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# Market Review

Real Estate  
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# When Fear Is a Friend

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# When Fear Is a Friend

## US Multifamily in Focus

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### EXECUTIVE SUMMARY

Rising interest rates have taken their toll on U.S. multifamily housing, as they have on other commercial real estate sectors. Debt levels relative to equity are higher in multifamily than in some other segments, a loan maturity wall looms, and interest rate caps are expiring, putting many owners in the position of refinancing at a time when their properties are worth less than their acquisition basis and interest rates are much higher. Plus, a wave of new supply will come on the market over the next two years. Some have wondered whether multifamily housing is in for a period of significant defaults and distressed deal flow similar to that of the office sector.

Unlike in the office sector, however, we think the challenges in U.S. multifamily are cyclical rather than secular in nature. The influx of new supply is likely to taper off after 2025, at which point we are optimistic about rent growth given the structural shortage of housing and unfavorable cost dynamics for new construction in the United States. As owners come under more pressure to sell assets, we see an exciting opportunity coming to buy high-quality properties below replacement cost while achieving attractive long-term yields. Scaled platforms with strong networks, on-the-ground knowledge of different markets, and ready capital will be in the best position to capitalize on the new market conditions.

# Introduction

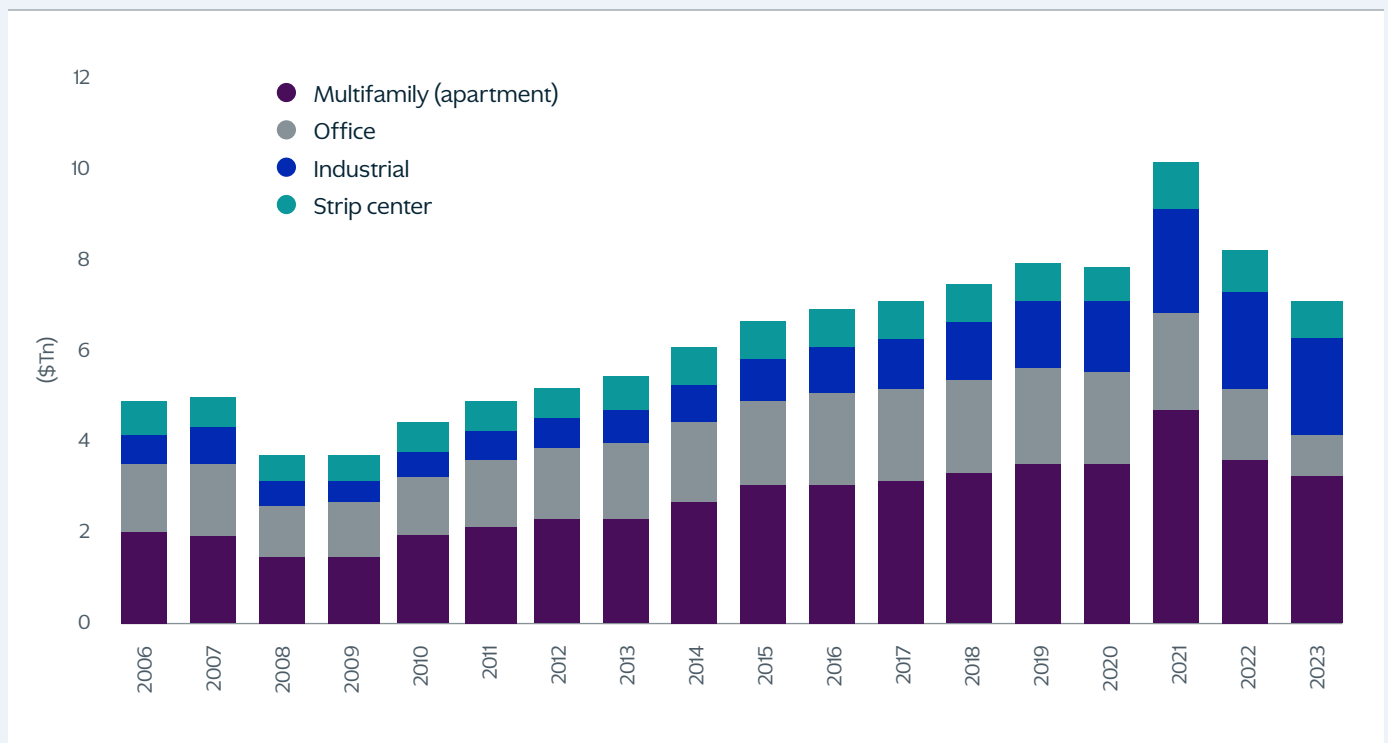
After the significant repricing in real estate assets over the past 18 months, a question lingers: Where are valuations justifiably cheap, and where do they represent a rare opportunity to buy assets at attractive relative values?

