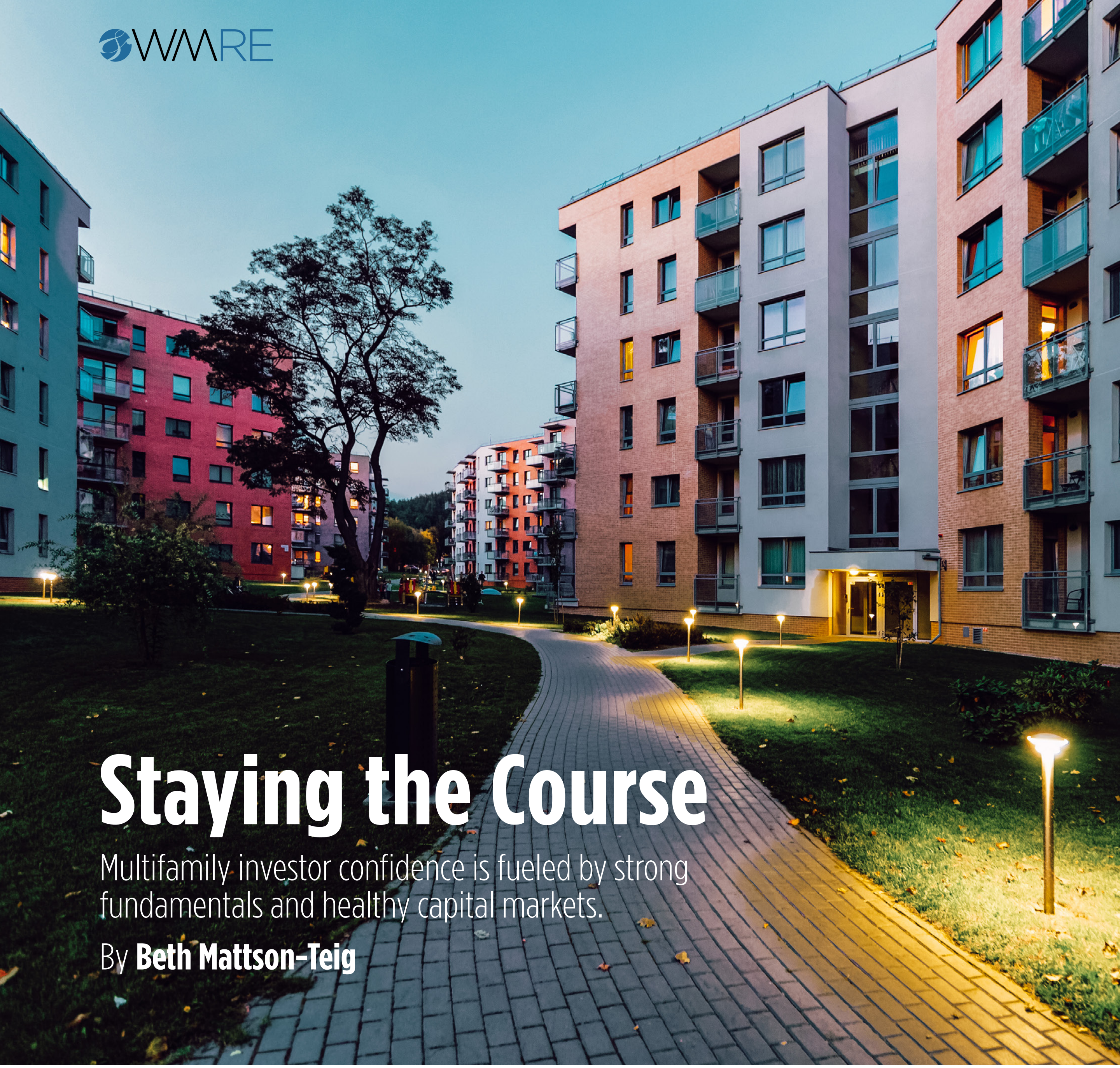

# Staying the Course

## Multifamily investor confidence is fueled by strong fundamentals and healthy capital markets.

By **Beth Mattson-Teig**

Competition, a shortage of quality buying opportunities and even a pandemic have not deterred apartment investors. The latest annual *WMRE* multifamily research report shows that investor appetite to hold or expand portfolios has changed very little in the past three years, despite the massive disruption in the broader markets.

