Coming Back to Earth

The scorching pace of rent growth will slow, but solid fundamentals mean the outlook for multifamily investment remains bullish even amid some concerns about availability of capital.

By **Beth Mattson-Teig**

The elephants in the room in just about every conversation about the multifamily sector these days are rising interest rates, a potential recession and the give and take between buyers and sellers about repricing assets. Yet despite the tumult, the 2022 *WMRE* Multifamily Research (this year brought to you by Think Wood), shows an overwhelmingly positive outlook on fundamentals and very little change in buyer appetite.

Respondents view multifamily as the most attractive property type. On a scale of 1 to 10, multifamily rated a mean score of 7.6, followed by seniors housing and industrial at 6.7 and single-family rentals and self-storage at 6.5. One in four respondents also said they plan to buy more assets over the next 12 months, which represents the highest level since 2018. Nearly half of respondents (49 percent) plan to hold assets in the coming year, while 11 percent intend to sell.

"One of the reasons we like apartments is that they tend to be the most inflation resistant of all the property types, because of the shorter term leases," says C. Allan Swaringen, president and CEO of JLL Income Property Trust. The non-traded REIT was a very active buyer in 2021, more than doubling its multifamily holdings to 24 communities valued at $2.1 billion. JLL Property Income Trust is less aggressive this year, but is on pace to acquire between $500 million and $600 million in apartments. "We haven't paused, but I would just say that we are being more selective," says Swaringen.

Investment sales activity in the multifamily sector and broader commercial real estate market has slowed of late in response to rising interest rates as the Federal Reserve has mounted an effort to tame inflation. "Many participants are putting their pencils down, whether that's in terms of buying or selling of assets as they wait for pricing discovery to happen," says Jason Kern, president of investment management at Cortland, a multifamily investment and management firm. "I expect a significant drop in activity in the second half, and I think Cortland will be no exception. No one wants to be catching a falling knife and transacting at the top of the market before there is a bit of a correction," he says.

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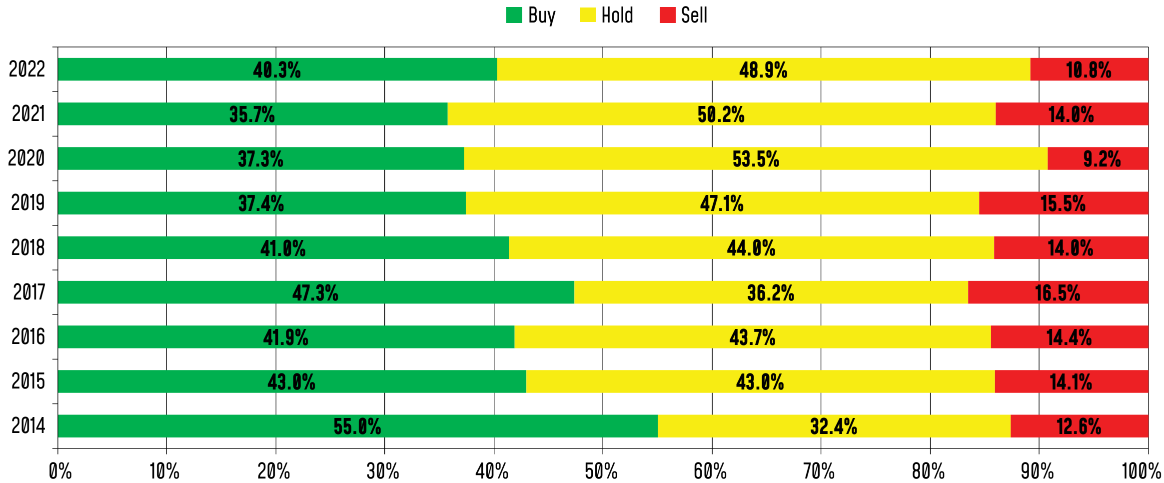
Still Looking to Spend

'Over the next 12 months, do you plan to buy, hold or sell in the multifamily sector?