We think interest rate dynamics rather than a sea change in fundamentals have driven the repricing of assets in most commercial real estate sectors. The office sector in the United States and Europe is an important exception, however, and many investors have been keen to understand whether the problem extends further, particularly to U.S. multifamily housing.

Multifamily housing is both one of the largest components of the commercial real estate market (Exhibit 1) and one of the most levered, meaning that properties tend to have high loan-to-value ratios (LTVs). At the same time, performance has traditionally remained stable through economic cycles. People always need places to live and spending on shelter tends not to fluctuate as much as more discretionary spending.

Multifamily housing is facing some of the same problems as the rest of the commercial real estate market—falling property values, high debt loads, a pullback in available debt capital, and a loan maturity wall—as well as some unique supply issues over the next two years. We think the sector is in for a multi-year deleveraging cycle. However, multifamily real estate owners who can carry their investments through the next two years are poised to benefit from sustained structural demand and a pronounced shortage of new supply starting in 2026.

**EXHIBIT 1: Historical Commercial Real Estate Inventory Values**



Source: Green Street as of December 31, 2023



## Key Themes

As we look across today's market, we will cover the following themes:

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01 How Multifamily Went from Boom to Stress

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02 Supply Challenges Today May Create Opportunities Tomorrow

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03 What Will Deleveraging Look Like in Multifamily?



# 01 How Multifamily Went from Boom to Stress

Multifamily valuations reached record highs in 2021 and 2022 as buyers looked to capitalize on post-COVID migration trends and pent-up household formation that contributed to significant rent growth. Readily available low-interest rate financing also helped to drive \$500 billion in transactions. However, few people anticipated how steep the rise in inflation and interest rates would be. Floating-rate interest payments rose faster than income from rent and fees, affecting a key credit metric called the debt service coverage ratio (Exhibits 2, 3 and 4), and LTVs increased as property values declined. Net operating income continued to grow quickly, but not quickly enough to outpace the rise in interest rates and decline in property values.

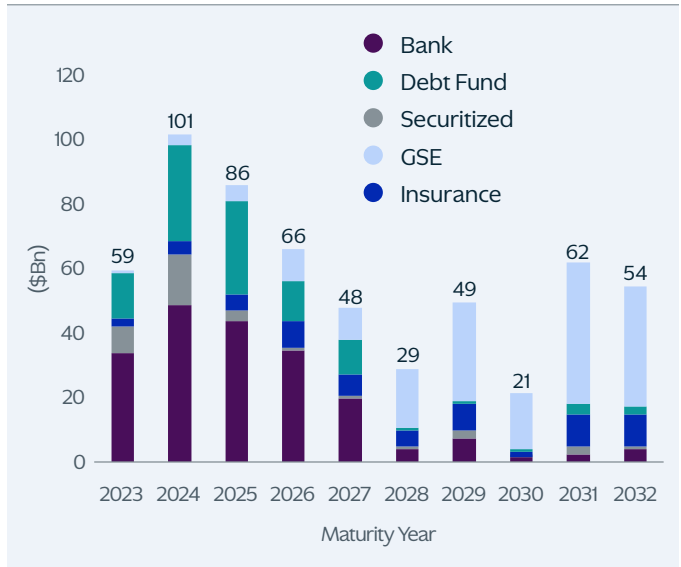
## EXHIBIT 2: How a Typical Multifamily Building's Debt Profile Has Changed



