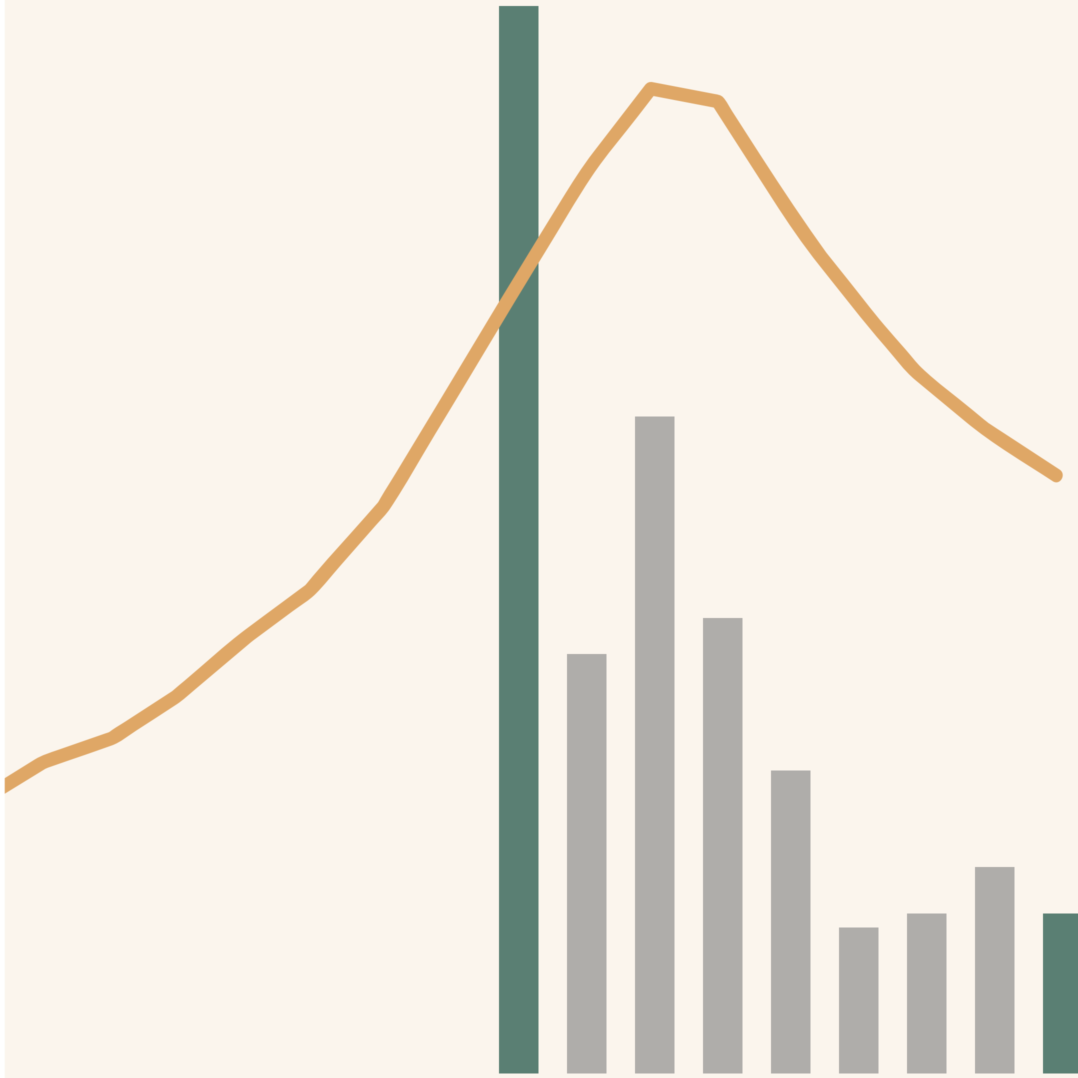
MULTIFAMILY GAP CAPITAL



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Many recent buyers and developers of Sunbelt multifamily properties are overleveraged and need capital to bridge the gap between their debt balances and the significantly depreciated equity value of their holdings. The current pall over the asset class, however, obscures its long-term attractiveness for patient investors.

The once sizzling market for multifamily properties in the Southeast and Southwest US has chilled, creating cracks in the capital stacks of owners—and possible opportunities for investors.

