# Q2 2019
# SMALL BALANCE
## MULTIFAMILY INVESTMENT TRENDS REPORT

ARBOR

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CHANDAN

# SMALL BALANCE LENDING SURGES THROUGH FIRST HALF OF 2019

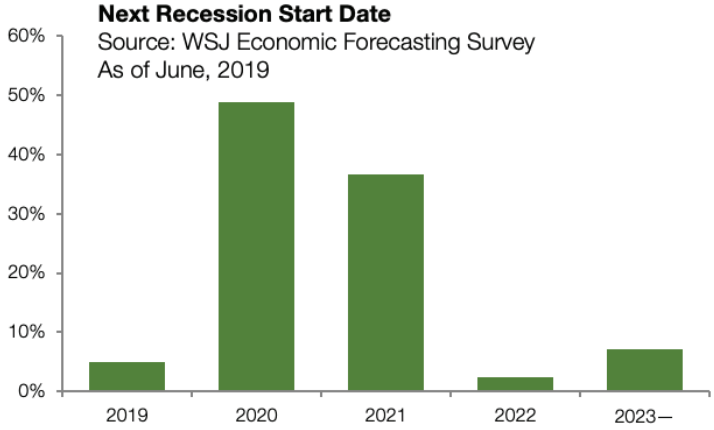
## Lower Interest Rates Ignite Lending Activity

Over the past six months, a growing number of Federal Reserve officials have come out in favor of a return to monetary easing. While the central bank has slowly moved away from tighter policy, measures of inflation have fallen below target. Chairman Jerome Powell's early-July testimony confirmed that the Fed is considering reducing its federal funds rate, and some policy-setting officials are publicly calling for two rate cuts in 2019. This reversal in monetary policy comes as the U.S. is now experiencing the longest economic expansion on record. While no expansion dies of old age, there are several concerns to watch, including trade disruption and global growth.

The yield spread between the 10-year and 3-month Treasury bills currently sits in negative territory — a signal that investors are expecting lower growth on the horizon. According to The Wall Street Journal's Economic Forecasting Survey, more than 53% of respondents believe the next recession will come before the end of next year (*Chart 1*). Extending the date out through 2021, over 90% of those surveyed say that by then we will have hit a downturn.

Consumers, on the other hand, are relatively upbeat. The University of Michigan's measure of consumer sentiment bounced back encouragingly in the second quarter, shaking off the remaining rust from the partial government shutdown. Consumer dollars typically follow their take on the state of the economy, and retail sales have risen for four consecutive months.

CHART 1
**Economist Expectations for Next Recession Start Date**
Source: WSJ Economic Forecasting Survey
As of June, 2019




The labor market remains exceptionally tight with the level of available job openings continuing to outnumber those who are unemployed. However, the effect on wages has been underwhelming. One of the prevailing explanations for why wage pressures have struggled to respond to generationally low unemployment levels is an emerging divide between the skills of available workers and the needs of employers. Chairman Powell's testimony countered the idea that the labor market is at peak-performance, quoting "to call something hot, you need to see some heat."

Whether the economy begins to slow in the medium-term or there is still some wind in the sails, it is constructive to consider how small balance multifamily might perform during the next market correction. The previous recession provided some useful lessons for the multifamily sector, and there are material differences in the market today that portend a better outcome

for small balance next time around. Small balance lending has remained disciplined, even when asset valuations accelerated. Risk premiums attached to smaller properties are appropriately priced, and small multifamily stands to see greater resilience should a market correction occur.

## LENDING VOLUME

Adjusted estimates of 2018 lending volume of new multifamily loans with original balances between $1 million and $6 million (and up to $7.5 million in select markets) — including loans for the sale and refinancing of rental apartment properties — jumped to $54.2 billion, the highest level of activity in Chandan Economics' post-financial crisis estimates (*Chart 2*). Following soft lending figures to begin 2019, lower-than-expected long-term interest rates have ignited a frenzy of refinancing activity. Annualized figures through 2019's halfway mark total $58.5 billion in lending volume, representing a 7.9% gain from 2018 (*Chart 3*).