**Multifamily Building**  
 Purchased in 2021  
 Cap rate: 3.5%  
 LTV: 65%  
 NOI Growth since Purchase: 15%

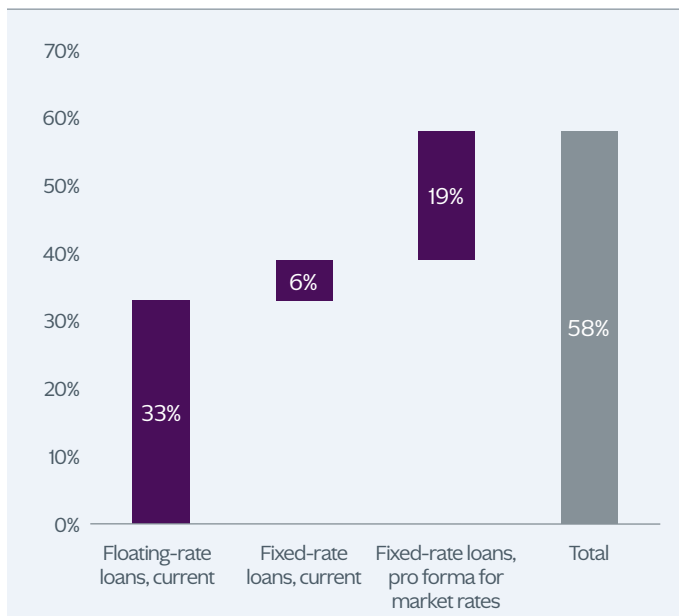
Scenario 1		Scenario 2	
Cap rate	LTV	Cap rate	LTV
5%	80%	5.5%	~90%