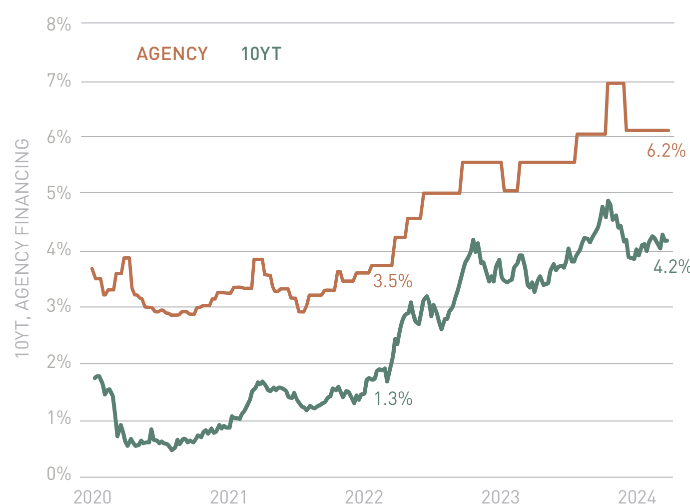
THE ROUTE TO TODAY

How times have changed for the once-booming multifamily housing sector across the Sunbelt—the band of US states stretching from the Southeast to the Southwest. The all-time high watermark for the sector came in the fourth quarter of 2021 when $97 billion in transactions took place, accounting for nearly a third of the nation's multifamily property transactions—which themselves were more than double the previous quarterly record level.[1]

Even then, many recognized that the pace of sales activity was unsustainable, with many describing it as an investor "feeding frenzy" fueled by cheap leverage. At the time, the 10-year Treasury yielded around 1.3% and all-in debt costs for stabilized multifamily were between 3% and 4% using government-sponsored enterprises (GSE) pricing as a proxy.[2]

In the first quarter of 2022, the US Federal Reserve embarked on a monetary tightening campaign, ending what effectively had been a golden period from the end of 2009 to the end of 2021, when 10-year Treasuries declined from approximately 3.5% to 1.3% and Sunbelt apartment cap rates declined from 7.5% to 4.5%.[3] The change in monetary policy resulted in a sharp decline in transactional liquidity over the following two years as base rates and financing costs rose by approximately 300 basis points, making most debt dilutive at best and generally unattainable without a meaningful paydown from a sponsor looking to refinance *(Exhibit 1)*. Subsequent stress in regional banks further compounded market liquidity challenges.

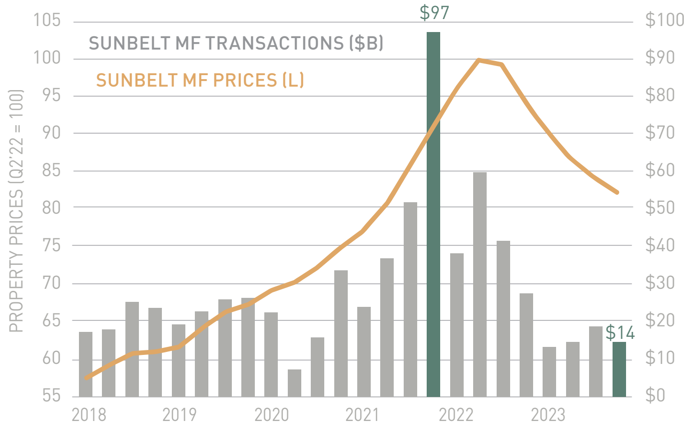
EXHIBIT 1: ERA OF CHEAP REAL ESTATE DEBT ENDS
10Y TREASURY, FINANCING COSTS



Sources: Federal Reserve, Green Street, Cred IQ as of Q1 2024

By the end of the first quarter this year, Sunbelt multifamily trades had declined to $14 billion. The pullback in transactional activity over the past two years also has driven a decline of 18% in unlevered property value from its peak in the second quarter of 2022 *(Exhibit 2)*.

EXHIBIT 2: 2021 BUYING FRENZY
SUNBELT MULTIFAMILY TRANSACTIONS, PRICING

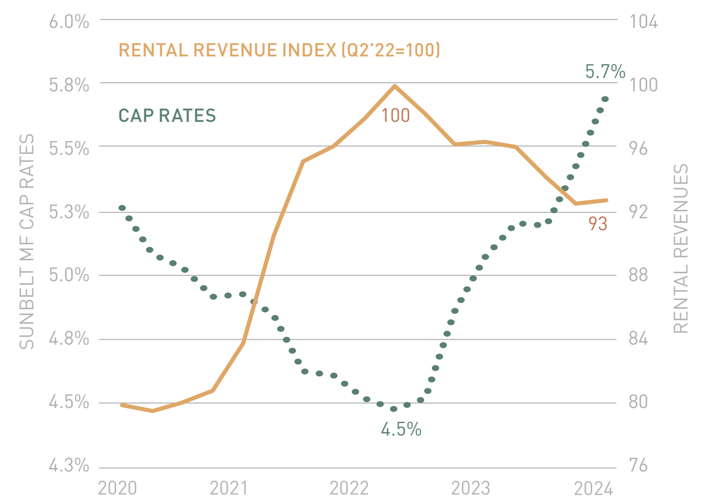


Sources: MSCI RCA, Costar as of Q1 2024.