However, Kern also believes that as soon as there is more clarity around Fed policy and how the Fed is likely to move rates in the near term, the sales market will quickly thaw. "The reality is that the underlying fundamentals in multifamily remain incredibly strong," he says. That's because regardless of what's happening with interest rates and the broader economy, growth in net operating income remains robust and too attractive for investors to ignore.

Fundamentals remain strong

The apartment sector has been posting some incredible stats, and survey respondents appear confident that there is more growth ahead. Nationally, average vacancies at mid-year were razor thin at 3.1 percent, with annual effective rent growth well into double digits at 14.6 percent, according to CBRE. Although available space is tight, two-thirds of respondents expect occupancies to increase over the next 12 months, with another 10 percent who believe occupancies will hold at current high levels. The overall mean increase predicted is slight at 20 basis points.

Given the incredible momentum for rent growth, it is not surprising that an overwhelming majority of respondents (88 percent) think rents will continue to rise in the coming year. Although those results are on par with 2021 results, respondents are slightly more optimistic on the mean rental growth at 5.0 percent this year as compared to 4.4 percent last year. Anecdotally, most investors also don't believe the current trendline of rent growth is sustainable, but do think rent growth will continue at a less heated pace. Capital Square is using traditional 3 percent rent growth on its proformas, even though the firm is currently seeing 10 to 12 percent rent growth at its properties. "We're realistic that at some point the rent growth will level off, and probably return to normal levels in 2023 or 2024," says Louis Rogers, founder and CEO of Capital Square, a sponsor of tax-advantaged real estate investments.

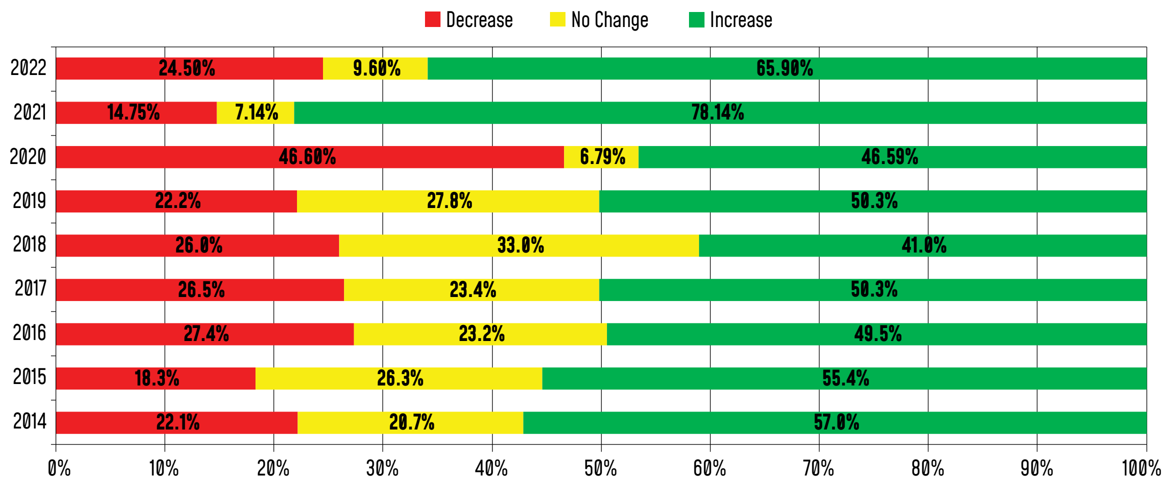
Capital Square has been building mixed-use multifamily communities throughout the pandemic, with strong lease-up and projects that are running at nearly 100 percent occupancy. Among the firm's 10 projects in development, all but one are located in the Southeast. For example, the firm broke ground in July on a new 50-unit luxury apartment hotel in Charleston, S.C., that is located within a qualified Opportunity Zone. The Sun Belt has been garnering significant attention from both developers and investors in recent years due to population and job growth. Survey respondents now view the South/Southeast/Southwest as the strongest region for performance, with a mean score of 8.2 out of 10, which is the highest rating in the nine-year history of the survey. The West/Mountain/Pacific also continues to rate high at 7.7, followed by the East at 7.3 and Midwest at 6.8.