## EXHIBIT 3: Potentially Troubled Multifamily Loans (LTV over 80%)



Source: Trepp, Green Street, RCA, MBA, Newmark Research as of January 16, 2024

## EXHIBIT 4: Multifamily Maturities from 2023-2025 with Debt Service Coverage Ratio under 1.25x



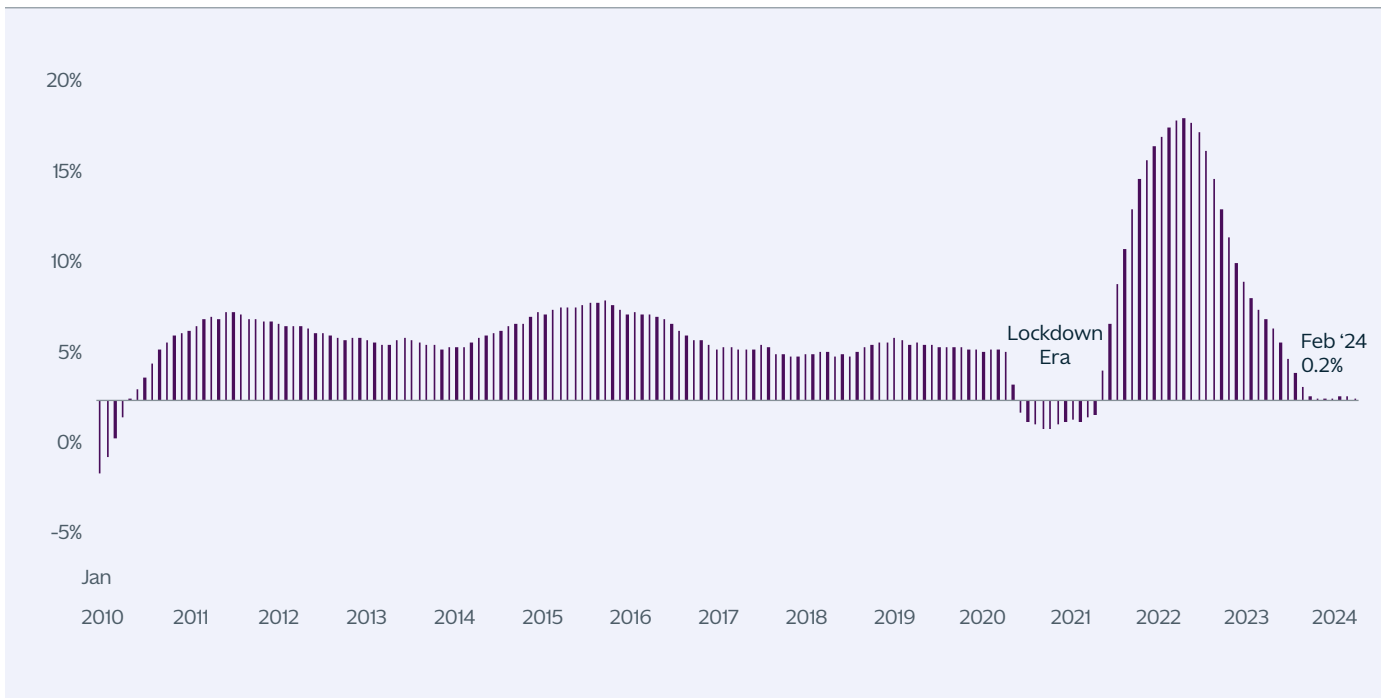
Source: Trepp, Green Street, RCA, MBA, Newmark Research as of January 16, 2024

Some multifamily owners who bought in 2021 and 2022 face a deadline to refinance properties that are now worth much less than their purchase prices at significantly higher prevailing interest rates. Over \$250 billion in multifamily loan debt matures in 2024 alone, and some owners will face a gap upon refinancing. Likewise, as interest rate caps typically last for three years, many owners are looking at a sharp increase in the cost of debt. Some developers who started projects during the post-pandemic boom years, particularly in markets that are now oversupplied, are also looking to deleverage and refinance. However, real estate capital is scarcer than it used to be, as we discussed in detail in our last Market Review.

## 02 Supply Challenges Today May Create Opportunities Tomorrow

U.S. multifamily is also processing a wave of new supply. The increase in the supply of apartments in 2023 was large enough to overwhelm strong demand. Overall rent growth was insignificant last year at 0.6% at year-end, and the markets where supply grew most experienced below-average rent increases (Exhibit 5).