Half of respondents plan to hold assets in the coming year, while 36 percent plan to buy more, and a minority, 14 percent, intend to sell. Although the share of active buyers has pulled back from a high of 55 percent in the 2014 survey, results show a strong, sustained buyer appetite for apartments that has held up for the past several years. In particular, the share who plan to buy assets has held firm at around 37 percent for the past three years. “The success of multifamily over the last 18 months or so has really highlighted the industry as, not necessarily recession proof, but an extremely attractive sector that has good risk mitigants. That is why we’re seeing a lot of capital flock to multifamily right now,” says Scott Lebenhart, director of acquisitions at Ashcroft Capital, a national multifamily investment firm that focuses on value-add opportunities.

Respondents continue to view multifamily as the most attractive type of investment property. On a scale of 1 to 10, multifamily rated a mean score of 7.7, followed by industrial at 7.4, single-family rentals at 7.2 and data centers at 6.9. However, sentiment didn’t come through the pandemic completely unscathed. Views on multifamily pulled back to 7.3 in the 2020 survey and remain slightly below the 7.9 rating that was recorded pre-pandemic in 2019. Likely, the bigger challenges facing dense urban centers are weighing on sentiment somewhat as fundamentals in suburban and less dense multifamily markets held up better than major metros such as New York City, San Francisco and Chicago.

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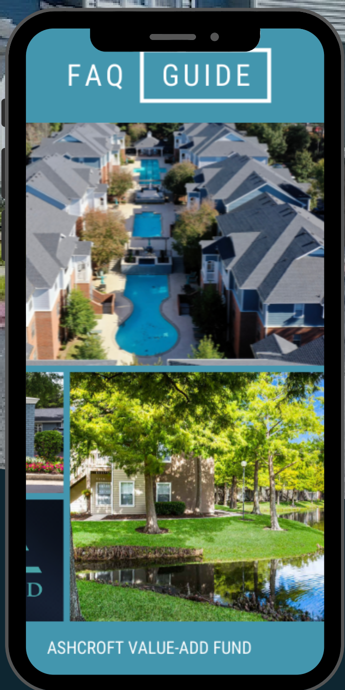


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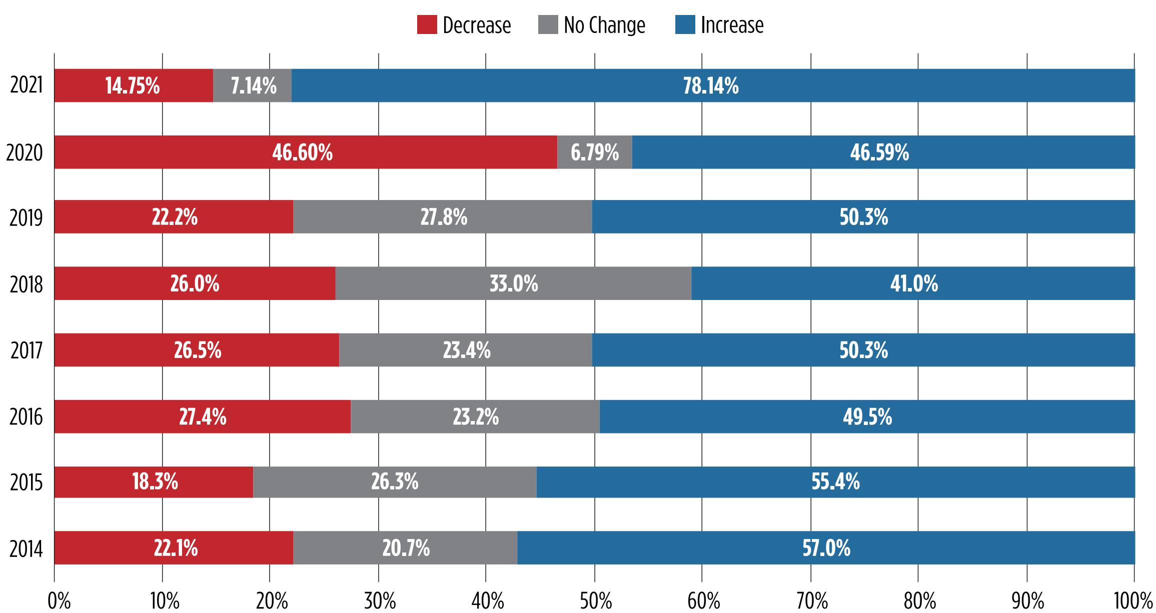
Optimism captured by the 2021 survey also is reflected in a surge in sales activity in the second quarter. According to Real Capital Analytics, transaction volume and pricing have both had a strong bounce this year with $92.1 billion in sales recorded in the first half and sale prices that are up 12 percent year-over-year. “Investor demand continues to be propelled by strong leasing momentum, dry powder and low interest rates. Suburban assets remain the most desirable, but, as markets reopen, investor demand for urban assets has gradually increased,” says Roberto Casas, a senior managing director and multi-housing group leader at JLL Capital Markets.

