Q1 2020
SMALL MULTIFAMILY
INVESTMENT TRENDS REPORT

ARBOR CHANDAN

COVID-19 UNCERTAINTY SLOWS NEW INVESTMENT YET SECTOR RETAINS RESILIENCY

STATE OF THE MARKET

Heading into 2020, the biggest question hanging over the small multifamily sector was that of local regulatory policy. While a recession appeared possible, its event probability was falling as trade tensions cooled. Consensus suggested that even if we did fall into a recession, it would be mild in both its depth and duration. Then the world met COVID-19.

KEY FINDINGS

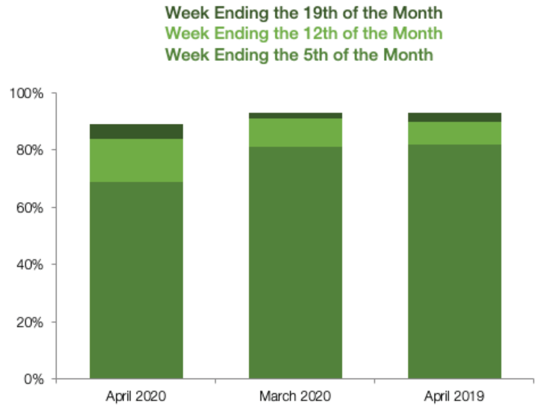
1. SMALL MULTIFAMILY PRICES FELL 0.9% FROM THE PRIOR QUARTER, PUSHING CAP RATES UP TO 5.8%
2. SMALL MULTIFAMILY ORIGINATIONS DROPPED BY AN ANNUALIZED 6.7% IN THE FIRST QUARTER OF 2020
3. CAP RATE SPREADS ABOVE TREASURYS REACHED A SIX-YEAR HIGH

Within the span of just a few short weeks, every facet of our intertangled economy has gone from peak conditions to levels of stress more extreme than those seen in the global financial crisis a decade ago. By the end of April, more than 30 million people have filed for unemployment. To put that in context, 39.5 million people filed for unemployment during the 2007-2009 recession. The worst single week of the prior recession came in late-March 2009 when 665,000 people filed initial claims. The new all-time weekly high of 6.9 million surpasses the previous record by 933% — a number that feels like it should be a typo.

When the first, and especially second-quarter GDP numbers eventually get released, they will be ugly. Still, there remains optimism that on the other side of this crisis, as social distancing gets relaxed and the economy begins to reopen, the recovery will begin relatively quickly. Most recessions are preceded by a period of slowing, then negative job growth — a noticeably absent feature this time around that gives us some clues about underlying demand. According to the Wall Street Journal Economic Forecasting Survey, 88.5% of surveyed economists believe that the U.S. will return to growth by the end of 2020.

With a record number of Americans out of work, the financial ability of households to meet their mortgage or rental payment obligations is a present and growing concern. The first meaningful indications of tenant cashflow performance were provided by the National Multifamily Housing Council, which reported that 89% of renters were able to pay their rent by April 19 (*Chart 1*). The reading only represented a relative decrease of 4% from the prior month. While these data points reflect that the multifamily sector is seeing, and will continue to experience its share of pain, incoming data are outperforming worst-case scenario forecasts. Further, households are just now beginning to access public relief funds in the form of unemployment benefits and the

CHART 1
National Multifamily Housing Council's Rent Tracker
Share of Rent Payments Made



Source: National Multifamily Housing Council's Rent Tracker

CARES Act stimulus — a factor that should provide both renters and indebted landlords a degree of breathing room.

With COVID-19 only beginning to influence markets in March, much of this report's data only reflect the partial effect of the liquidity, risk tolerance and uncertainty driven concerns currently affecting real estate markets. Small multifamily cap rates ticked up marginally, and originations have slowed. On balance, the small multifamily sector will see a period of softness. Property-level cashflows will be impaired for as long as the ability for many renters to re-enter the workforce remains physically impossible. All else equal, the sector is better positioned to weather the storm than most. Multifamily tends to be a more resilient asset during periods of uncertainty due to the simple truth that people will always need somewhere to live.