Respondents have a much more positive outlook for class-A and class-B multifamily properties over the next 12 months. Three-fourths of respondents rated the outlook for class-A apartments as excellent or very good compared to two-thirds in the 2021 survey. Respondents also have a favorable view on class-B apartments, with 60 percent who said the outlook in the coming year was excellent or very good. Views on class-C assets are less positive with 38 percent who thought the outlook was very good or excellent. However, more than half of respondents (57 percent) view the outlook for class-C assets as good or fair and only 5 percent rated it as poor.

JLL Income Property Trust is one investor that favors newly constructed or recently renovated class-A assets versus older vintage apartments that often require more capital. "We're investing in apartments for their cash flow generating potential and growing that cash flow. If you have to renovate and put capital back in, it's hard to get that cash flow," notes Swaringen.

Packing Them In

What is the outlook for national multifamily occupancy rates in the next 12 months?



Development accelerates

Positive performance and strong investor demand are proving to be a powerful incentive for developers. Despite high construction costs, there continues to be a robust pipeline of new projects underway and planned. According to CBRE, the trailing 12-month total of completions reached 307,400 units in the second quarter, with an additional 700,000 units under construction. Similar to the 2021 survey, respondents are somewhat divided with regard to the current level of development in the multifamily sector. Thirty-eight percent think there is the "right amount," while 31 percent said there is "too little," 22 percent believe there is "too much" and 8 percent were unsure.

Capital Square is taking a "Goldilocks view" that the market is just right, and the company is continuing to build, with a strong pipeline of new projects. Through its seven Opportunity Zone funds, Capital Square has 10 apartment projects in development spanning about 1,700 units. Developers have been challenged by rising construction costs and higher debt costs. "For strong developers, and strong projects in strong markets, there is construction financing, there is permanent financing and there is a way to get deals done," says Rogers.

The shortage of housing, coupled with higher costs of homeownership, is driving more demand for all types of rental housing. Freddie Mac estimates the shortfall in market rate housing across both for-sale and for-rent properties amounts to some 3.8 million units. Cortland believes that number is lower, at around 1 million. However, the firm also anticipates that it will take another three to four years to get the housing supply back to near equilibrium.

"That does give us some runway for growth, and we think that rental rate growth will continue to be strong for the foreseeable future," says Kern. Rent growth is also helping to offset higher construction costs. "In our chosen target markets, we're experiencing very favorable spreads between replacement cost and stabilized value. So, we're still seeing reasonable margins on our development business," he says.

A clear majority of respondents (68 percent) believe there is too little affordable housing being developed. "One in four renter households in the U.S. spends more than half their income on rent, and another 610,000 are experiencing homelessness," says Ryan Flom, chief marketing officer for the Softwood Lumber Board, an industry-funded initiative established to promote the benefits and uses of softwood lumber products in construction. "There is no one-size-fits-all solution to creating more affordable housing, but wood construction systems—be it light frame, or prefabricated modules, or cross-laminated timber—can help build more affordable housing quickly, sustainably and cost effectively," he adds.

