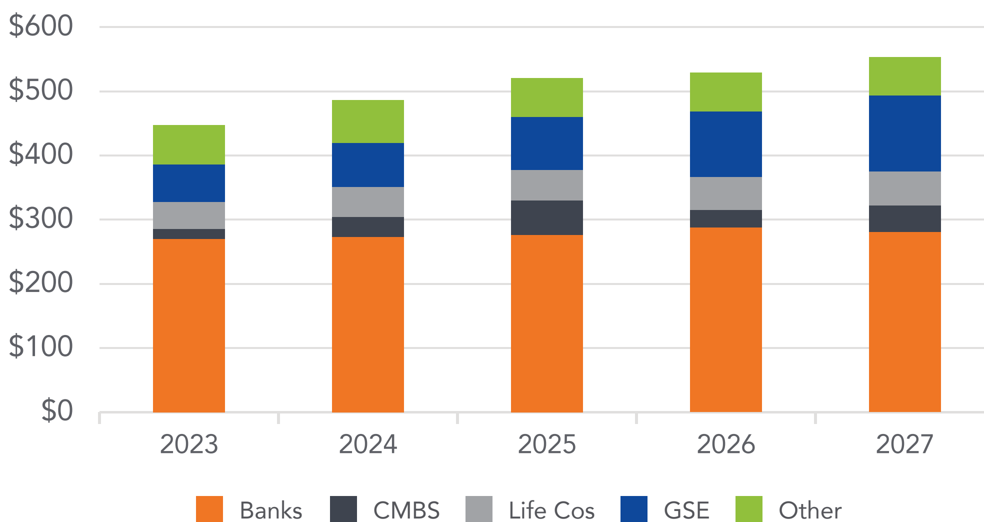
Rising interest rates, inflationary pressures, a potential recession and now a banking crisis are testing investors' nerves, driving many of them to money market funds, where for the first time in years, they can earn a reasonable rate of return. As of the end of March, total money market fund assets increased by $65.99 billion to $5.20 trillion fueled by both institutional and retail investors alike.[1]

High profile investors are calling for the Fed to stop raising, or cut rates, and backstop all bank deposits for a period to stem fears while attempting to identify the next shoe to drop. One sector that is getting a lot of headlines is the commercial real estate market due to the $2.5 trillion of commercial real estate debt set to mature over the next five years.

It is estimated that $447.42 billion of commercial real estate loans will mature in 2023, with another $486.24 billion in 2024 and over $500 billion annually from 2025-2027. Over half of these loans are held on the balance sheets of banks and thrifts, the institutions that are seemingly the most vulnerable in the current storm.

Commercial Real Estate Mortgage Maturities ($ in Billions)[2]



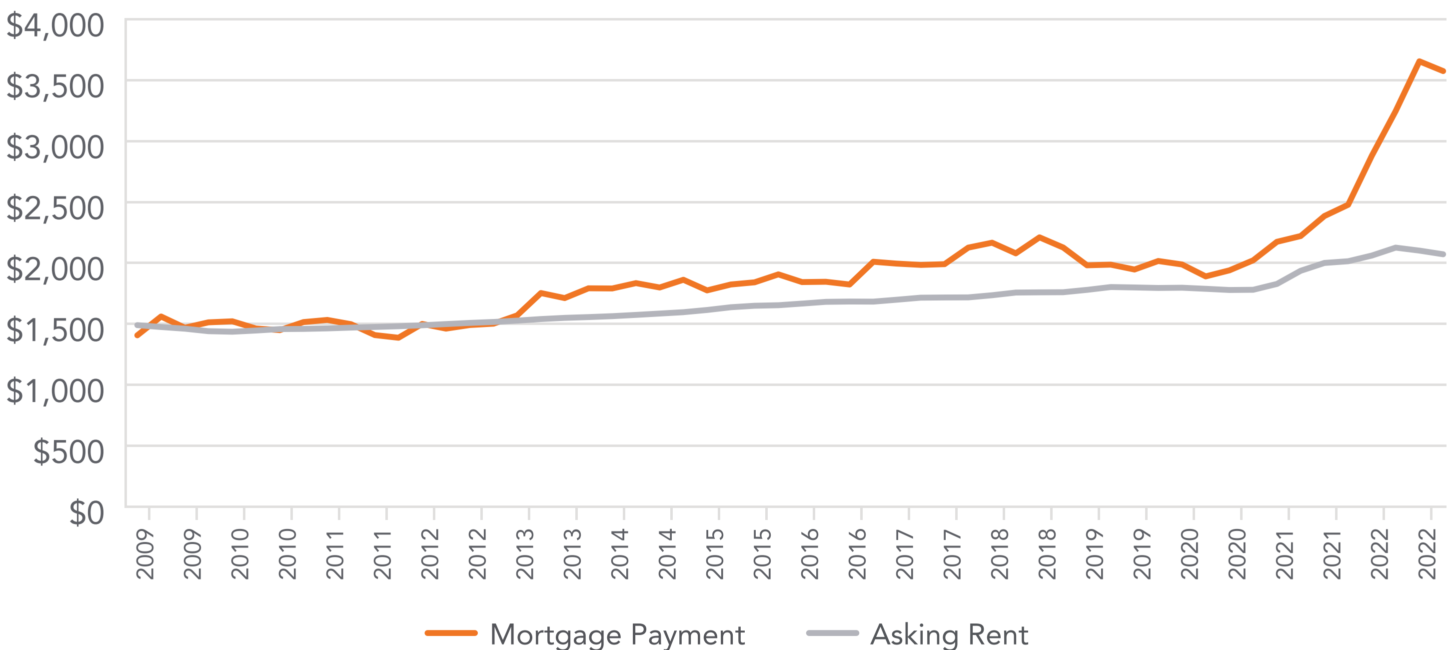
1. Source: Investment Company Institute 2023. https://www.ici.org/research/stats/mmf.
2. Source: Trepp Inc. https://www.trepp.com/trepptalk/commercial-mortgage-universe-grows-multifamily-universe-tops-2-trillion.

