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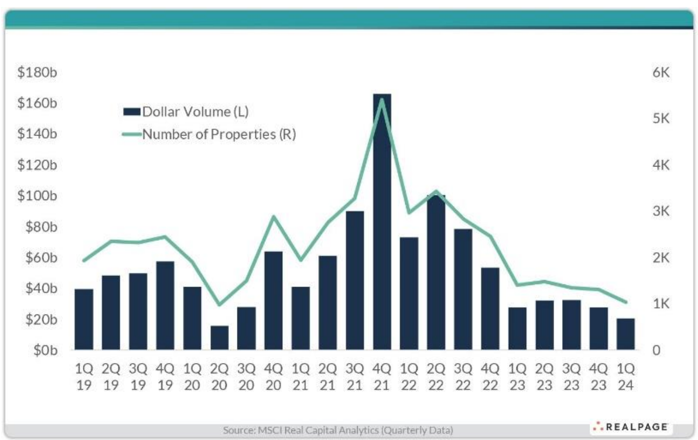
Midyear 2024 Market Update – Multifamily

The last 2 ½ years has seen difficulties in the multifamily industry from both the fundamental but also from the capital market perspectives. Oversupply has pushed occupancies and rents down while rising interest rates have put downward pressure on pricing while also hampering existing asset-level cash flows. Through early 2022, the intense supply of capital chasing investment opportunities pushed pricing up while buyers used aggressive debt structures to win deals while taking on more financial risk. Even with interest-rate caps in place on many of those floating-rate loans the cost of the caps, and cost to escrow for those caps, sky-rocketed leaving many assets cash-strapped while pricing dropped significantly reducing or eliminating prior equity in deals. It remains to be seen how much distress will hit the market as those loans come due as many investors and lenders have kicked the proverbial can down the road in hopes of future interest rate reductions. Potential buyers with dry powder appear to be waiting for price declines beyond what has already taken place while sellers would generally prefer to hold if possible and sell in a better environment.

Although being an investor in multifamily of late may have been painful, there are many positive signs that there may be a significant buying opportunity on the horizon (if not already here).

Investment Sales/Pricing:

On the investment sales side, transaction volume is down to levels not seen since the beginning of Covid in early 2020:

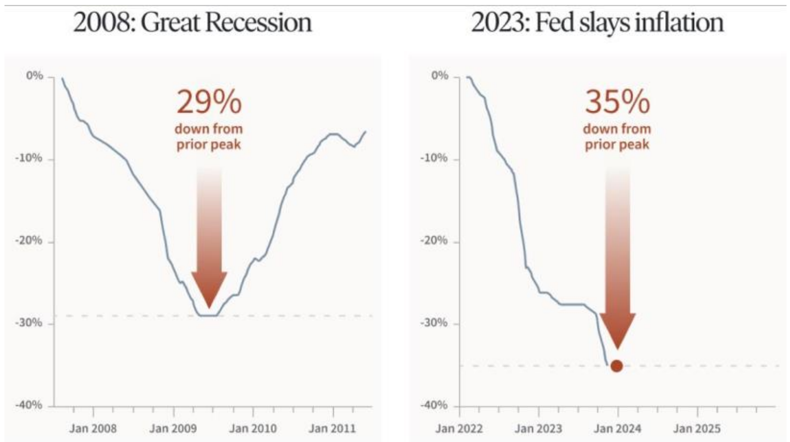


Source: RealPage

In the Sunbelt, cap rates have generally increased 150-250bps from peak pricing of late 2021 and early 2022 when deals were trading in the mid-to-high 3% range with little to no differentiation in cap rates for varying asset classes or vintages. Today, investor preference for newer "flight to quality" deals appear to have pegged those assets in the low 5% cap rate range. Older, out of favor, assets now have a differentiated cap rate that appears much more dependent upon positive leverage out the gate with cap rates seemingly settling into the 6% plus levels (some very undesirable assets seemingly pushing the 7% cap levels although there is still limited transaction data on those deals).