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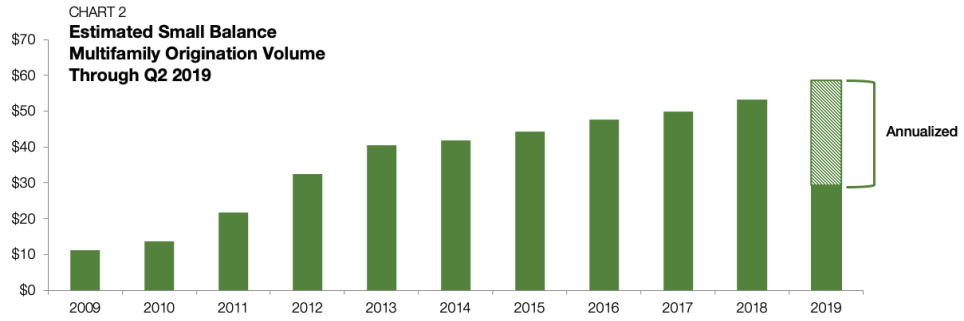
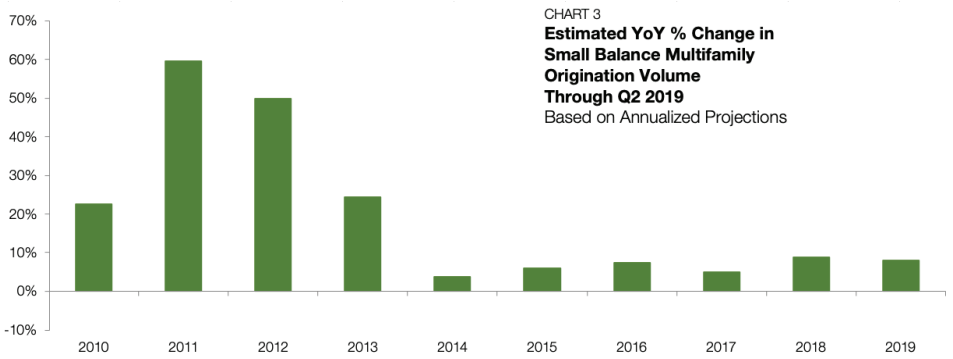
While a spike in mortgage lending amid lower interest rates has excited originators and borrowers alike, continued refinancing momentum will depend on whether Treasury rates decline further. The question of Fed rate cuts leaves open the possibility that Treasurys have not yet hit bottom. However, another 100-basis point (bps) decline, like the one observed in the past six months, is highly unlikely. Recessionary concerns are prevalent, which are likely to temper borrower demand for new investment sales.

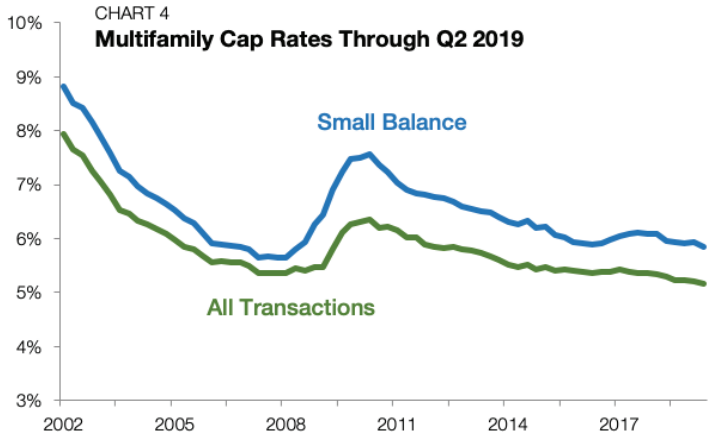
Whether the macroeconomic and real estate cycles continue to lengthen or we begin to observe a market correction, the multifamily sector is expected to outperform other property types, both in terms of liquidity and the stability of operating fundamentals. The continued growth and stability of operating income, a diversity of capital sources, and elevated demand for refinancing will continue to support healthy levels of lending activity. These tailwinds, which are strengthened by an improving pace of household income growth, are slightly offset by a potential slowdown in commercial real estate investment sales.