A common complaint from investors is the challenge in finding good buying opportunities in a highly competitive market. Respondents viewed the biggest hurdles to meeting real estate investing goals as lack of quality deals (49 percent), followed by time required to source/manage deals and lack of capital, each at 20 percent. “Competition is as fierce as I’ve ever seen it, and the lack of quality deals out there is frustrating,” says Lebenhart. Ashcroft Capital looks at about 100 deals each quarter but ends up buying only one or two. The vast majority lack the quality or location the firm is looking for, or are not the right fit for the firm’s value-add strategy. It also is interesting that one out of five investors cited lack of capital as the biggest hurdle. “I was surprised at that 20 percent because financing is extremely aggressive right now on the debt side, and there is increased demand from all levels of equity from individual accredited investors to international pension funds that are looking to deploy capital into the multifamily space,” he says.

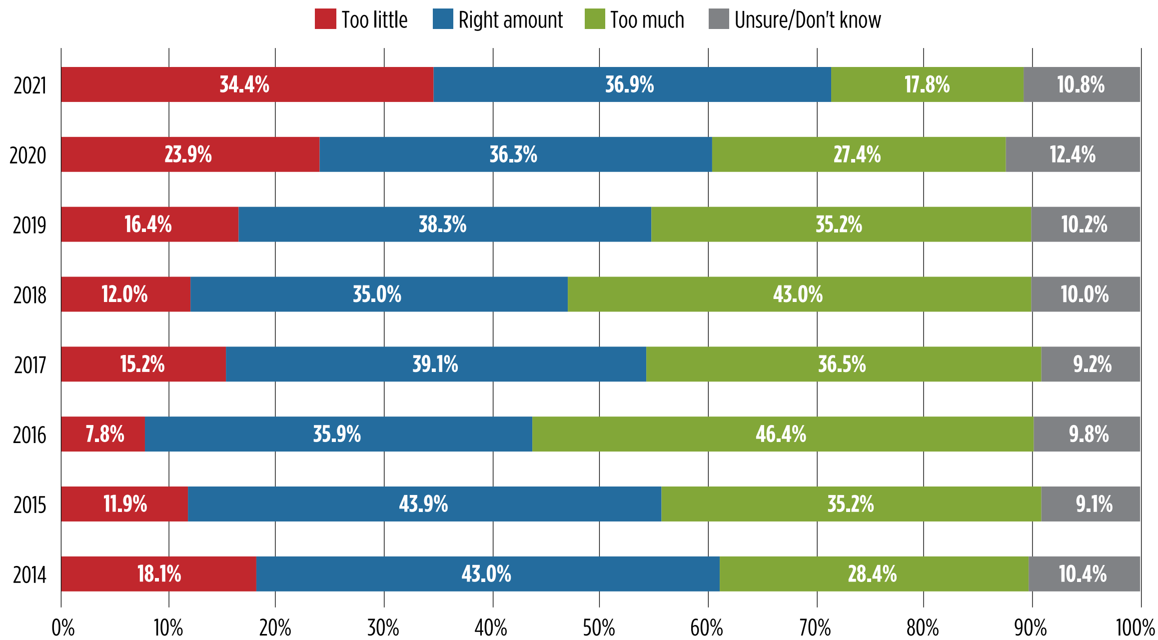
## Roaring Back to Bullishness

After some COVID-19 fueled trepidation a year ago, sentiment has swung back on the outlook for occupancies. Nearly 80 percent expect vacancy rates to fall in the next 12 months.



## A Need for More Product

Despite a robust pipeline throughout the country, more than one-third of respondents believe there is "too litte" development occurring in the sector currently.




### Fundamentals underpin demand

Nationally, vacancies remain at relatively healthy levels. Reis reported that first quarter vacancies remained unchanged at 5.3 percent, and respondents have greater confidence in rising occupancies ahead. Nearly three-fourths (78 percent) predict that occupancy rates on multifamily properties will increase in the next 12 months compared to just 47 percent who thought occupancies would likely rise a year ago. However, the average improvement expected is a slight 27 basis points.