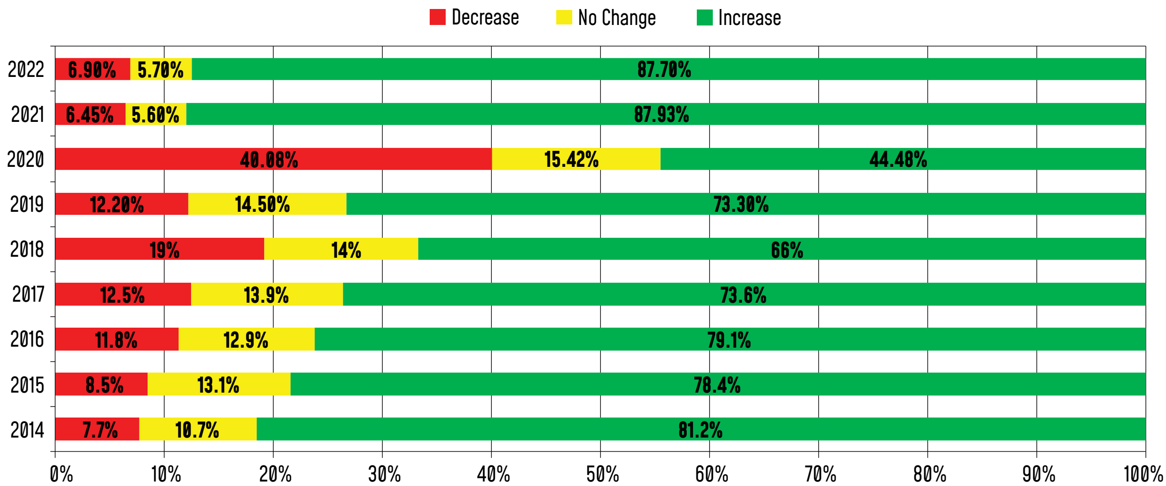
Sustainability is top-of-mind

A growing focus on ESG is elevating the importance of both sustainability and social responsibility issues. When asked to rate the importance of environmental considerations when making development decisions, 73 percent of respondents rated those considerations as important, with 19 percent who said it was very or critically important. When the same question was asked of social responsibility considerations, such as diversity and human rights, 62 percent said social responsibility was important in decision making, with 18 percent who said it was very or critically important.

The need to reduce carbon emissions is increasingly urgent, especially as the built environment is growing at a record pace, notes Flom. Now is the time for every emitting sector to evaluate their emissions. Without decisive action, building materials used in new construction in cities across the globe will generate 100 gigatons of embodied carbon

Pushing Rents Further

What is the outlook for multifamily rents in the next 12 months?



by 2050, he says. "To reduce the GHG emissions associated with that construction, communities need to act now to create embodied carbon strategies that reduce environmental impacts." Since an estimated 80 percent of the embodied carbon attributable to building materials comes from structural products, it is vital to have accurate information when selecting structural building elements, he adds.

"Sustainability is a huge focus for us in both our existing portfolio and development projects," adds Kern. In its existing assets, Cortland continues to push initiatives such as lighting retrofits and other energy efficiency measures. Development offers more opportunity in regard to sustainability as there is more control in the process, materials selection and overall design. "When you are developing a brand new asset, you really have to think longer term," he says. For example, it's important to add features such as EV charging stations so that an asset isn't at risk of becoming obsolete by the time it is built and stabilized. "It's a lot more expensive to retrofit an asset once it's built. So, we spend a lot of time thinking about sustainable design and materials up front," says Kern.

Access to capital tightens

Respondents are more pessimistic on the availability of capital. Although 41 percent see no change in the availability of equity compared to 12 months ago, 37 percent think it is less available and 16 percent said it is more available. On the debt side, 38 percent said there was no change in availability compared to 42 percent who consider it to be less available and 15 percent who believe it is more available than 12 months ago. With the exception of 2020, respondents have the most negative view on the availability of capital in the history of the survey in this year's results.

The survey was taken just ahead of the July 26 Fed meeting, which resulted in a 75-basis-point rate hike and the Fed has signaled that more raises are likely. So, it is no surprise that 91 percent thought interest rates would rise over the next 12 months. Rising interest rates translate directly into higher capital costs. As of mid-August, 10-year and seven-year fixed rate loans were pricing identically due to the yield curve with an all-in rate around 4.25 to 4.50 percent, depending on the individual transaction. That is a sizable move compared to 12 months ago when borrowers could finance at around 3 percent, notes Jeff Erxleben, president of debt and equity at Northmarq.