**EXHIBIT 5: Change in Effective Asking Rents on New Leases on U.S. Multifamily (Apartments) (YOY)**



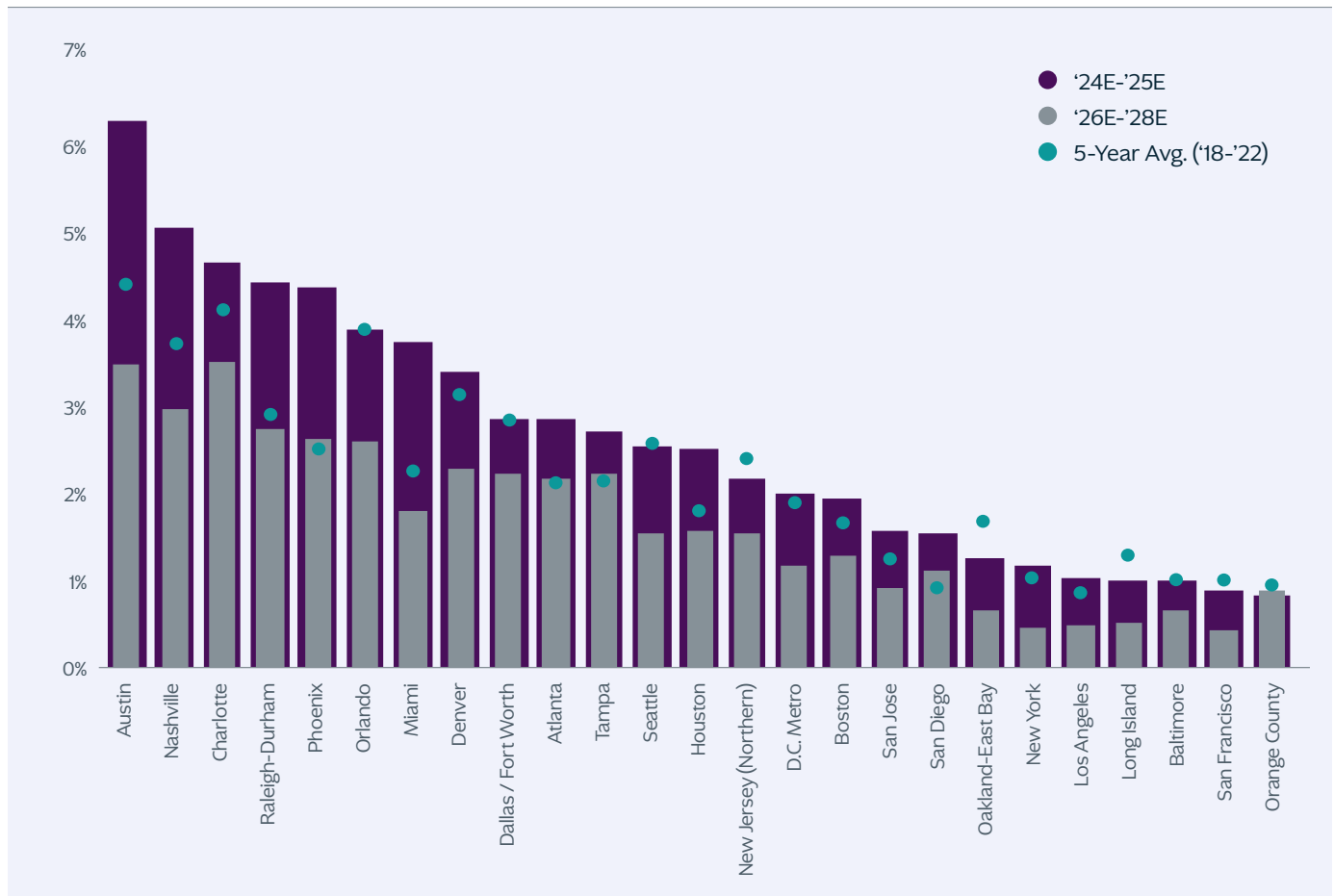
Source: RealPage Market Analytics as of December 31, 2023

1 National Association of Realtors. "Commercial Real Estate Market Insights," December 2023. [https://cdn.nar.realtor/sites/default/files/documents/2023-12-commercial-real-estate-market-insights-01-03-2024.pdf?\\_gl=1\\*1p2pitn\\*\\_gcl\\_au\\*NTA00DcyNjAzLjE3MTE2NTAINTQ](https://cdn.nar.realtor/sites/default/files/documents/2023-12-commercial-real-estate-market-insights-01-03-2024.pdf?_gl=1*1p2pitn*_gcl_au*NTA00DcyNjAzLjE3MTE2NTAINTQ).

More supply is coming. The research firm RealPage Market Analytics forecasts that some 670,000 units will be delivered this year. That’s nearly 50% more than in 2022, with another 385,000 units slated for 2025. Most of the new supply is slated for the Sun Belt (Exhibit 6). It will take time for these markets to absorb the new supply, and NOI growth is likely to turn negative for many assets over the next 18 months. These trends are already taking shape. In 2023, most of the markets that experienced negative growth on a combined measure of rent and occupancy were in fast-growing parts of the South and West of the United States, including Austin, Tex.; Nashville, Tenn.; and Phoenix, Ariz. (Exhibit 7).