LENDING VOLUME

Annualized first-quarter 2020 estimates of new multifamily lending volume on loans with original balances between $1 million and $7.5 million[1] — including loans for rental apartment building sales and refinancing — fell to $55.2 billion. In 2019, small multifamily originations reached an all-time high of $59.2 billion, according to Chandan Economics' post-financial crisis market tracking and model estimates (*Chart 2*). The current estimate falls below last year's annual pace by $4.0 billion and would represent a 6.7% decline in lending activity (*Chart 3*).

"High levels of uncertainty" and "high transaction volumes" are two phrases that rarely reside in the same sentence.

In periods of volatility, the difference between what a real estate buyer is willing to spend on an asset, and what a seller is willing to accept, invariably grows. The net result is a lack of buying and selling activity. The uniqueness of the current crisis adds fuel to the fire, as even if a willing buyer and seller did come to an agreement on price, the ability to conduct the necessary due diligence to complete any transaction is severely limited.

Still, despite the bleak nature of current circumstances, there are reasons for reassurance. The role of the agencies (Fannie Mae and Freddie Mac) in backstopping market liquidity and acting as a countercyclical stabilizer has never appeared more critical than today. If business activity begins to return to normal in short order, it is possible that the rebound will be as robust as this contraction is severe.

CHART 2
Estimated Small Multifamily Origination Volume Through Q1 2020

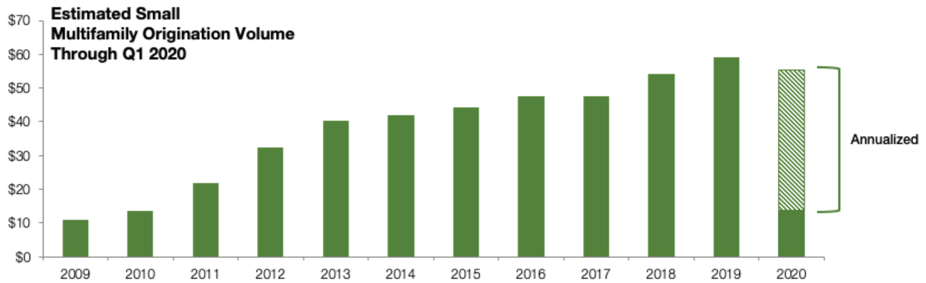
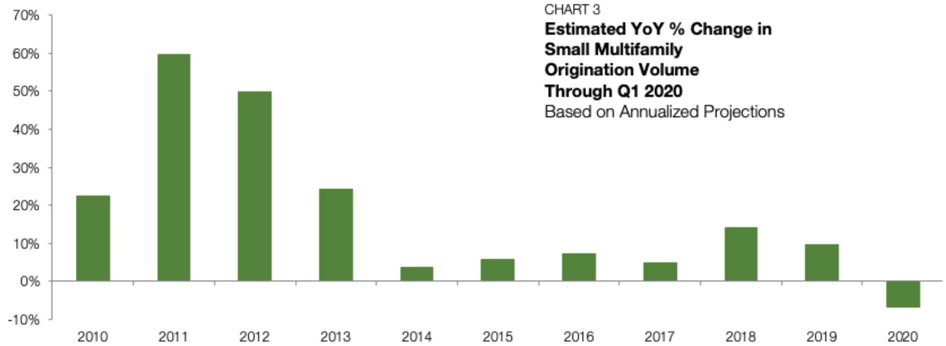


CHART 3
Estimated YoY % Change in Small Multifamily Origination Volume Through Q1 2020
Based on Annualized Projections



[1] All data, unless otherwise stated, are based on Chandan Economics' analysis of a limited pool of loans with original balances of $1 million to $7.5 million and loan-to-value ratios above 50%.