"Rising interest rates and disruptions in certain segments of the credit markets has resulted in a shift in where financing activity is happening," adds Erxleben. Last year, the CLO market and bridge loan market were where most of the transactions were happening. That is still happening to some extent, but the real trend in where financing activity sits today is with Fannie Mae, Freddie Mac and the banks. Life companies are still active, but on a very select basis, he says.

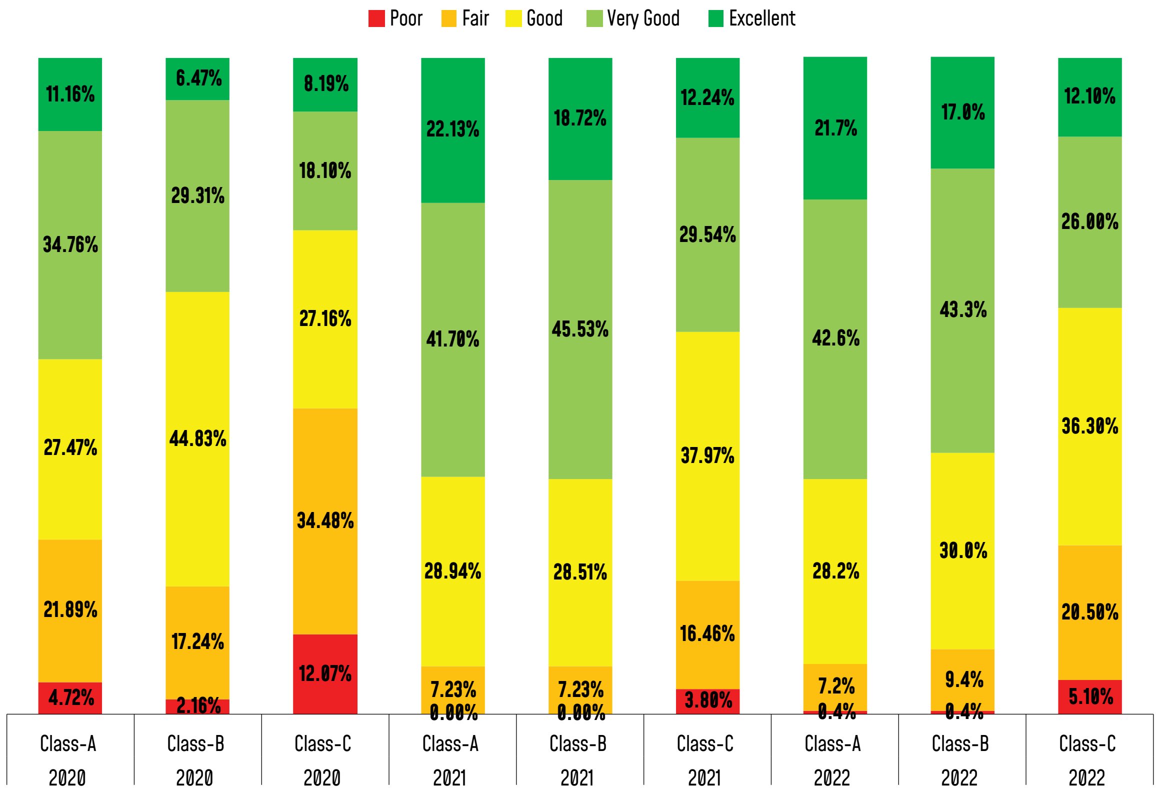
"Freddie and Fannie are really the go to source for refinance activity and for select acquisition activity," says Erxleben. Refinance activity is being driven by investors looking to convert shorter-term bridge loans into longer-term fixed or floating rate options from the agencies. On the acquisition side, Fannie and Freddie continue to dial in their loan proceeds and underwriting to find loan-to-values that are accreditive for acquisitions. That is also balanced with acquisitions that have adjusted to the current market dynamics in terms of higher cap rates, notes Erxleben.