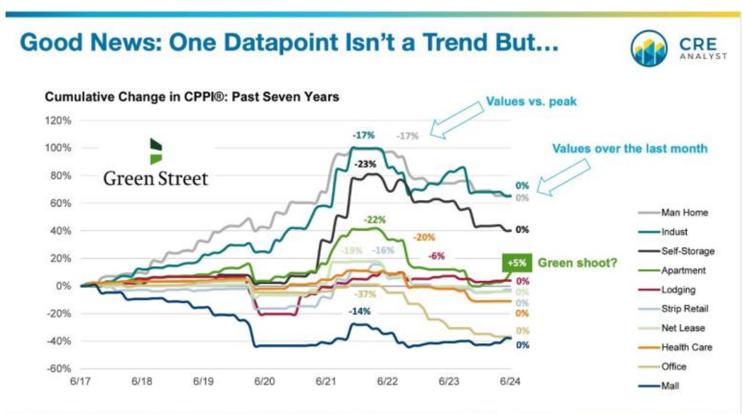
If comparing price reductions of today vs the most recent peak to price reductions during the Great Financial Crisis, it does seem to be a great time to re-enter the market as prices are down 35% from the peak today vs just 29% during the GFC, according to Green Street's tracking from earlier in the 2nd quarter. These price reductions are very much inline with what has been seen tracking deals in the

Phoenix and Las Vegas markets over the past year plus. It certainly appears to be the best buying opportunity over the last 15 years at least from solely a pricing viewpoint, but it also certainly doesn't imply we've hit a bottom.

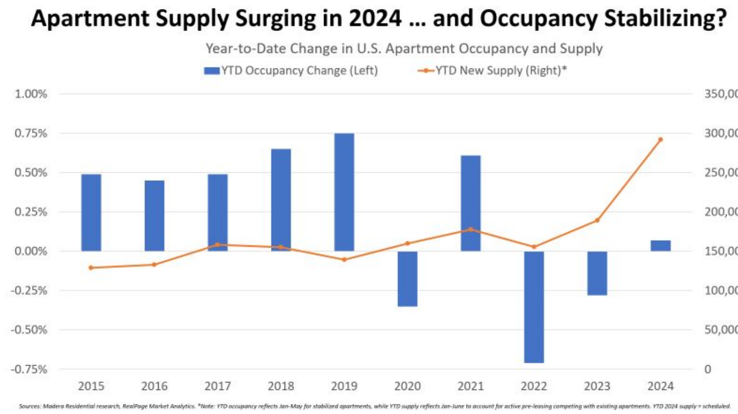


Source: Green Street

Green Street recently shared data on the month-over-month pricing analytics showing that most commercial real estate flattening out while apartment values seem to have started a slight uptick in values at a 5% increase based upon recent data. I'm not an advocate of thinking one can time the market perfectly, but Green Street is showing data that pricing has at least been bouncing along the floor for a few months and might be finally trending upwards. If this continues, anticipate more capital flowing into multifamily as most investors are waiting to come back into the market once they're confident prices have not only hit bottom but are showing strong signals of moving back up again.

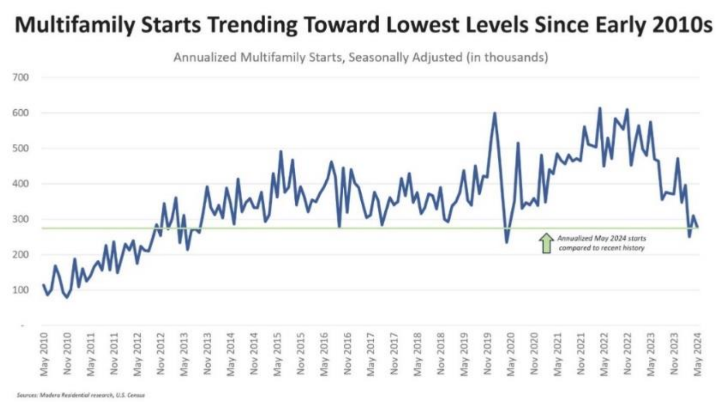


Fundamentals - Supply:
Supply is certainly on the minds of many investors and industry professionals with approximately 300,000 units set to be delivered in just the first half of 2024. This is significantly higher than the normal, annual levels in the 150,000-unit range over the past 10 years or so. Even with this high level of supply, the occupancy drops nationally seem to be leveling off.