"Market fundamentals have changed rapidly as occupancy and rent growth for assets, especially in suburban markets, have rebounded quickly," says Casas. JLL is generally seeing lease trade out increases of anywhere from five to 20 percent, depending on the property, while assets in lease-up are seeing weekly double digit lease absorption rates. Thus, investors are optimistically underwriting rent growth for well-located assets on forward looking rents, he adds.

Although research firm Moody's Analytics Reis reported a slight decline in effective rents of 0.2 percent in the first quarter, survey respondents are very optimistic on the near-term outlook for rent growth. A majority, 88 percent, expect rents to increase in the next 12 months, with an average increase of 4.4 percent anticipated. That is a big change from the 2020 survey where views were split between 45 percent of respondents who predicted increases and 40 percent a decline in rents.

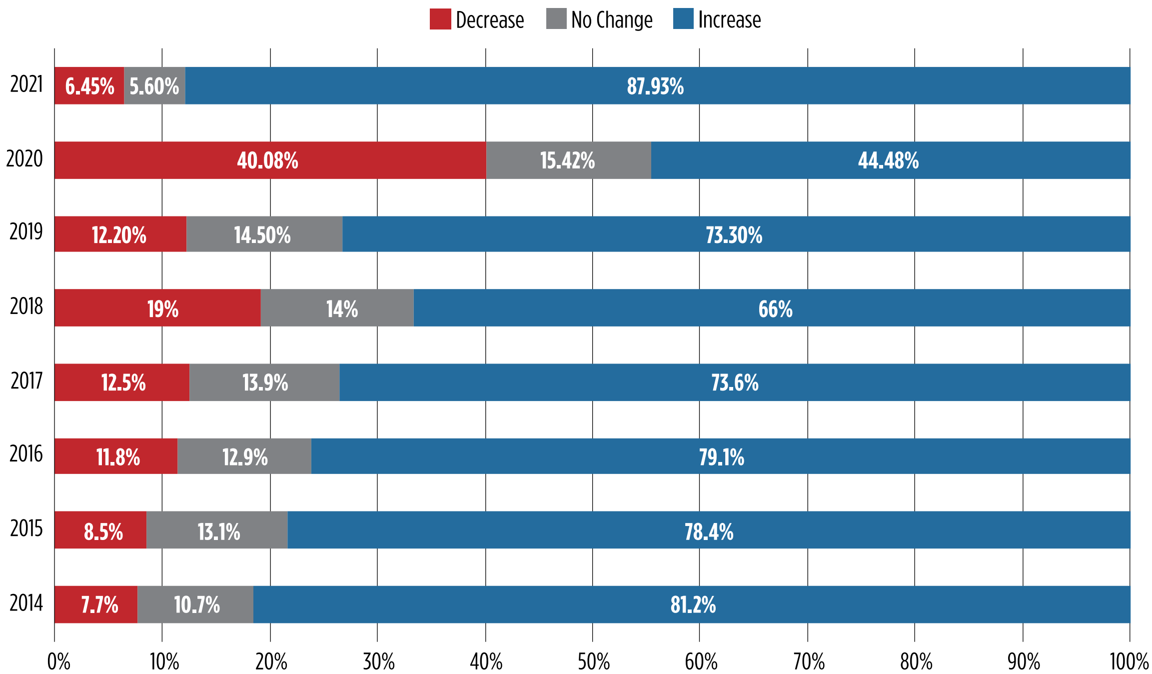
There has been a fundamental shift in the market in the last 90 days where investors are being much more aggressive in their underwriting on rent growth, notes Brian McAuliffe, president of capital markets and lead of the multifamily investment sales business at CBRE. Investors are underwriting annual rent growth anywhere from 3 percent to 7 percent during the first few years. "What has happened is that investors are seeing the rent growth in existing portfolios, which gives them more confidence to go into investor committees with aggressive underwriting that mirrors what's happening in their portfolios," he says.

However, respondents have a more positive outlook for class-A and class-B multifamily properties as compared to class-C properties. Nearly two-thirds of respondents rated the outlook for class-A and class-B apartments as excellent or very good over the next 12 months, whereas 42 percent held a similar view for class-C.

The response is a little surprising given the strong investor interest in workforce housing in recent years. However, class-C assets are typically a little more difficult to manage, and many were more negatively impacted by the pandemic in terms of rent collections, notes Lebenhart. "That also speaks to the fact that investors are looking for, not necessarily passive investments, but properties that are easier to manage," he says. Class-C properties also may require more capital improvements, such as a new roof or parking lot, that don't generate any additional income, he adds. "We have also seen a lot of the class-B space become more true workforce housing, in part because of increasing wages in many markets," he adds.