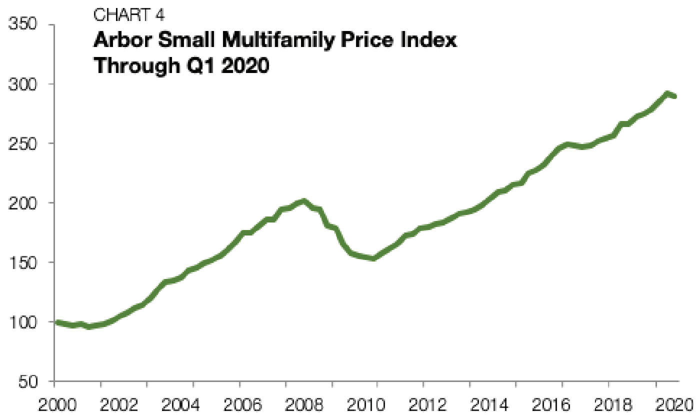
ARBOR SMALL MULTIFAMILY PRICE INDEX

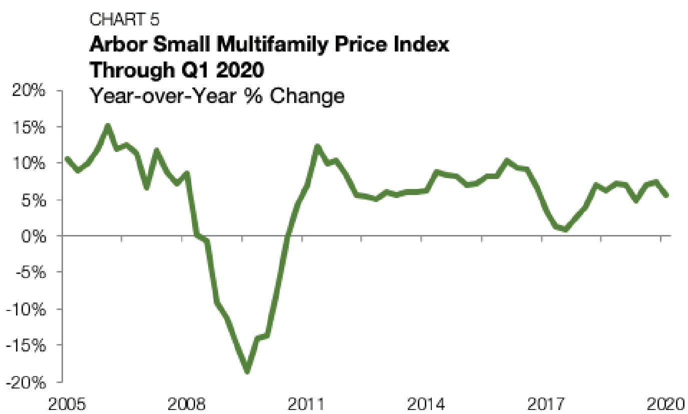
Small multifamily prices, as measured by the Arbor Small Multifamily Price Index, slowed in the first quarter of 2020 (*Chart 4*).[2] According to initial estimates, while small multifamily prices are up 5.5% from one year ago (*Chart 5*), they receded by 0.9% from the fourth quarter of 2019. On a year-over-year basis, valuations have increased for 37 consecutive quarters, dating back to mid-2010.

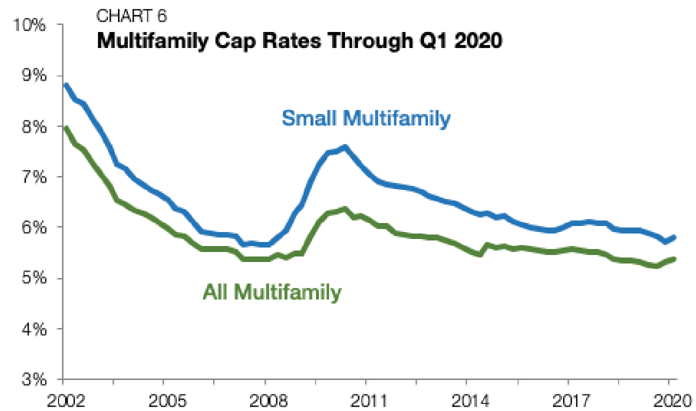
Whether valuations have merely hit a pause or there is an impending period of contraction remains to be seen. Falling benchmark interest rates and agency support should provide some positive pricing momentum and insulate asset valuations from an extended slowdown, all else equal.