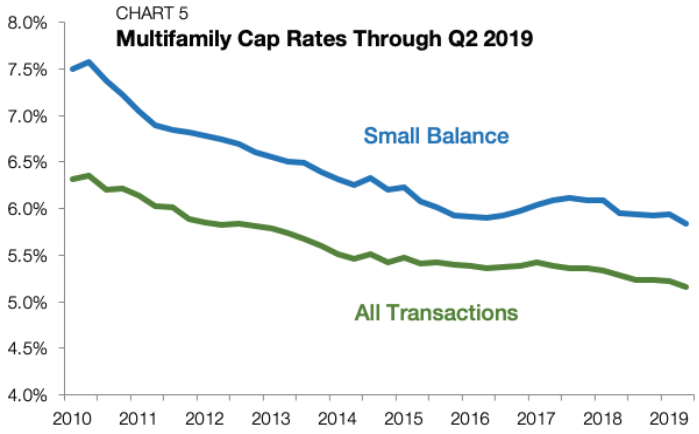


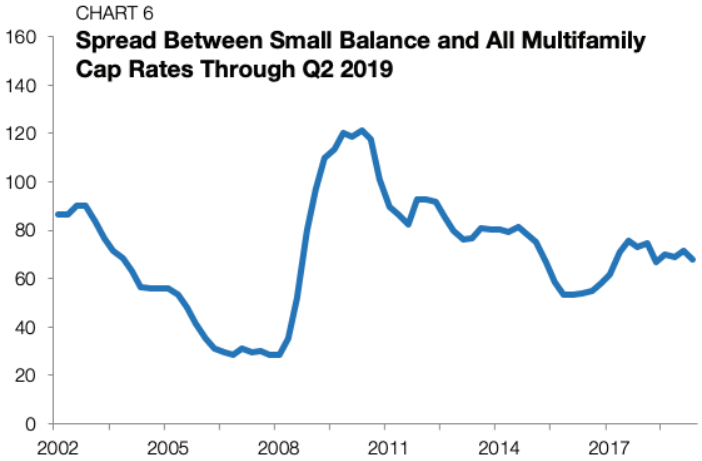



## CAP RATES & SPREADS

National average cap rates for multifamily properties backed by small balance loans dropped to their lowest post-crisis level following a steep drop in Treasury yields (*Chart 4*). In the second quarter of 2019, small multifamily cap rates dropped to 5.8%, a decline of 9 bps from the preceding quarter and down 11 bps from a year earlier (*Chart 5*). Price appreciation for small multifamily property values has generally been stable or increasing. Excess demand for affordable apartment supply, a niche oft-served by small multifamily properties, is expected to support pricing over the long-term.

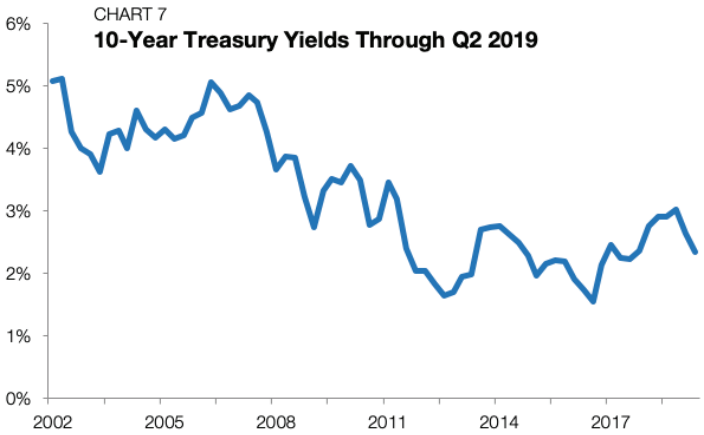


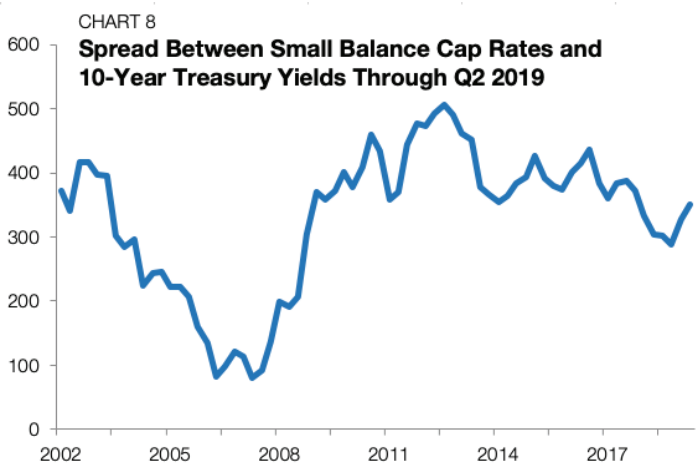




The cap rate spread between small multifamily and the rest of the sector measured 68 bps through second-quarter 2019 (*Chart 6*). The risk premium was bid-up from 2016 to 2017, and has moderated since. Looking back to the previous cycle, spreads sat below 30 bps leading up to the financial crisis.