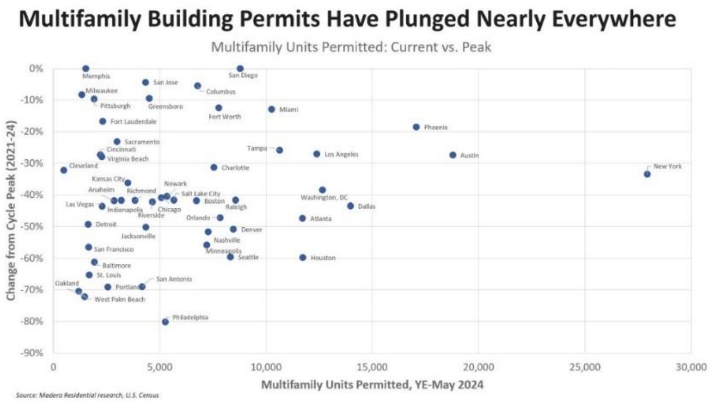
Source: RealPage

How long is this high level of supply expected to last though and can demand keep up (or does it have to)? Well, multifamily starts have trended down to their lowest levels (under 300K) in 10 years nationally according to the US Census (annualized). This is less than half of what they were just a year ago (nearly 600K).



Source: Madera Residential Research-Jay Parsons

In addition to new starts, new permits have fallen off dramatically nationally as well down 60-80% from their peaks (2021-2023) in some parts of the country. It is important to remember that even with these massive declines in new permits, it is unlikely for many of these to convert to new starts in the coming years.



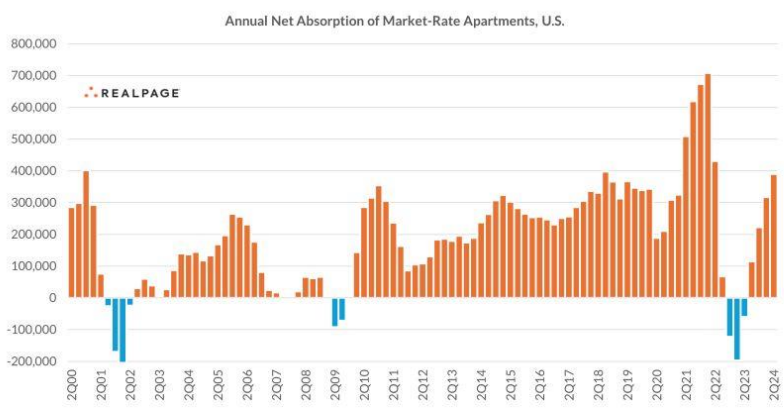
Source: Madera Residential Research-Jay Parsons

Why such the drop-off in permits and starts? High interest rates make it difficult and expensive to finance new projects. It is cheaper to purchase a new apartment building (with little to no lease-up risk) than it is to develop a new property. Rent reductions and cap rate expansion have made projecting an exit price that exceeds today's pricing (leaving room for some profit) a very difficult bet to make. It just doesn't make much economic sense to keep developing new projects right now when investors can buy below replacement cost.

In most high-supply markets, this data suggests strongly that deliveries drop-off to early 2010's levels by then end of 2025 or early 2026.

Fundamentals – Net Absorption/Demand:

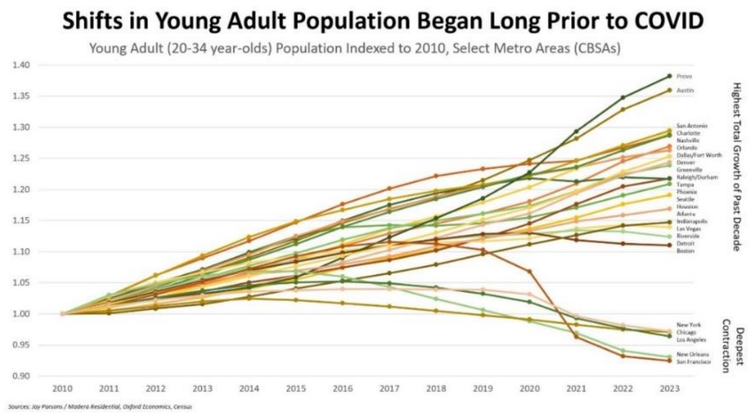
Although new supply is at historic highs in many Sunbelt markets (as well as nationally, overall), net absorption has been a pleasant surprise off-setting those supply headwinds. Year-ending 2Q 2024 (rolling 12 months), almost 400K net units were absorbed (net) – far outpacing the heavy new supply levels. This period (annualized) was one of the highest in nearly 25 years.