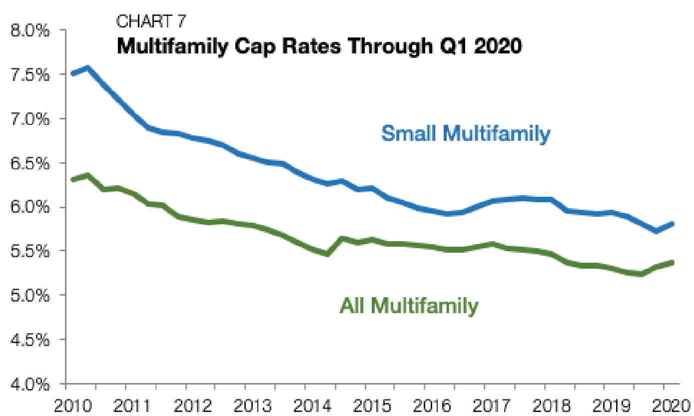
CAP RATES AND SPREADS

National average cap rates for small multifamily properties widened by 8 basis points (bps) in the first quarter of 2020, reaching 5.8% (*Chart 6*), (*Chart 7*). The most recent reading, in all likelihood, reflects a point of inflection. Through February, both real estate and the economy generally were still improving on a year-over-year basis. It wasn't until early to mid-March that COVID-19 had started to upend all aspects of normal business operations. In times of uncertainty, investors demand more yield to hold risk. As a result, cap rates may see further upward pressure in the coming months across all real property sectors. The extent to which small multifamily will see more or less pain than the broad real estate average will depend on several evolving factors — none more important than the dependability of in-place cashflows.



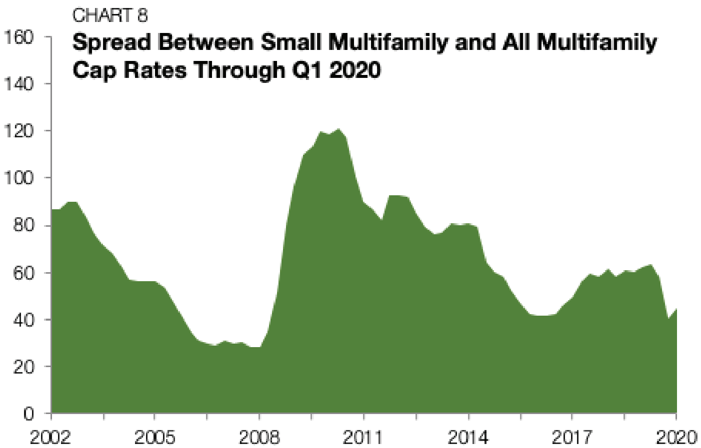






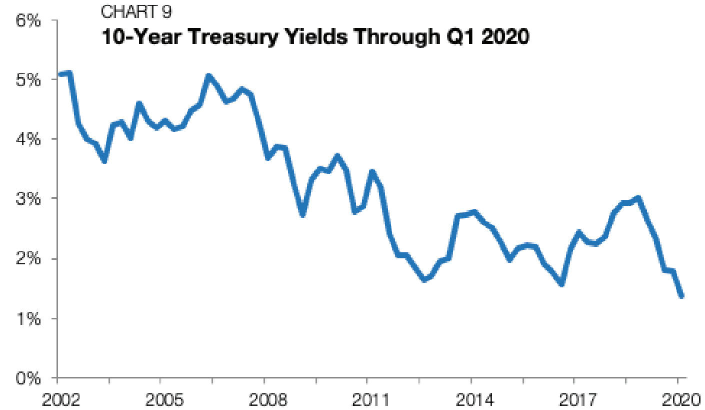
[2] The Arbor Small Multifamily Price Index (ASMPI) uses model estimates of small multifamily rents and compares them against small multifamily cap rates. The index measures the estimated average price appreciation on small multifamily properties with 5 to 50 units and primary mortgages of $1 million to $7.5 million. For the full methodology, visit arbor.com/asmpi-faq.