Many banks, acknowledging that deposits are fleeing, and loan maturities are looming, are predictably reticent to approve new loan originations in favor of preserving liquidity. One of the corresponding effects of the pressures that these institutions face is the broad-based pull-back in loan origination over the near term. That sound you hear is liquidity getting sucked out of the market just as rates have increased as steeply and as quickly as any time in history.

A silver lining of this dynamic is that it is deflationary by nature and will help the Federal Reserve achieve its near-term objectives relative to inflation by further restricting investment, and in turn driving down asset prices as fewer market participants are able to access capital. When you put this together, it is a bad time to have to refinance maturing debt or look for a new loan and its easy fodder for generalists to sound alarms to illicit clicks and quotable soundbites. Without more context, it is a compelling bear case.

Is the news all bad for property market investors? That depends on the segment of the market you are invested in and your time horizon. Real Estate is a broad category encompassing various sectors, all of which have different demand drivers and liquidity profiles. Commercial real estate property types include office, retail, industrial, multifamily, hospitality and more thinly traded sectors such as self-storage, cell towers, life sciences and data centers and the outlook for each is very different.

Given the differences in the underlying fundamentals across these varied sectors, the demand drivers for occupancy, who finances them, the structural nuances to those loans, and the discrepancies in asset quality and location, the dispersion of returns for investors in this part of the cycle will be unusually broad.



For illustrative purposes only. Past performance is no guarantee of future results.

3. Estimated mortgage payment assumes 10% down payment, 30-year amortization, estimated property taxes and homeowners' insurance premiums of 0.79%, 0.50% of property value, respectively, and private mortgage insurance (PMI) premiums of 1.235% of loan amount. Home prices based on median sale price of houses sold for the United States as retrieved for https://fred.stlouisfed.org. Monthly rent represents average U.S. rent for four and five start rated properties as retrieved from Costar. As of December 31, 2022.

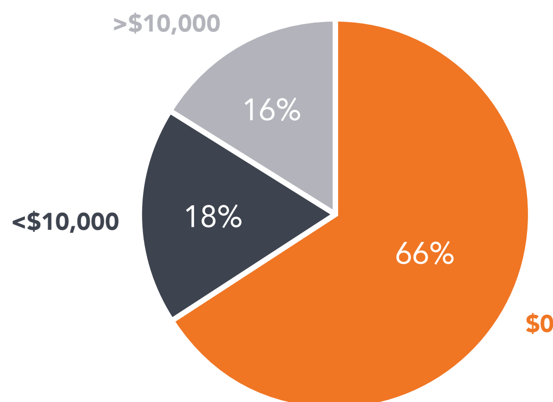
For multifamily investors, particularly developers, some of the cyclical and near-term macro challenges will catalyze stronger fundamentals over the intermediate term. Investors that want to allocate to growth but are hesitant about the prospects for traditional growth oriented financial assets may want to consider multifamily development as a less correlated investment opportunity to potentially meet their growth needs, as the strategy represents a counter-cyclical investment for three reasons.