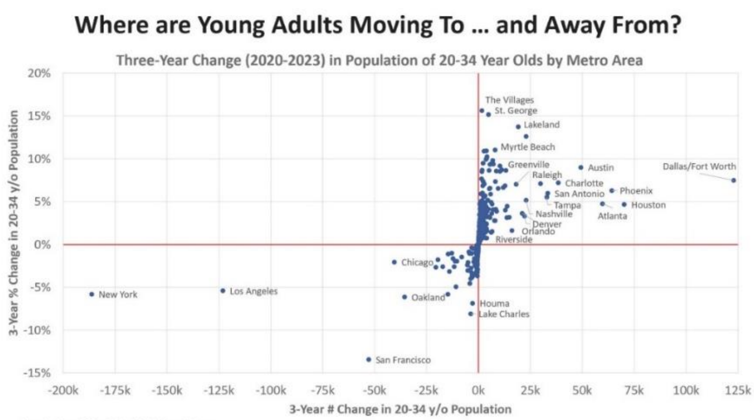
Source: RealPage

Driving this high-level of demand has been a variety of factors including wage growth, rent declines, pent-up demand, migration patterns, job growth, population growth and elevated household formation. An argument can be made that household formations have improved dramatically due to rent-to-income ratios moving back to pre-pandemic levels. Renters don't need to "double-up" as much as when rent-to-income ratios were elevated post-pandemic. Also, with high inflation appearing to be on the downward trend, it appears some pent-up demand from prior years is moving back into the renter pool as consumer confidence increases.

Migration patterns have favored population shifts to Sunbelt cities for over 20 years with Covid helping to spur that along, especially for the prime renter demographic (20–34-year-olds), but this has been a long-term trend that started years ago and hasn't slowed down post-Covid. Even some tertiary markets have made major gains (percentage-wise) over the last 3 years. This migration shift helps explain the strong net absorption numbers in the high-supply, Sun-belt region over the past few quarters.

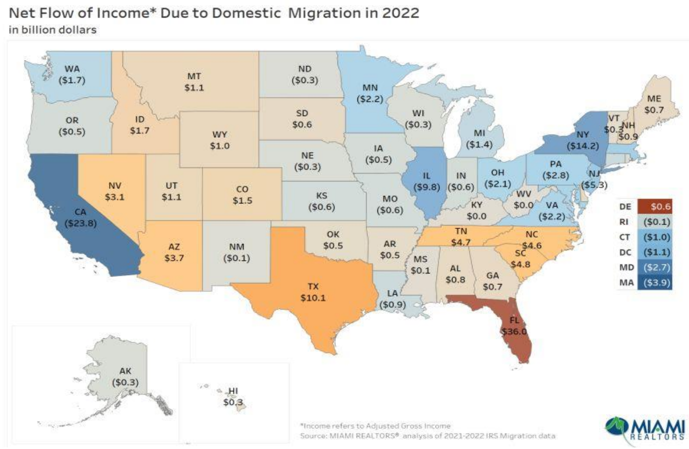


Source: Madera Residential Research-Jay Parsons



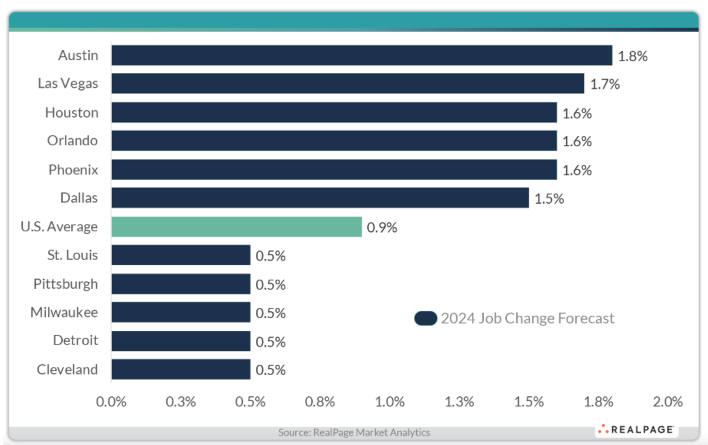
Source: Madera Residential Research-Jay Parsons

With migration comes income movement with the Sunbelt also leading the way in net income inflow pulling from the Northeast and West coast states. This additional influx of income to an area supports additional rent growth over the long term.