## Expect to Push Rents Higher

Almost nine out of 10 respondents in this year's survey said they expect multifamily rents to go up in the next 12 months.




### Developers restart pipelines

Apartment operators are getting a reprieve from supply pressures. Developers slowed down new projects due to some of the uncertainty created by the pandemic. According to Moody's Analytics Reis, construction has dropped sharply, with about 180,000 units anticipated to come online during 2021. Survey sentiment is mixed on whether there will be too much, too little or just the right amount of new supply. In all, 37 percent think there is the right amount, while 34 percent said too little, 18 percent believe there is too much.

"The reason you're seeing mixed results is that it is really market dependent," says John Akin, chief investment officer at Gables Residential. "Across the country as a whole, the demand is going to outstrip the supply. There is plenty of demand. But on a micro-market level or sub-market level, you can have pockets where supply has gotten heavy and it's going to take some time to absorb," he says. In aggregate, the supply and demand picture is very attractive for continued development and rent growth and job growth are both helping support that positive outlook, he adds.

Development is starting to pick up. For example, Gables Residential is now back in full production mode with a robust pipeline of about 2,500 units that the company is planning to start over the next 12 months. Some of those were projects put on hold during the pandemic, while others were in the development pipeline and previously planned for 2021 starts. "We did pull back to make sure we were being cautious. We wanted to complete the projects under construction and get through lease-up, which we did successfully," says Akin. "Lease-up has picked up and been extremely strong in 2021, and we're seeing lots of velocity with rent growth and a pullback on concessions," he adds.

Gables Residential broke ground in July on Gables Union Market, a 300-unit apartment project located in the Union Market district of Washington, D.C. "Return expectations have had to moderate a little bit, but rent growth combined with compressed cap rates have really made the deals continue to pencil out despite the increase in construction costs," says Akin.

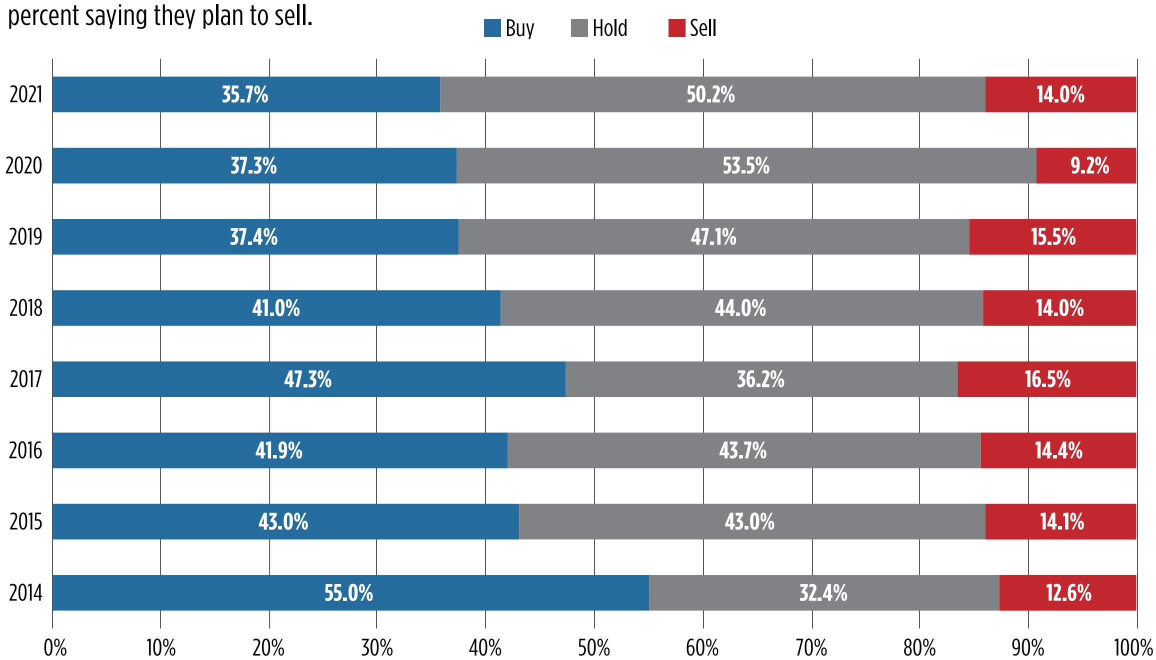
### Strong locations remain a key

Despite the continued demand to increase multifamily holdings, investors remain strategic in where—and how—they are placing capital. Survey respondents reported that the most important considerations when deciding whether or not to invest in a multifamily property are the property location (84 percent rating either "critical" or "very important") and investment returns (81 percent), followed by sponsor track record at 69 percent.