Respondents rated local/regional banks as the most significant source of debt capital for multifamily, with a mean score of 6.4 out of 10, followed closely by national banks at 6.2 and Fannie Mae/Freddie Mac at 6.0.

Survey results related to the outlook for LTVs were mixed. Thirty-nine percent predict no change, while 36 percent

Optimism at the Upper Echelon

Respondents were asked to rate the outlook for different segments of the multifamily sector.



believe they will decline, and 25 percent think LTVs could increase. Views on DSCRs are also split, with 41 percent who think they will remain stable and 45 percent who think they will rise. Those who expect a decline in DSCRs are in the minority at 14 percent.

The reality is that DSCRs and LTVs have gone up as values have gone down, notes Erxleben. According to Erxleben, loans that were maxing out at 50 percent LTV 12 months ago are now in the 60s or even moving close to 75 percent on agency loans. The good news is that the fundamentals remain very strong with good cash flow coming out of properties, and lenders are still underwriting aggressively. “Lenders continue to be bullish on the sector itself and the performance of the properties remains strong. So, they’ve dialed in their assumptions, and they are willing to lean in a little bit more,” he says.

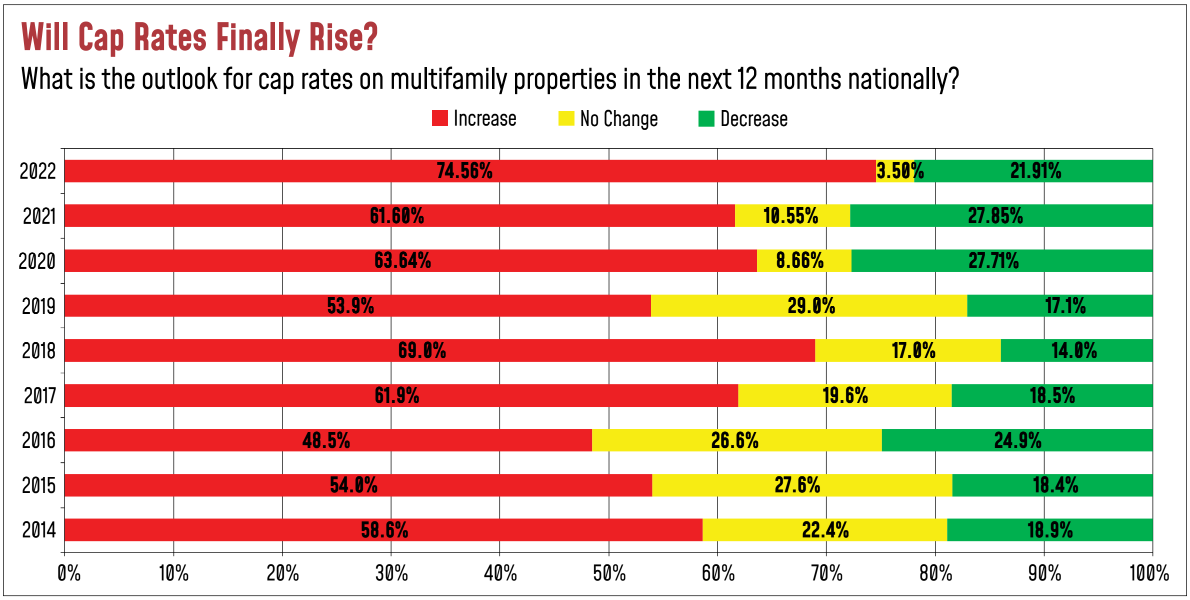
Multifamily loans have been performing very well with delinquencies below 0.5 percent. However, three-fourths of respondents think delinquencies will rise in the coming year, which does reflect a sizable jump from the 57 percent who held that view a year ago. Likely, that response is related to the fact that delinquencies have been incredibly low. “Any uptick that does occur is likely to be in select instances where the business plan didn’t work out or other forces were at play, but on a broad brush in multifamily we don’t see delinquencies going up materially,” says Erxleben.