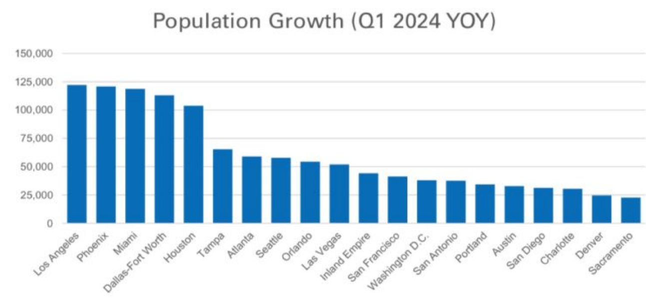
Source: Miami Realtors

Given migration patterns, it's no surprise that employment growth in these Sunbelt markets exceeds the national forecasted average for 2024.



Source: RealPage

Overall population growth shows similar patterns for sheer numbers in early 2024 as many of the same Sun-belt markets lead the way in total population growth, so this is not just a young renter phenomenon.



Source: Newmark Q12024 Report

These population growth trends are, not surprisingly, expected to continue over the next 5 years with many Sun-belt markets expected to lead the way on a percentage-increase basis. Relative affordability and lifestyle are primary reasons for these migration patterns.

The Greatest Population Growth Over the Next 5 Years on a Percentage Basis Will Be In Secondary Markets

Top 15 Markets: 2024-2029 Population Growth

Market	2023 Population	2024-2029 (F) Population Growth	Absolute Change
Boise	834,460	11.7%	99,384
Las Vegas	2,335,740	10.0%	237,004
Austin	2,486,538	9.9%	252,867
Phoenix	5,060,618	8.3%	425,613
Raleigh - Durham	2,134,911	8.0%	173,982
Orlando	3,619,738	7.2%	263,690
Dallas	8,389,864	6.8%	580,564
Houston	7,484,134	6.6%	502,071
Salt Lake City	2,885,626	6.4%	188,179
Charlotte	2,777,060	6.4%	179,159
Savannah	739,018	5.4%	40,284
Nashville	2,121,349	5.2%	111,955
Colorado Springs	771,986	5.0%	39,049
Seattle	3,117,193	4.9%	154,177
Denver	4,056,985	4.9%	201,593

Bottom 15 Markets: 2024-2029 Population Growth

Market	2023 Population	2024-2029 (F) Population Growth	Absolute Change
Chicago	9,450,967	-1.6%	-147,977
Pittsburgh	2,345,980	-1.0%	-23,706
Los Angeles	9,778,367	0.1%	7,832
San Diego	3,263,046	0.1%	4,741
New York	14,485,844	0.2%	22,179
Philadelphia	6,258,035	0.4%	26,110
Albuquerque	1,070,341	0.5%	5,201
Tulsa	1,041,281	0.6%	6,609
Boston	5,347,589	0.7%	37,763
Kansas City	2,348,469	1.1%	24,978
San Francisco	5,698,539	1.3%	75,279
Grand Rapids	1,616,405	2.1%	33,757
Oklahoma City	1,610,423	2.1%	33,856
Huntsville	684,365	2.2%	15,617
Omaha	1,327,912	2.9%	38,576