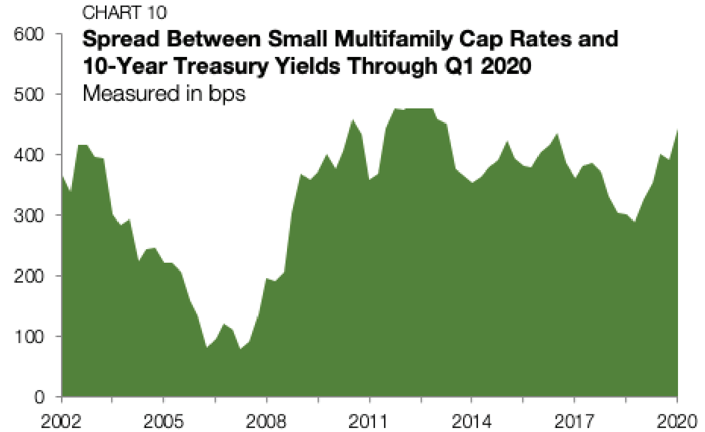
The cap rate spread between small multifamily and the rest of the sector fell to 44 bps through the first quarter of 2020 (*Chart 8*), the lowest reading since mid-2016. While small multifamily cap rates rose through the first three months of the year, they did not rise as much as the rest of the sector, causing the spread to narrow.



Through the first three months of the year, 10-year Treasury yields averaged 1.37% — the lowest quarterly reading on record, though it hardly begins to tell the full story. Between mid-February and mid-March, 10-year Treasury yields fell to depths previously unseen. On March 9, Treasurys fell to their new all-time low watermark of 0.54% (*Chart 9*). Naturally, these yield movements are a direct result of the pandemic.

As the state of the world has become less certain and market risks are more difficult to gauge, investors prefer "safe-haven" assets to preserve wealth and ride out the storm. This process has resulted in a considerable widening of spreads between small multifamily cap rates and Treasurys. Through the first quarter, the spread stood at 443 bps, the highest level since mid-2013 (*Chart 10*).