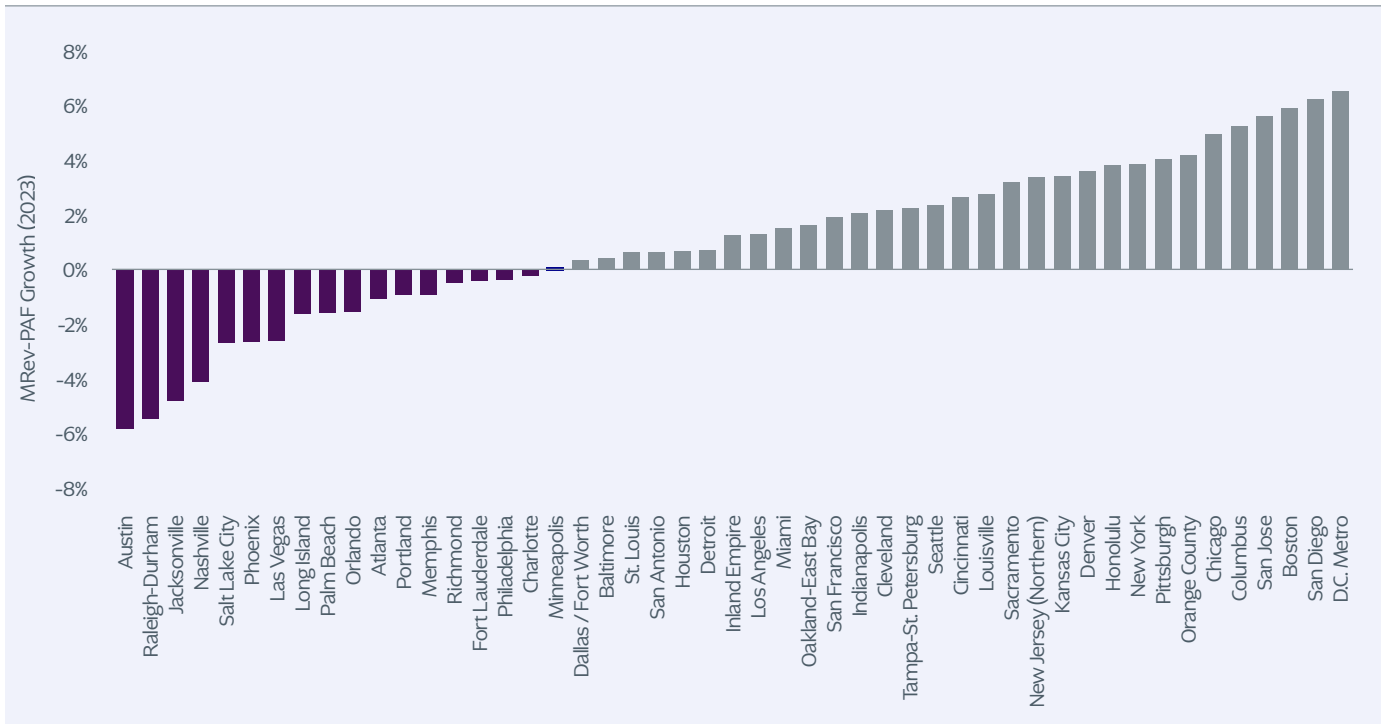
However, we think supply will fall dramatically in 2025 (Exhibit 8). It is difficult to justify the complexity and expense of new construction with multifamily housing trading below estimated replacement cost. The costs of construction, labor, debt, and insurance rose sharply during the pandemic and have remained elevated. While our Global Macro & Asset Allocation team predicts that growth in construction costs will moderate in the near future, we expect it to continue to outpace both the pre-pandemic trend and inflation. This is partly due both to a scarcity of skilled labor and competition with infrastructure and other large-scale projects for labor and materials. Commercial real estate and single-family home construction make up only about 40% of total construction spending, down from a peak of 57% in 2005. Meanwhile, banks that are overexposed to real estate lending and subject to new capital reserve regulations are unlikely to come off the sidelines, making capital for new development scarce and likely expensive.

