YEAR-END 2018 SMALL BALANCE
MULTIFAMILY INVESTMENT TRENDS REPORT

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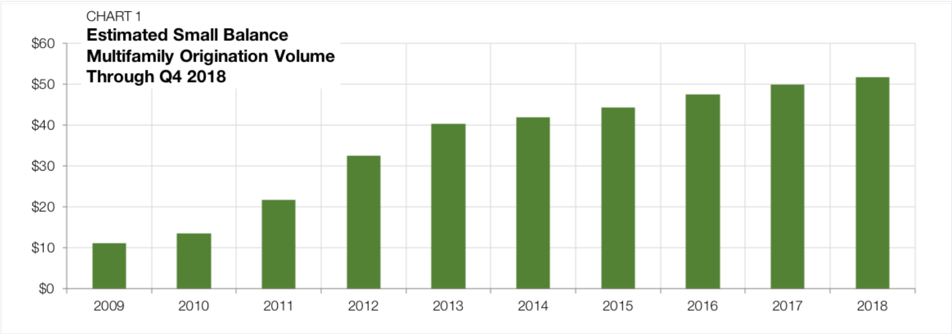
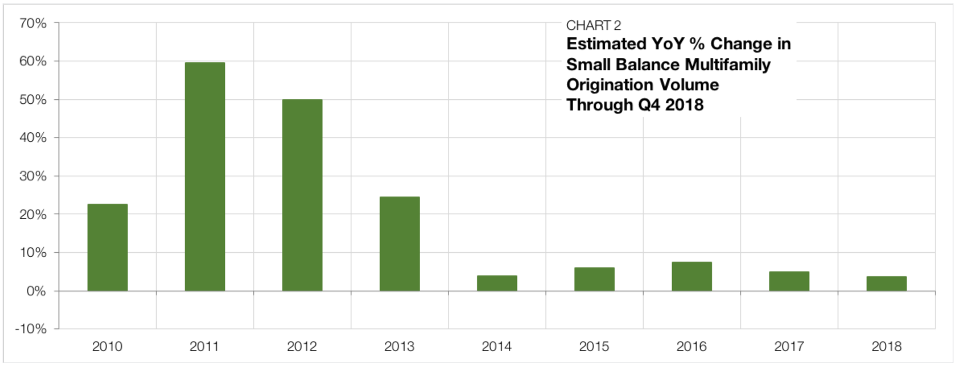
CHANDAN

SMALL BALANCE MARKET ENDS 2018 ON A HIGH NOTE

Cap Rates Hold Constant as Market Readies for Potential Rate Hikes

Benchmark interest rates on the short end of the yield curve ticked up to end the calendar-year 2018. The move came as the Federal Open Market Committee (FOMC) deemed the current and expected future economic conditions strong enough to warrant further monetary tightening. When the dust settles, despite a slowdown from the third quarter to the fourth quarter, 2018 will likely go on record as the expansion's strongest year thus far.





The labor market remains exceptionally tight. Based on the most recent available data, there are 1.1 job openings available for every unemployed person. While the U.S. economy's underlying strength has been a great source of optimism for many market participants, warning signs are beginning to flash.

The yield differential between long-term and short-term government-issued securities has flattened to just 19 basis points (bps) — a sign that investors are less optimistic about the economy's path ahead. The proximate cause of the next recession has yet to emerge definitively, but a protracted government shutdown headlines a growing list of potential downside triggers.

The yield on the 10-year Treasury averaged 3.0% during the fourth quarter of 2018, up 12 bps from the third quarter and 67 bps from a year earlier. This, however, fails to tell the full story.

From early-November through the end of the year, 10-year Treasury yields fell from 3.2% to 2.7% — a drop made further worrisome by the fact that the FOMC raised short-term interest rates at their December meeting. The Federal Reserve had been expecting two more rate hikes throughout 2019, but recent market volatility has led several high-ranking Fed officials, including Chairman Jerome Powell, to suggest the Central Bank will be patient in the year ahead.

Preceding the fluctuations to end the year, 2018 had seen significant pressure from rising rates. This proved to be a powerful test case as valuations on properties securing small balance multifamily financing displayed a clear resilience. Compared to the fourth quarter of last year, both cap rates and debt yields are essentially unchanged as the liquidity and borrowing capacity of the small balance market has been both strong and consistent.