Compared to the movements in Treasury yields, small multifamily cap rates are a beacon of stability. From July 2016 through November 2018, 10-year Treasury yields gradually ascended from 1.4% to 3.2%,influenced both by Federal Reserve intervention and an improving macroeconomic outlook (*Chart 7*).



The risk-free rate fell through the beginning of 2019, albeit marginally. In the second quarter, Treasurys dipped all the way down to 2.0%. Small multifamily cap rates have fallen slightly as a result, though the movement is benign in comparison. The observed net-effect is a wider spread between small balance cap rates and benchmark interest rates. The spread stood as low as 289 bps to end 2018, before jumping to 328 bps in first-quarter 2019 and 350 bps in the second quarter (*Chart 8*).



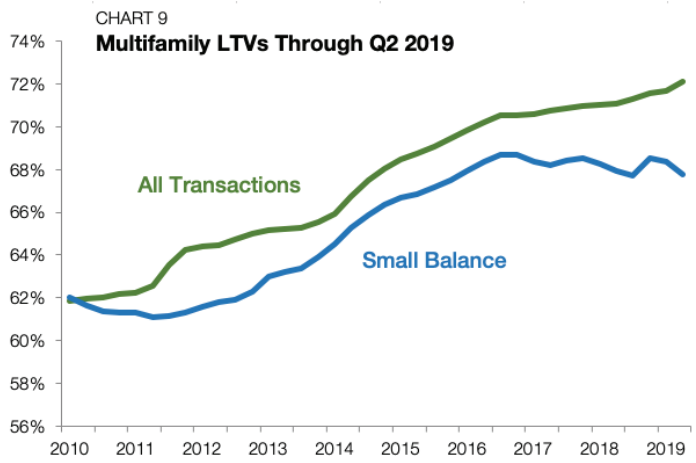

## INTEREST RATES

Chandan Economics' projections for benchmark interest rates do not point to significant upward pressure in 2019, all else being equal. After hitting pause on its plan to gradually raise interest rates, the Fed is now openly acknowledging that rate cuts are likely this year.

According to the Wall Street Journal's Economic Forecasting Survey, economists expect the 10-year Treasury yield will stabilize near 2.3% by the end of 2019, but then remain below 2.6% through 2021.

## LEVERAGE & DEBT YIELDS

Loan-to-values (LTVs) on small balance loans originated during the second quarter of 2019 averaged 67.8%, down 58 bps from the first quarter and 49 bps for the second quarter of 2018 (*Chart 9*). Across the broader multifamily market, LTVs marched up to 72.1%, according to Chandan Economics' initial estimates, the highest post-crisis reading to date. LTVs are where we see some of the biggest differences between small multifamily and the rest of the market, specifically on the lending side.




As recently as 2014, spreads between small balance and all other multifamily loans were only 141 bps. In the past few years, lenders have been more conservative with their lending criteria on smaller properties, expanding the spread to 432 bps.

Debt yields — the ratio of net operating income (NOI) to loan balance — for small balance loans fell to 8.6% in second-quarter 2019, the lowest level during this cycle. Between 2010 and mid-2016, small balance debt yields were bid

down from 11.9 % to 8.7% (*Chart 10*). Cautious underwriting then pulled small balance debt yields back up through 2017, before resuming their fall once again in 2018. For all multifamily properties, debt yields pushed further downward in the second quarter, falling to 7.2%. The spread between small multifamily and all multifamily debt yields currently sits at 139 bps, a hair below the post-crisis average of 146 bps (*Chart 11*). Debt per dollar of NOI, the inverse of debt yields, rose to fresh peaks for both small balance and all multifamily loans in second-quarter 2019 (*Chart 12)*. Small balance debt encumbrance has now increased for five consecutive quarters, as borrowers are securing an average of $11.68 in new debt for every $1 of property NOI. This is up 38 cents from a year earlier.

## OUTLOOK

For 2019's second half, the immediate path ahead is unclear, as questions of how long this cycle will continue remain. Consensus suggests that we may be approaching a market correction, though the timing of which is an open debate.

Despite the possibility of a gradual slowdown, we can expect the small balance market to hold steady, as lenders continue to maintain conservative underwriting. In the interim, favorable interest rates will elevate refinancing activity, and the sector's continued maturation and increased agency support will continue to promote liquidity. The balance of favorable structural factors and uncertain cyclical factors will dictate how the remainder of 2019's script plays out. However, even in the event of a modest pullback, the overall lending environment for small multifamily properties is projected to remain healthy. ■