Investors, sponsors and developers are all looking for that edge that will help them achieve the outperformance that they're looking for today, and location is a big part of that, notes McAuliffe. The technology available today allows investors to really lean into data and analytics that will provide greater market insights. For example, investors are looking at

## Keeping it in the Portfolio

A majority of respondents said they plan to "buy" or "hold" apartment assets in the next 12 months with only 14 percent saying they plan to sell.




inbound and outbound population growth, job growth, wage growth and rate of change in household incomes to help pinpoint locations at the submarkets and micro markets that are more likely to outperform, he adds.

Respondents hold mixed views on whether they are more likely to invest in a private (506c) offering versus a fund. Overall, 17 percent said they were extremely or very likely to invest in a fund, 41 percent somewhat likely and 42 percent not likely to invest in a fund. That mixed response shows that there is no one-size-fits-all approach for investors. Some investors like the excitement of picking a home run that is going to outperform the market, while others prefer the ability to spread capital over multiple assets to create diversification and to mitigate risk, says Lebenhart.

Investors are most likely to focus on the overall deal return (53 percent) versus 10 percent who focus on current return and 37 percent who view them both equally. Ashcroft Capital has recognized demand among its investor base for different structures, which prompted the firm to modify its investment structures in 2019. The company now offers an A-Class investment that is structured to deliver current returns and cash flow with some future upside and a B-Class investment that aims to deliver lower current returns and greater future upside. "Some investors want the passive income coming in every month, while others are investing more longer term and want the overall higher return," says Lebenhart.

When asked how respondents are communicating multifamily asset performance to investors, nearly half prefer one-on-one conversations (53 percent) or email (51 percent), while 28 percent favor video calls and 20 percent investor portals. An additional 8 percent said they use other methods.

### Access to capital expands

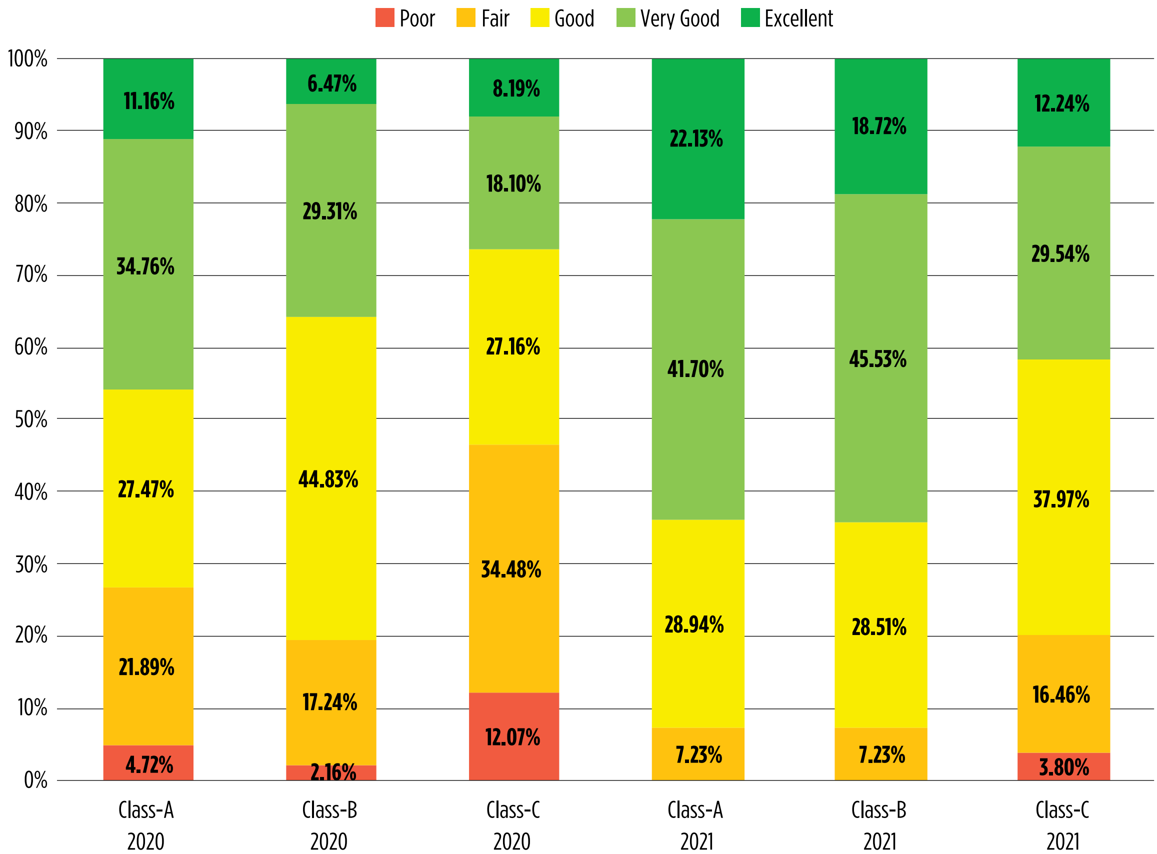
Nearly half of respondents have a positive outlook on liquidity for multifamily transactions. In all, 55 percent said equity is more widely available today than it was 12 months ago, while 46 percent said debt is more widely available. On the equity side, 28 percent said availability has been unchanged and 12 percent said it has declined. Views are similar on debt with 35 percent who said availability has not changed and 13 percent said it is less available.