LENDING VOLUME

The volume of new multifamily loans with original balances between $1 million and $5 million — including loans for rental apartment building sales and refinancing — reached $51.7 billion during 2018, the highest level of activity in Chandan Economics' post-financial crisis market tracking and model estimates *(Chart 1)*. After a slow start to the year, lending picked up in the third and fourth quarter of 2018, resulting in a 3.7% increase in volume from the year prior *(Chart 2)*.

The pace of lending volume growth, however, has slowed each of the past two years. Looking ahead, 2019 has a sense of balanced ambiguity. Economic uncertainty will serve as a headwind over the immediate time horizon, though the continued commoditization of small balance multifamily will further support the sector and minimize the effects of any industry-wide pullback.

Whether the macroeconomic and real estate cycles continue to lengthen or we begin to observe a modest pullback, the multifamily sector is generally expected to outperform other property types, both in terms of liquidity and the stability of operating fundamentals. Healthy operating income, a structural diversity of capital sources, and elevated demand for refinancing from the sector's higher indebtedness will support an elevated level of lending activity. These tailwinds, which are strengthened by an

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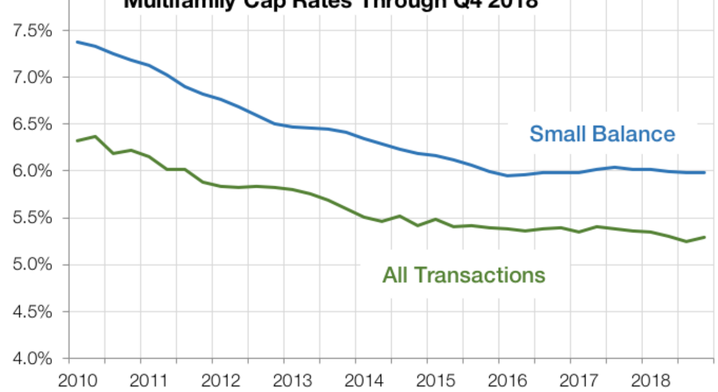
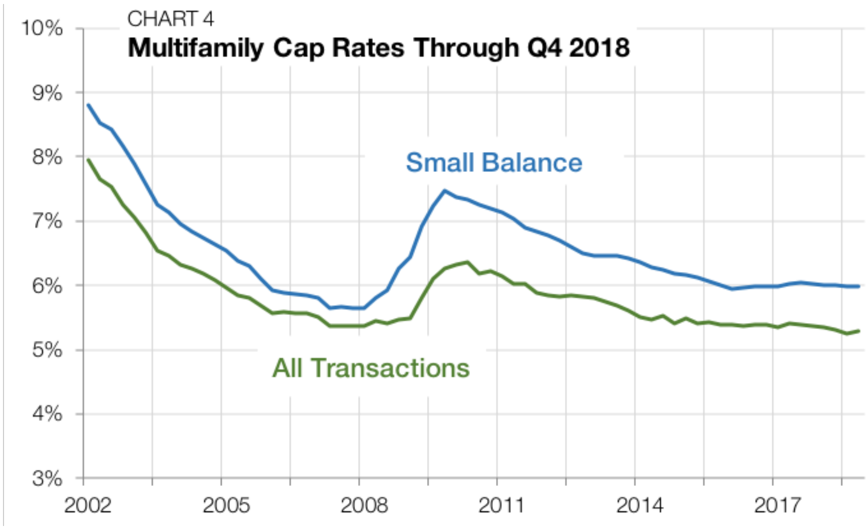
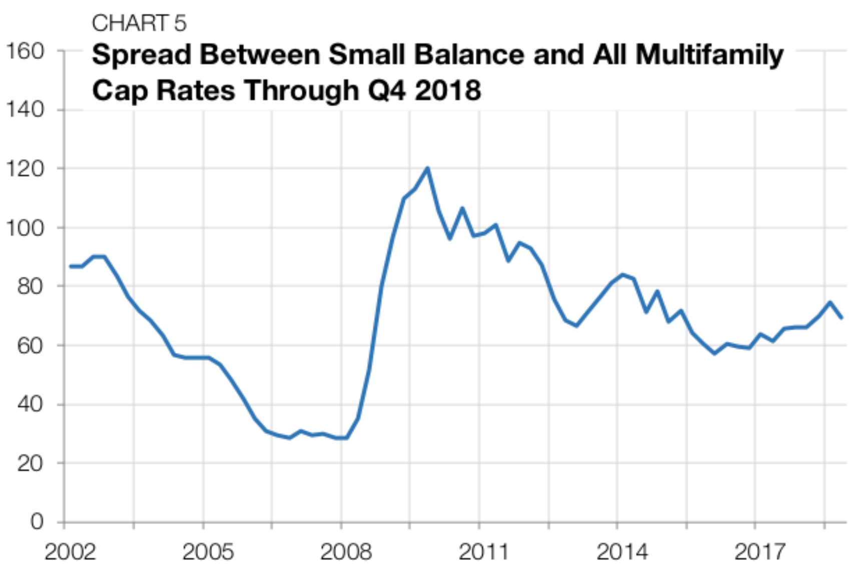
improving pace of household income growth, are offset in part by a general slowdown in commercial real estate investment sales. While it's unlikely in the near- to medium-term that housing finance reform will have an adverse shock to multifamily liquidity, uncertainty in the policy priorities of the administration could lead to potential disruption.