### EXHIBIT 6: Supply Growth Forecasts in U.S. Housing Markets



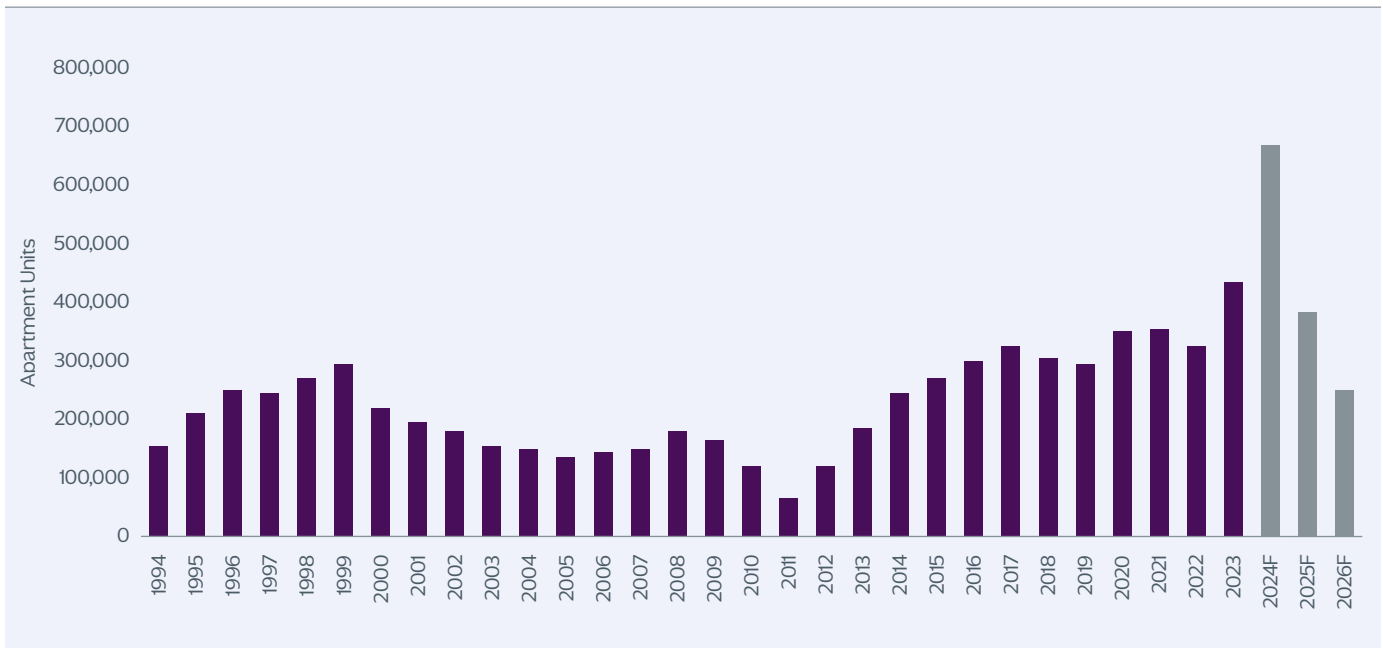
Source: Company filings, Compstak, INTEX, NCREIF, RealPage, U.S. Census Bureau, and Green Street as of December 31, 2023

### EXHIBIT 7: Multifamily Rent and Occupancy Trends in 2023 by Market



Note: M-RevPAF growth combines changes in effective rents and occupancies into a single measure, based on Q4 2023 vs Q4 2022. Source: Company filings, Compstak, INTEX, NCREIF, RealPage, and Green Street as of December 31, 2023.