"The lending market right now is incredibly strong to the point of frothy," says Paul M. Fried, an executive managing director at Greystone Co. Unsurprisingly, liquidity is greatest in the part of the market with the lowest risk, which is refinancing stabilized assets. At the other end of the spectrum is construction lending where debt is available, but lenders are more cautious, he says.

One potential reason why respondents said that debt is more available is that Fannie Mae and Freddie Mac have lifted COVID-19 reserve requirements that were put in place last year, which has made loans available to some borrowers who might not have qualified. Fannie/Freddie is considered the most significant source of debt capital for multifamily among 44 percent of respondents, followed by local/regional banks at 39 percent and institutional lenders at 32 percent.

## Feeling Better Across the Board

Sentiment improved across the board compared to a year ago on the outlook for all classes of apartments.




"The amount of capital the lending community is trying to put out is huge, and you're seeing tremendous competition to lend," adds Fried. Generally, lenders have been providing loans at debt service coverage ratios (DSCRs) of 1.25-1.30x. Although most respondents (58 percent) anticipate no change in DSCRs over the next 12 months, 32 percent believe lenders could be less aggressive in the coming year. Those who believe DSCRs could move lower are in the minority at 10 percent. "If anything, I would expect to hold those DSCRs, and maybe even tighten them a little bit among lenders who need to put money out over the next 12 months," says Fried. There is more capital in the market than there are good borrowing opportunities.

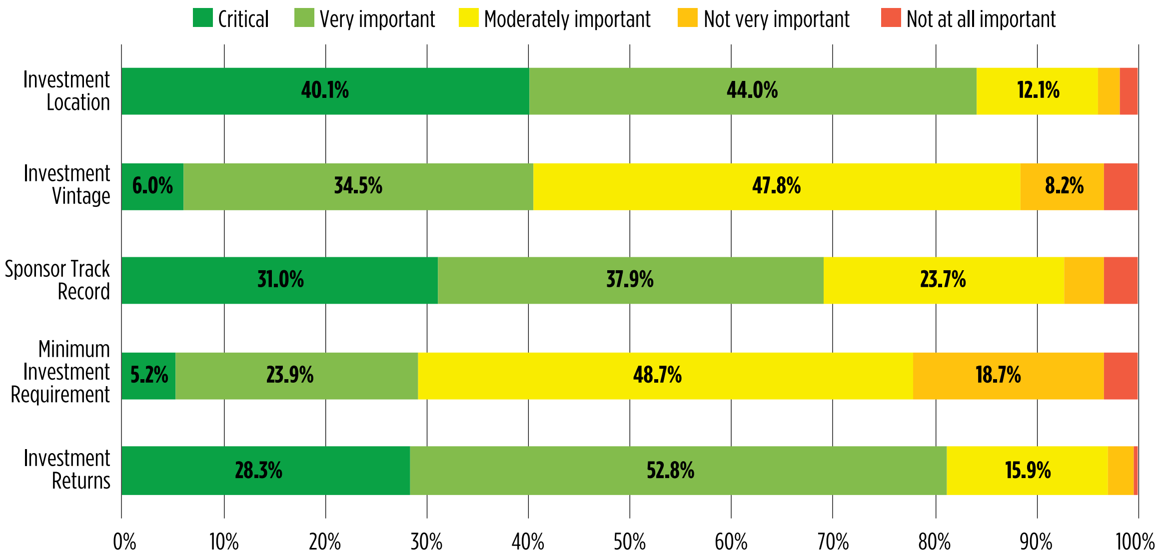
More than half of respondents (57 percent) expect no change to LTVs in the coming year, while 30 percent said LTVs could increase over the next year. Those who believe LTVs will decrease are in the minority at 13 percent. "Increasingly, lenders are more willing to take some level of leasing risk as a competitive factor to put money out," says Fried. However, the willingness to take on risk is more than just having dollars to put out, it also speaks to the confidence that lenders have in the economy and the outlook for fundamentals, he adds.