CHART 3
Multifamily Cap Rates Through Q4 2018







CAP RATES & SPREADS

National average cap rates for small balance loan-backed multifamily properties have been a model of consistency for more than three years, holding near 6.0% since the end of 2015 *(Chart 3)*. Small balance loan cap rates finished 2018 unchanged from the prior quarter and down just 4 bps from a year earlier. Small balance property values have generally been stable or increasing. Excess demand for affordable apartment supply, a niche oft-served by small balance properties, is expected to support pricing over the long-term.

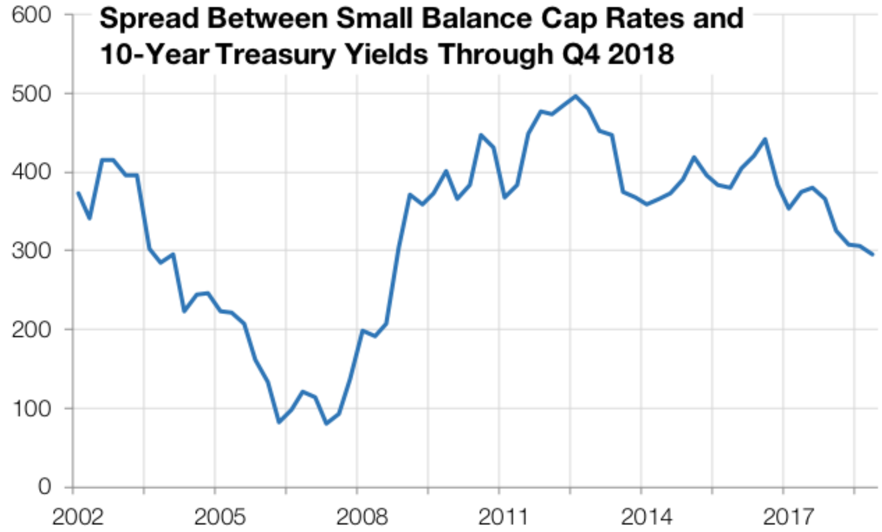
Small balance cap rates peaked at 7.5% in the immediate aftermath of the Great Recession, rising sharply from a data series-low of 5.6% that coincided with the commercial real estate market peak in 2007 *(Chart 4)*. Despite small balance cap rates remaining near their cyclical nadir, attention to risk pricing remains appropriate.

In the lead up to the financial crisis, risk premiums on small balance loans compared to all multifamily eroded to just 28 bps *(Chart 5)*. Today, spreads between small balance loans and loans on all multifamily properties currently sit at 69 bps — down from the 74 bps observed in the third quarter, and 1 bps above the 5-year rolling average of 68 bps.

The lack of volatility in small balance cap rates contrasts with the underlying interest rate environment. From its most recent quarterly low of 1.6% during the third quarter of 2016, the 10-year Treasury has increased by nearly 150 bps *(Chart 6)*. A substantial part of this increase has been absorbed into spreads. The difference between small balance cap rates and the Treasury declined to 295 bps during the fourth quarter of 2018, the lowest level since 2008 *(Chart 7)*.