Buyers anticipate higher cap rates

Following a robust year of sales in 2021, transaction volume remained strong in the first half of 2022. According to MSCI Real Assets, multifamily transactions totaled $154.6 billion, 53 percent higher than the same period in 2021. However, many are anticipating that third quarter data will reflect the slowdown that many have witnessed in July and August.

“Everyone seems to think that interest rates are going to continue to go up, and that has basically put the market in a transition,” says Jorg Mast, executive vice president, capital markets, at Colliers International in Dallas. The high valuations and low cap rates don’t make a lot of sense when buyers are facing 4.5 percent leverage, he says. “People don’t want to overpay. So, they’re waiting to see how things shake out,” he says. In addition, sellers are more hesitant to bring assets to the sales market if buyers are not as active or aggressive as they have been.

Three-fourths of survey respondents expect cap rates to rise. That represents a sizable increase compared to 62 percent who thought cap rates would move higher in the 2021 survey, and it is also the highest level of sentiment for rising cap rates



in the nine-year history of the survey. Twenty-one percent think cap rates could decline and 4 percent predict no change. However, the forecast increase averages out to a relatively modest 31 basis points. Two-thirds of respondents also expect a rise in the risk premium (i.e., spread between the risk-free 10-Year Treasury and cap rates).

Once buyers and sellers have more clarity on pricing, sales activity is likely to accelerate as there is still a significant amount of capital that has been raised for multifamily strategies. Forty-four percent of respondents said they see new competition in the market for multifamily assets.

"I think there will be a big transaction volume in fourth quarter because of pent-up demand," says Mast. For example, Colliers has provided a number of broker opinions of value for owners that are now on the sidelines waiting to see what happens with interest rates. "It seems that everyone we talk to has a new fund or has raised their biggest fund ever, and they need to put that money to work," he says. "So, I'm very optimistic that sales activity is going to be good in fourth quarter, but it is not going to be as hot as it was in 2021." Buyers will likely not be as aggressive due to higher capital costs and expectations that rent growth will moderate.

Location, location, location

Given rising rates and concerns that the U.S. might be headed for a recession, investors remain keenly focused on fundamental principles of investing. The most important consideration when deciding whether or not to invest in a multifamily property is location, with 87 percent rating location as either "critical" or "very important". Respondents were allowed to choose their three top factors, and investment returns also rated high with 80 percent of respondents, followed by sponsor track record at 69 percent.

JLL Income Property Trust prioritizes location because of its long-term hold strategy, which is often 10 years or longer. "We find those location impacts to be more important than the near-term underwriting, because in a competitive environment where returns have been compressed, your conviction about longer-term occupancy and rent growth and resiliency of demand is really important to us," says Swaringen. A key part of the non-traded REIT's strategy is to buy apartments in highly-rated school districts. "I think that has contributed to the very high occupancy of our portfolio," he says. The REIT's portfolio was 96 percent leased and occupied as of the end of July. According to Swaringen, the school district strategy bodes well from both a supply and demand perspective with higher retention and more barriers to new construction.

Recent volatility in the market also highlights the need to communicate with investors. When asked how respondents are communicating asset performance to investors, the majority prefer email (59 percent) or phone calls (52 percent), while video calls also rated favorably among 27 percent of respondents. "We all learned new strategies for communications during the pandemic with webinars and zoom calls," says Swaringen. "Investors are demanding more frequent and more real-time communication, as well as less paper and more digital. That has increased through the pandemic, and we don't see that going away." ■

Survey methodology: *The WMRE Multifamily Research Study (brought to you by Think Wood) was conducted via an online survey distributed to WMRE readers in July 2022. The survey results are based on responses from 289 participants. Respondents represent a cross-section of different roles in the multifamily sector, including investors, building owners and managers, developers, lenders and brokers. Nearly three-fourths hold a senior management position within their firms, including 50 percent who identified as an owner, partner, president, chairman, CEO or CFO.*