YARDI

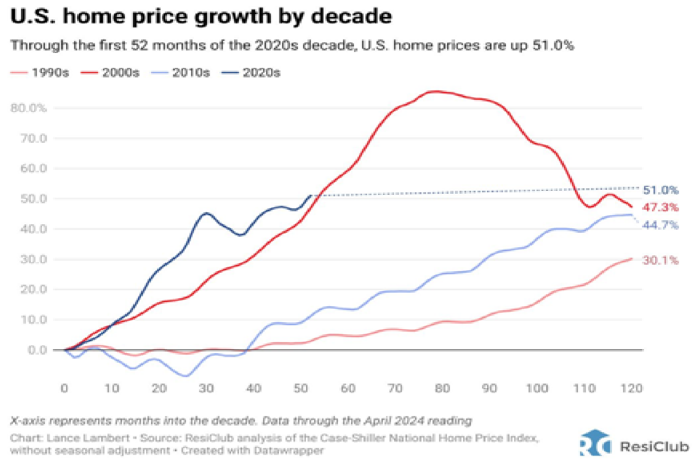
Gateway markets in bold. Sorted by Population Growth. | Source: Yardi Matrix; Moody's Data Analytics

Source: Yardi Matrix

Fundamentals – Rents vs Own:

With the rise in interest rates, owning a home with a new mortgage has become increasingly more expensive. Even with rising interest rates, home values in many metros continue to climb (although this varies vs peak pricing metro to metro).

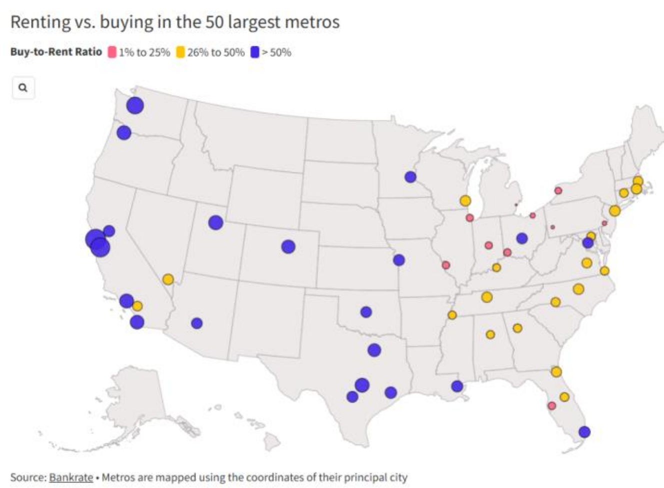
Less than halfway through the 2020's home prices have grown by 51% nationally which is higher growth than any of the full decades of the 2010's, 2000's or 1990's.



Source: ResiClub

Home price escalation during this decade in conjunction with higher interest rates combined with the recent drop in multifamily rents has created quite the beneficial situation in favor of renting for most of the country compared to buying an entry-level home today. In many major metros it is over 50% cheaper to rent vs own today. This, of course, has boosted demand for multifamily rental units.

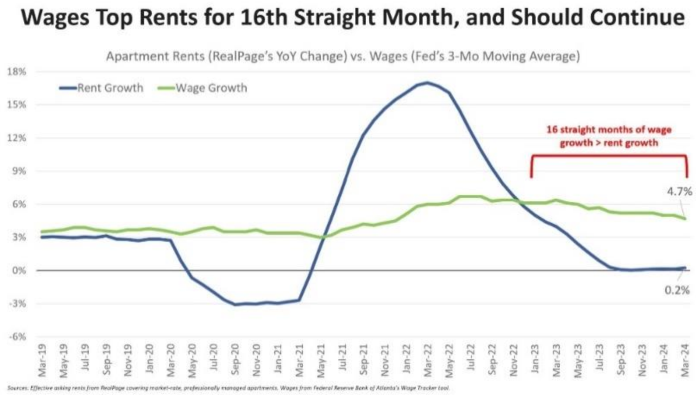
Source: Madera Residential Research-Jay Parsons



Source: Bankrate

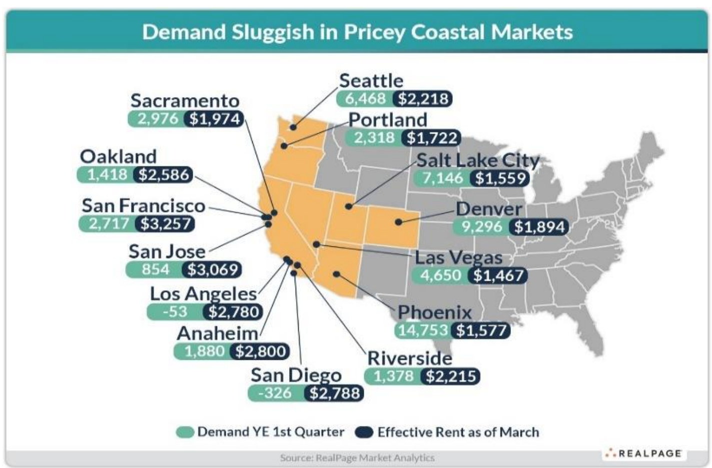
Wage Growth vs Rents:

Wage growth has exceeded rent growth for 1 ½ years which has reduced the rent-to-income ratio to pre-pandemic levels. Nationally this ratio has fallen to 22.5%, according to RealPage. This, of course, is another strong determinant of demand.



Source: Madera Residential Research-Jay Parsons

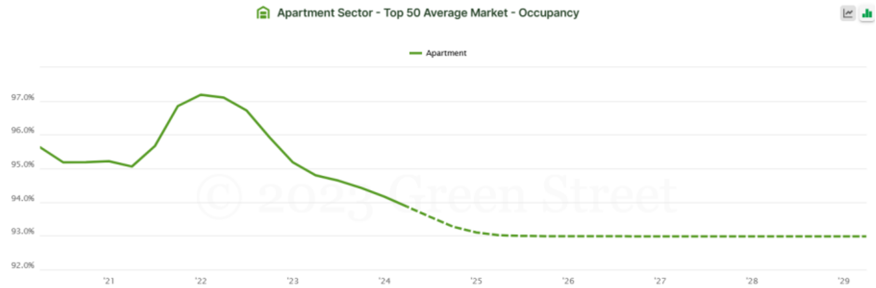
As income-to-rent ratios drop, affordability is becoming a major factor as to where demand is the strongest. On the West coast, relative demand is highest in the most affordable markets, generally.



Source: RealPage

Occupancy/Rent Growth Projections:

Occupancy is expected to stabilize around 93% nationally once new supply drops off in 2025. This is down over 4 percentage points from the pandemic peak but only down 2 percentage points from pre-pandemic levels.



Source: Green Street

With stabilizing occupancy, rents are expected to increase to more normalized levels in the medium-to-long term nationally (2-3% increases).

Source: Green Street

Final Thoughts:

There is a generational opportunity today to buy multifamily assets in the right markets with the right strategy in the near-to-medium term. Most high-supply, Sun-belt markets have held up reasonably well operationally of late (after a short, rent correction period) with most of the distress in the market stemming from a financing issue on existing assets. In the short-term, there are still some supply headwinds that make projecting rent growth difficult, but those rent reductions appear to be bottoming with occupancies stabilizing. In the medium-to-long term, multifamily fundamentals appear very strong with reasonable rent growth projections becoming the norm again in 2026 and beyond. Also, it appears pricing is bouncing along the bottom with the downside/floor being fairly well protected now, so acquiring well-located deals in high-growth markets appears very attractive. The window to find those types of deals appears to be opening as competition from buyers is still weak (many still on the sidelines), but competition should increase once fundamentals have put the high-supply headwinds in the rearview mirror in late 2025 and early 2026. There is plenty of dry powder on the sidelines, seemingly, waiting for fundamentals to show the more solid footing that is predicted in the next couple of years. With interest-rate uncertainty still in the market (and predicting any immediate rate reductions difficult even with the latest CPI release), fixing long-term debt on an acquisition can provide that final piece of comfort for new investors that some existing owners don't have today given their current floating-rate loans.

Blackstone recently announced that they have $65 billion in dry powder for commercial real estate as they "feel like there's a bottom happening." In April, they acquired Apartment Income REIT Corp, taking the firm private citing reduced supply and interest rate pressures in the near term.

More recently, KKR acquired a $2.1 billion multifamily portfolio of 5,200 units primarily recently built, Class A properties in Sunbelt and growing coastal markets. They specifically cited the current pricing dynamics as well as the supply reduction on the horizon as being a great time to take advantage of opportunities in the market.

Are these high-profile announcements an early preview of increased investment sales activity in multifamily? That remains to be seen, but they're certainly highly confident that now is a great time to buy multifamily properties due to the medium and long-term fundamentals within the sector.