CHART 7

Spread Between Small Balance Cap Rates and 10-Year Treasury Yields Through Q4 2018

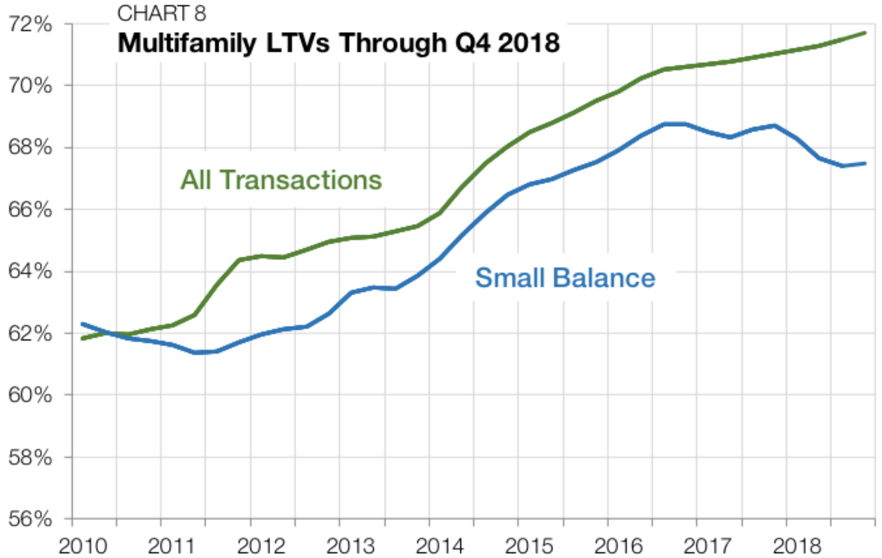


INTEREST RATES

Small balance cap rates have seen little movement off of their cyclical lows of 2016, and while Chandan Economics' projections for benchmark interest rates point to some upward pressure in 2019 and the years ahead, the magnitude is likely to be marginal. Based on implied probabilities derived from Treasury futures contracts, investors are skeptical that the Fed will continue to raise interest rates in the coming months. According to the Wall Street Journal's Economic Forecasting Survey, economists expect that the 10-year Treasury yield will approach 3.1% by the end of 2019, but will not eclipse 3.2% before the end of 2021.