### EXHIBIT 8: U.S. Apartment Completions and Forecast (2024-2026)



Source RealPage Market Analytics as of December 31, 2023



## 03 What Will Deleveraging Look Like in Multifamily?

Unlike the office sector, multifamily fundamentals are solid. Same-store net operating income growth (comparing growth in the same building from year to year) for U.S. publicly traded REITS has been healthy in most core markets. Multifamily assets tend to be financed with fixed-rate debt, and thus, the majority have maintained sufficient cash flow to meet their debt service.

Commercial real estate should also benefit from what appears to be a peak in inflation and interest rates. Historical data suggests it would take a severe downturn that significantly reduces employment levels to have a strong impact on multifamily. If the U.S. economy achieves a soft landing, which seems increasingly likely, we are optimistic about multifamily rent growth starting in 2026. Even Sun Belt markets where supply is growing fastest should rebound quickly once new supply slows, as they have strong job growth and are relatively affordable. This is a trend we identified years ago, when valuations were often too rich to support investment. A temporary period of oversupply may provide more attractive entry points.

Another factor supporting long-term rent growth is the structural U.S. housing supply shortage—some 2.1 million homes, according to the U.S. Census Bureau. New housing starts for would-be homebuyers were down 40% in 2023 and are expected to decline further in 2024 due to the lack of available construction financing, higher mortgage rates, and the costs of construction. Many people who cannot find a home or afford to buy one are likely to turn to multifamily rentals.

As yet, the sector has not yet experienced much observable distress aside from a handful of multifamily foreclosures of more stabilized assets in cities such as San Francisco, as well as select distressed construction projects financed with floating-rate debt. One reason is that well over half of the U.S. multifamily market is financed by government agencies, insurance companies, and banks with longer term, fixed-rate debt that was locked in before interest rates began to rise. Those assets have more time before they contend with loan maturities or a higher cost of capital.

Another reason is that some borrowers have been able to negotiate extensions or lower interest rates on their existing loans in exchange for small paydowns of some 5%-10% of their debt. The hope with these kinds of temporary solutions is that the owner can hold on until interest rates fall, pricing improves, or rent growth and NOI catches up to the change in the cost of debt. However, amendments to existing loans are not always possible, and some borrowers will need capital urgently enough to sell assets. That means well-capitalized equity investors should have a window of opportunity to buy high-quality properties at attractive yields or a significant discount to current estimated replacement cost.

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**Consider what would happen to a multifamily property purchased in February 2024 at a 5.5% cap rate (a measure of the one-year yield on a property calculated by dividing NOI by asset value) with 50% leverage. Assume that NOI grows at a 3% CAGR. As interest rates come down, it might be possible to sell at a cap rate of 5.0% five years later, in 2029.**

That equates to an internal rate of return of roughly

# 14.5%

over five years, which is attractive for a historically stable, in-demand asset class.

## Conclusion

Rising interest rates have taken a toll on property values, capital structures, and the availability of capital in multifamily and other property sectors. In contrast to the office sector, where many companies have shrunk their corporate footprints in response to work-from-home trends, multifamily occupancy has been stable and the secular trend is toward more demand, not less. The structural shortage of housing in the United States and high mortgage rates are pricing many would-be homebuyers out of the market and pushing them to rent instead. Meanwhile, high construction costs make an influx of new residential housing beyond 2025 somewhat unlikely.

The U.S. multifamily market is not uniform, however, and we believe that real estate players will need experience and expertise to make smart long-term investments in this environment. Scaled players will see opportunities first and have the freedom to deploy without much leverage, an essential component to success in this environment. We continue to focus on data, ensure full communication and integration among all our business lines in both debt and equity and around the globe, and leverage our deep connections in the industry to help identify opportunities early and pursue them proactively.

The once-in-a-decade opportunity for real estate equity investors is complex, but also exciting. It's time to start thinking of fear as a friend.



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