1. **Inflationary pressures keep tenants in the rental pool longer;**
2. **Tighter credit, higher rates and more conservative lending means fewer new construction starts and future supply issues;**
3. **The duration of development means that short-term macro events are less important than intermediate and longer-term trends.**

Inflationary Pressures Keep Tenants in the Rental Pool Longer

The largest segment of the U.S. population, millennials, are not only the prime rental cohort but are also under tremendous financial pressure. They don't have financial assets, such as a house, and the benefit of accumulating wealth over multiple market cycles relative to older generations. Personal savings rates are declining, credit card debt has ballooned, totaling over $930 billion at the end of 2022, an all-time high, and mortgage rates have risen by a magnitude of almost 3X.

The Majority of Millennial Renters Have No Down Payment Savings[4]

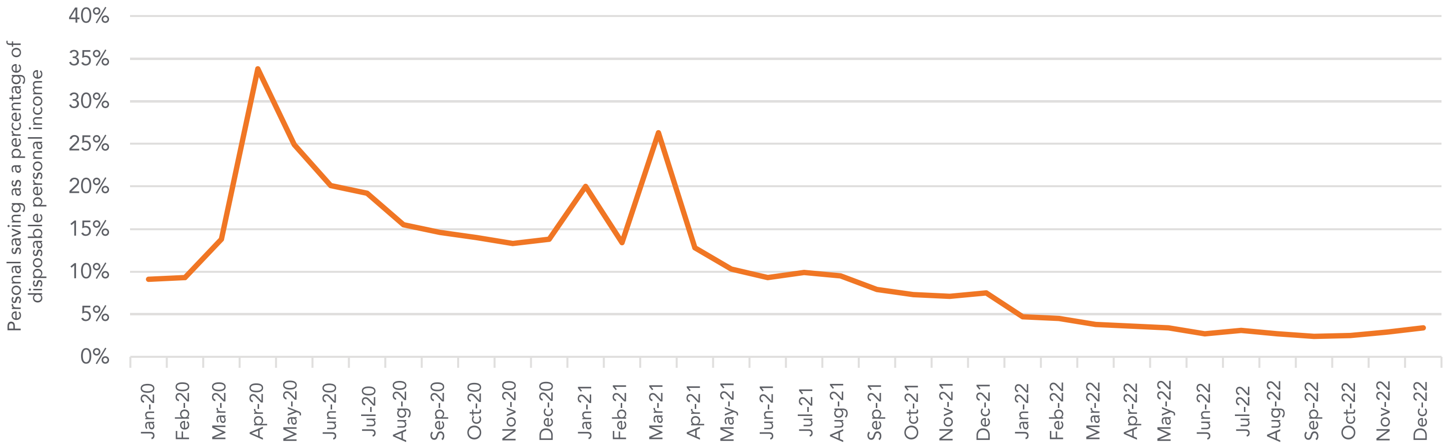


Home ownership costs have risen by 71% over the past three years alone, and inflationary pressures are making everything else like fuel and food more expensive.

At the same time, wage growth is not keeping pace, extending the time required for first time home buyers to save for a down payment. It is a simple equation, the cost of home ownership versus the cost to rent makes homeownership less affordable, on a relative basis, than any time since 2006.

4. Source: Annual Apartment List Renter Survey
5. Source: FRED, Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org.

Personal Savings Rates Are Declining[6]

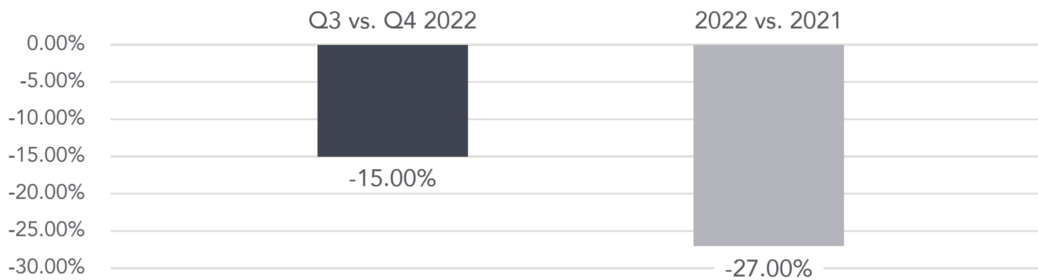


The confluence of all these issues is clear; we are going to have a deep and sticky renter pool for a long-time to come as these pressures make it harder for renters to access the single-family housing market.