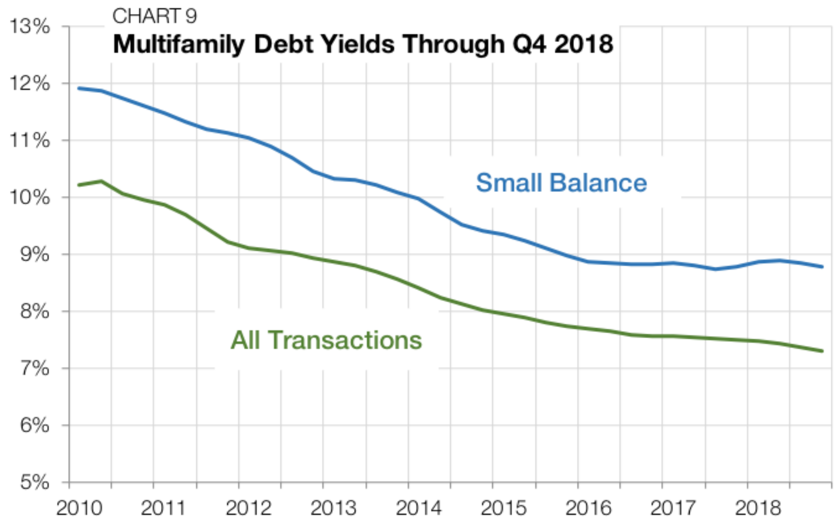
CHART 8

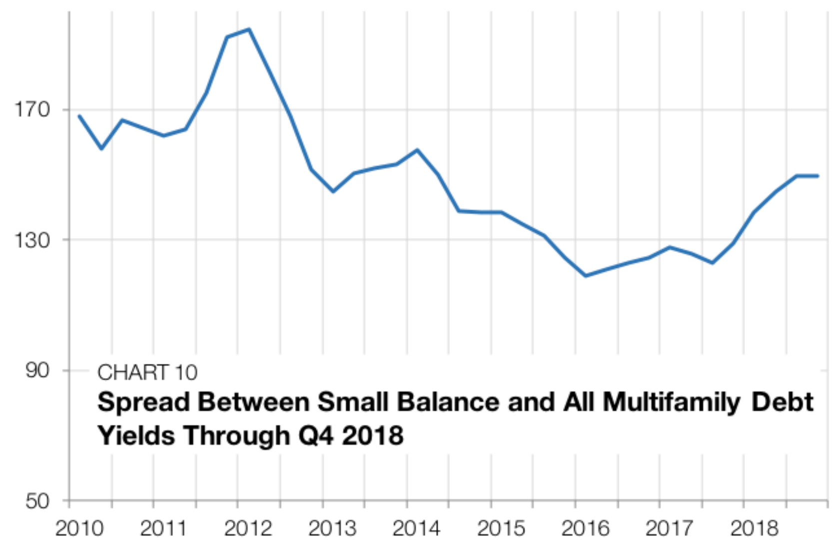
Multifamily LTVs Through Q4 2018

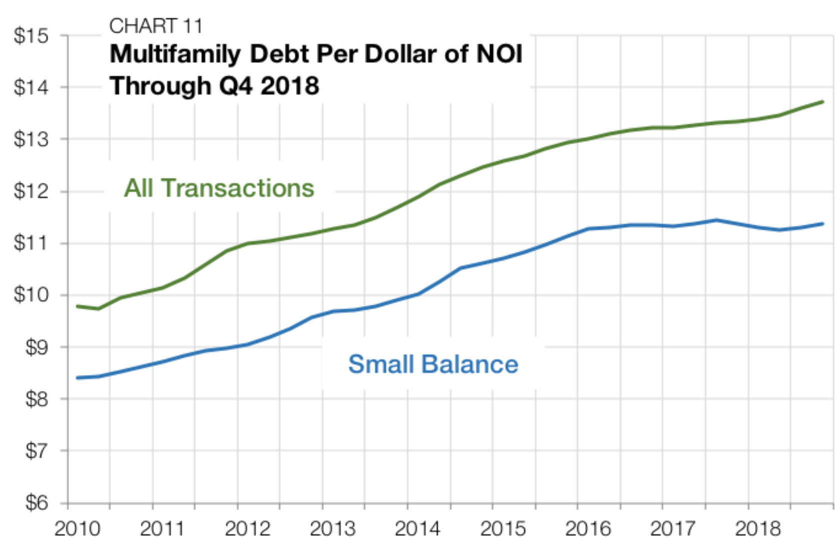


LEVERAGE & DEBT YIELDS

Leverage on small balance loans declined in 2018, reflecting the impact of mortgages originated and held on balance sheet by regional and community banks. The loan-to-value (LTV) on small balance loans originated during the fourth quarter of 2018 was 67.5%, up a negligible 8 bps from the third quarter, but down a full 123 bps from the fourth quarter of 2017 *(Chart 8)*. In comparison, LTVs across the broader multifamily market increased to their post-recession high watermark in the fourth quarter, touching up to 71.1%, a 68 bps increase from a year earlier.







Divergent leveraging trends between small multifamily and the overall multifamily market have driven up the LTV spread between the two groups to 424 bps, the highest level recorded in Chandan Economics' post-crisis tracking.

Debt yields — the ratio of net operating income (NOI) and loan balance — for small balance loans have gone essentially unchanged from 2017 to 2018. Small balance debt yields fell by 7 bps between the third and fourth quarter, and sit squarely where they were to finish 2017 *(Chart 9)*. While there has been little directionality for small balance loans, debt yields across the rest of the multifamily sector continued to fall further in 2018. For all multifamily properties, debt yields have now declined for 33 consecutive quarters, reaching a new low of 7.3% in the fourth quarter. These dissimilar trend lines have contributed to a 149 bps spread between small balance and all multifamily debt yields, the highest level since mid-2014 *(Chart 10)*.

Debt per dollar of NOI, the inverse of debt yields, ticked up in the third and fourth quarters of 2018. During the third quarter, small balance borrowers secured $11.30 in financing for every dollar of income generated by the property, with the measurement rising to $11.39 in the fourth quarter *(Chart 11)*. For the broader multifamily market, encumbrance increased to the highest level in Chandan's data set, at $13.72.

OUTLOOK

Favorable supply and demand dynamics for smaller assets just outside the urban core should lead to relatively stable property income trends over the current investment time horizon, notwithstanding any rise in the cost of financing or upward pressure on cap rates and debt yields. Despite signs of softening in the overall real estate market, small balance investment activity and liquidity have improved in part by this cycle's increase in aggregate agency support. Barring a downturn in the economy or a policy misstep by the administration, the overall lending environment for small cap properties is projected to remain healthy.