Another surprising survey result that appears to run contrary to optimism for improving fundamentals is that more than half of respondents (57 percent) anticipate a rise in loan delinquency rates ahead. Although expectations for loan delinquencies have improved dramatically compared to the 88 percent who held that view in the 2020 survey, it remains a relatively high number. One in four believe there will be no change, while a minority 18 percent think loan delinquencies are more likely to decline. The overall mean change is an increase in the delinquency rate by 1.8 percent.

According to the Mortgage Bankers Association, the percentage of non-current multifamily loan balances did tick a slight 30 basis points higher in June to 2.1 percent. However, the overall volume has been low compared to the spike in unemployment that occurred last year. There are a couple of reasons why people might be expecting an increase in loan delinquencies. One is that there is an anticipation that the year-over-year rent growth isn't sustainable and will eventually level off. There also may be some skepticism that the market was able to outrun the huge spike in unemployment without some type of market correction, notes Fried.

## Weighing Factors

Repondents were asked to rate how various factors affect their decisions when making multifamily investment decisions.




### Higher cap rates ahead?

Liquidity in the market is likely contributing to pricing growth and cap rate compression. According to Real Capital Analytics, cap rates declined 30 basis points to average 4.9 percent in the second quarter. However, survey respondents are bracing for higher cap rates, likely due to growing expectations for rising interest rates. Nearly three-fourths of respondents (72 percent) are preparing for a rise in interest rates over the next 12 months—a big swing compared to 19 percent who predicted an increase in the 2020 survey. Nearly half of respondents also believe the risk premium will increase, which is comparable to the 54 percent who held that view in the 2020 survey.

Although most respondents also think cap rates will rise over the next 12 months, the share is not as high as views on rising interest rates. In all, 62 percent of respondents said cap rates will rise over the next 12 months compared to 28 percent who predict a decrease and 11 percent who think cap rates will remain the same. Overall, the average expectation is an increase of 19 basis points.

It also is important to note that 64 percent of respondents thought cap rates were likely to rise in the 2020 survey—a prediction that did not materialize. "The pressure on cap rates is going to continue, and the primary reasons for that are that we continue to have very low and attractive borrowing costs," says McAuliffe. Even though cap rates have declined by 30 basis points or more, there is still positive leverage of 75 to 100 basis points between the cap rate and borrowing costs. Investors also are underwriting rent growth more aggressively in the first couple of years, and the amount of capital flowing into the sector is creating competitive bidding on for-sale properties, he adds.

Respondents view the West/Mountain/Pacific and South/Southeast/Southwest as the two strongest regions for performance at 78 percent and 71 percent respectively, rating them as an 8 or higher on a scale of 1 to 10. In fact, sentiment for both jumped compared to the 2020 survey where fewer respondents were confident in the strength—60 percent for the South and 58 percent for the West. The East region was viewed as strong by 55 percent, while the Midwest trailed at 25 percent.

"The Sun Belt markets continue to be hot markets given the positive net migration and corporate relocations to tax-friendly markets," notes Casas. Interest also is increasing in the West Coast, primarily in suburban locations. Confidentiality agreement counts are up across the country, and we are seeing significant increases per deal on the West Coast, he says. "Investor demand continues to be propelled by strong leasing momentum, dry powder and low interest rates," he says. "Suburban assets remain the most desirable, but as markets reopen investor demand for urban assets has gradually increased." ■

***Survey methodology:*** *The WMRE /Ashcroft Capital research report on the multifamily sector was conducted via an online survey distributed to WMRE readers between June 28 through July 6, 2021. The survey results are based on responses from 297 participants. Respondents represent a cross-section of different roles in the multifamily sector, including investors, building owners and managers, developers, lenders and brokers. Two-thirds hold a senior management position within their firms, including 52 percent who identified as an owner, partner, president, chairman, CEO or CFO.*