Since the peak, cap rates have risen from 4.5% to 5.7% (as of Q1 2024), equating to a 21% decline in value if net operating income (NOI) had remained constant. But NOI has not remained constant over the period. Instead, rental revenues have fallen on average by approximately 7% *(Exhibit 3)*, which may not seem like much except that when buyers transact at peak pricing, they do not anticipate declining rental revenues as their base case.

Looming ahead are an estimated $120 billion in Sunbelt multifamily commercial mortgages scheduled to mature through 2027.

EXHIBIT 3: STRESSED FUNDAMENTALS AND PRICING DISLOCATION RENTAL REVENUES AND CAP RATES



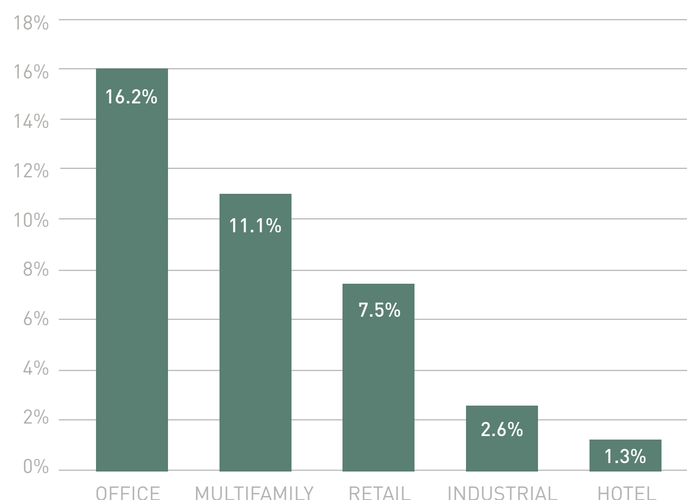
Sources: MSCI RCA, Costar as of Q1 2024. Rental revenues are effective rents multiplied by occupancy.

WHERE WE ARE NOW

Clearly, many recent buyers of Sunbelt multifamily projects are overleveraged and sit atop capital stacks that must be reconfigured. In many cases, additional capital is needed to bridge the yawning funding gap between what sponsors owe and the significantly depreciated equity value of their properties. In other cases, time has run out; distress events in the form of foreclosures, discounted payoffs, and other drastic actions are imminent absent loan modifications, which are difficult to come by as underwriting standards have tightened. Looming ahead are an estimated $120 billion in Sunbelt multifamily commercial mortgages scheduled to mature through 2027.[4]

Commercial real estate collateralized loan obligations (CRE CLO) secured by multifamily properties, delinquency rates have jumped to 11.1% *(Exhibit 4)*. Unlike CMBS, loans in CRE CLO pools are made primarily on transitional assets. That means there is usually a specific business plan justification making these loans riskier than those on stabilized properties. Capital stacks associated with strategies in which pricing is amplified by disruptions to the project timeline face greater urgency for a capital infusion, than do stabilized properties with diminished but sufficient cashflow.

EXHIBIT 4: PAINFUL DELEVERAGING UNDERWAY
US CRE CLO 30D+ DQ RATES



Source: Federal Reserve, Green Street, Cred IQ as of Q1 2024

While valuations have not yet stabilized, a cyclical bottom and eventual recovery are closer now than they were two years ago when the current downturn began.

STRUCTURAL DEMAND DRIVERS STILL INTACT

Despite the gloom—which has been compounded by record levels of new construction that have caused occupancy rates to drop and rents to flatten or decline—there are reasons for investors with "patient capital" to consider the sector. Sunbelt demand growth, driven by ongoing demographic tailwinds, will likely continue to lead the rest of the US over the next five years. Additionally, Sunbelt states offer favorable business environments, lower operating costs, and less stringent regulations. These spur business relocations and the expansion of existing facilities, creating a positive feedback loop of population and employment growth. Over the medium term, therefore, the outlook for multifamily Sunbelt properties looks brighter than what today's prevailing pricing dislocation suggests.

While valuations have not yet stabilized, a cyclical bottom and eventual recovery are closer now than they were two years ago when the current downturn began. Preqin estimates that $250 billion in dry powder was available for US real estate investment in May 2024, and much of it has been there for some time. With capital so much in demand, disciplined investors with a keen eye for value and a willingness to stand apart from the crowd may be able to capitalize on potential opportunities in this sector.

ABOUT THE AUTHORS

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NOTES

[1] MSCI Real Capital Analytics; as of Q1 2024.

[2] Federal Reserve, Green Street, Cred IQ; as of Q1 2024.

[3] MSCI RCA, Costar; as of Q1 2024.

[4] MSCI RCA, Cushman Wakefield; as of Q4 2023.