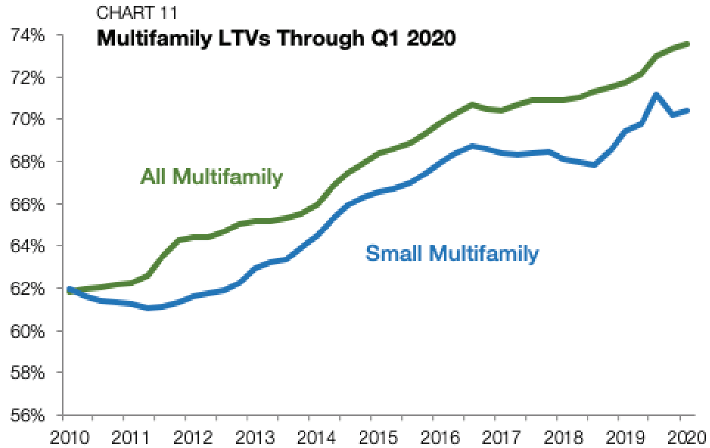




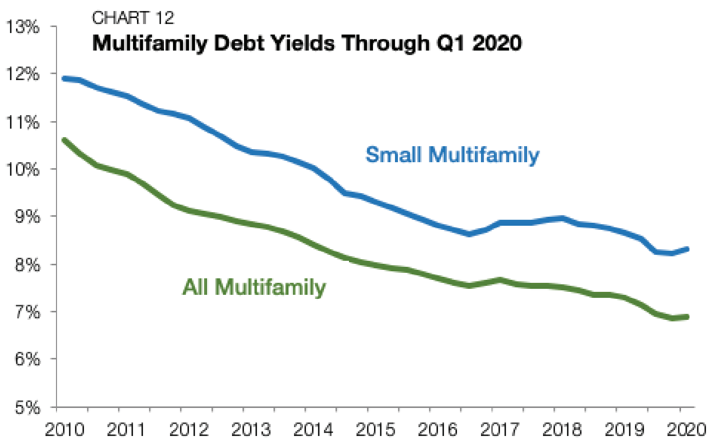
LEVERAGE AND DEBT YIELDS

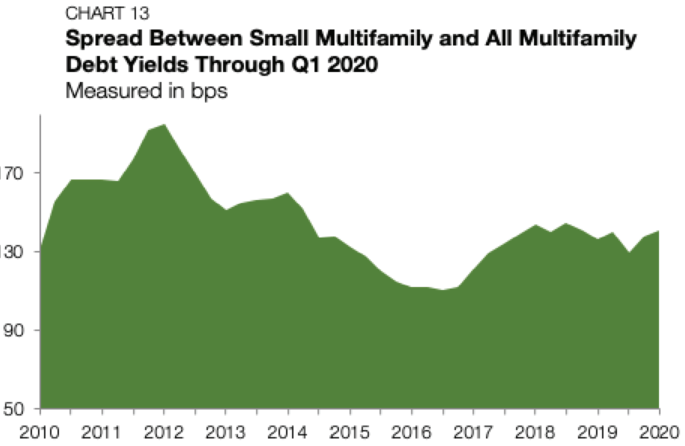
Loan-to-value ratios (LTVs) averaged 70.4% on small multifamily loans originated during the first quarter of 2020, up 23 bps from the fourth quarter of 2019 and up 96 bps from a year ago (*Chart 11*). Across the broader multifamily market, LTVs marched up to 73.6%, the highest post-crisis reading to date, according to Chandan Economics' initial estimates.

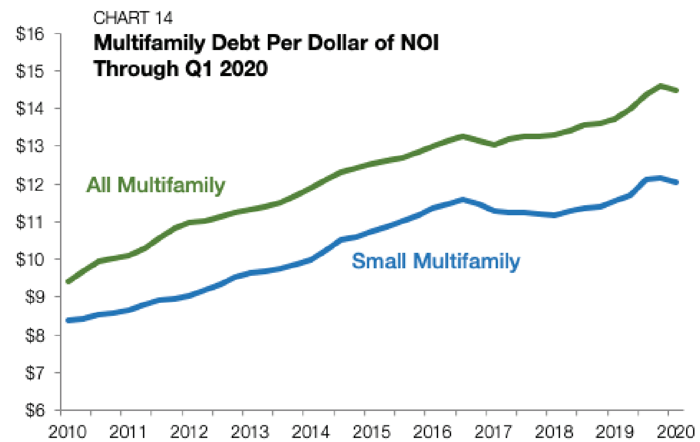
The LTV spread between small multifamily and all multifamily currently stands at 313 bps, the highest reading in six quarters.



Debt yields — the ratio of net operating income (NOI) and loan balance — for small multifamily loans ticked up to 8.3% in the first quarter of 2020, up from a cyclical low of 8.2% observed in the fourth quarter of 2019 (*Chart 12*). For all multifamily properties, debt yields held steady through the beginning of the year at 6.9%. The spread between small multifamily and all multifamily debt yields has moderated since the middle of 2017 and currently sits at 141 bps (*Chart 13*). Debt per dollar of NOI, the inverse of debt yields, fell for both small multifamily and all multifamily loans in the first quarter. Borrowers are securing an average of $12.03 in new debt for every dollar of property NOI, down 13 cents from the prior quarter (*Chart 14*).







OUTLOOK

Both the human and economic hardships of this moment in history cannot be overstated. The path forward is far from clear, though reasonable expectations of a slow return to everyday life are starting to firm. After individuals can complete routine trips to grocery stores without serious concerns about their health, we can expect that local, state and federal leaders to turn greater attention to the country's economic revival. A "V-shaped" recovery, or one with a rapid rebound, lies on the spectrum somewhere between optimistic and realistic. However, the longer the wheels of economic activity remain stationary, the longer it will take them to get rolling again. In the months ahead, the small multifamily sector's resilience should come into greater focus as more performance data becomes available. As the country gets back to work, end of the month rent bills should become less of an anxiety-inducing topic, and multifamily should be one of the first areas of real estate to see cashflows return close to normal. Sectors such as lodging and retail, which depend on discretionary spending and a willingness to congregate in areas of density, will not be as fortunate. Between the lessons learned during the last global financial crisis, the dependability of underlying demand, and the presence of the agencies backstopping liquidity, we can credibly expect that the multifamily sector will outperform most other property types as it navigates the uncertainty ahead. ■