Tighter Credit Means Fewer Market Participants and Future Supply Shortfalls

Small and mid-sized banks have been very significant participants in the construction loan market and in the wake of the recent banking crisis, many are stepping back, if not out of the market, in the near-term in favor of preserving liquidity. In fact, this was the trend even before the collapse of Silicon Valley Bank as lenders took a more conservative view in light of the potential for recession.

Change in CBRE Commercial Real Estate Lending Momentum Index[7]



A much tighter credit environment is unfolding quickly. The lenders participating in loan origination are focused on larger, more well capitalized relationships and limiting the leverage they are extending to more conservative levels. Many small and mid-sized developers relied on inexpensive debt at higher levels of leverage and enjoyed a period of strong returns by executing this strategy, as capital was readily available and interest rates were at all-time lows.

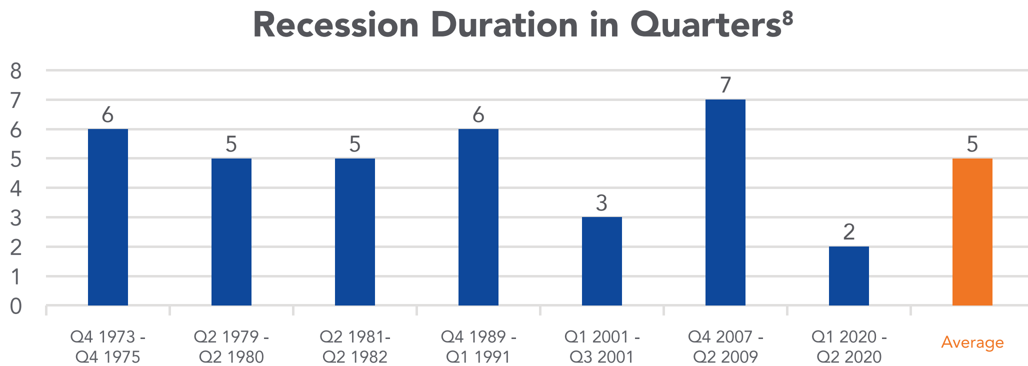
Today, leverage is generally only available for well-capitalized and experienced developers with deep relationships that contribute more equity to capital structures. This means fewer market participants, and less new construction. This is likely to be deflationary as well, driving down the cost of labor and materials in the near-term. Still, the biggest impact

6. Source: FRED, Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org.

7. Source: CBRE 2023 U.S. Lender Intentions Survey

will be felt three to four years from now when a dearth of housing supply materializes as a function of shutting down housing pipelines today. This follow-on impact will likely fuel strong supply and demand imbalances for U.S. housing over the intermediate term.

The Duration of Development Allows Investors to Take an Intermediate Term View



As a function of the cyclical and macro challenges, values for real estate assets are likely to decline in the near-term. For a buyer evaluating a stabilized core asset based on its current leveraged cash flow, and prospects for growth, near-term macro issues are hard to ignore. Conversely, a multifamily developer, seeking to build a 300 to 450 unit community today will likely be building into a declining cost environment, over a period where interest rates have the potential to decline and will be leasing that asset 24 months from now during a period where demand is likely to accelerate given the historical duration of typical economic contractions and lack of new supply being created as a function of today's tightening credit environment. A well-capitalized multifamily developer is less impacted by the current environment and more focused on intermediate and long-term trends, which is when return realization is targeted.

Key Takeaway

When considering these factors, the prospects for multifamily development become increasingly more compelling. The renter pool is deep due to demographic factors and is sticky as a function of inflationary pressures. Housing affordability skews strongly in favor of rentership and both single-family and multifamily supply over the next several years is likely to be impacted dramatically by tightening credit. Therefore, for those that can can take exposure to multifamily development today, the intermediate and long-term trends appear to be favorable and, in some ways, improved by the current macro-challenges facing investors. For these reasons, multifamily development represents a compelling counter-cyclical investment opportunity today. For investors that are struggling to meet their return objectives and seeking to diversify their growth allocations by benefiting from some of the issues that are creating headwinds in other parts of their portfolios, multifamily development could be a valuable part of a growth allocation in today's environment.

8. Source: FRED, Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org.

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