ARBOR

# Q3 2021

# Small Multifamily Investment Trends Report

**Topics**

- State of the Market
- Lending Volume
- Arbor Small Multifamily Price Index
- Cap Rates & Spreads
- Leverage & Debt Yields
- Outlook

# Reliability of Small Multifamily Tenant Base Fuels Recovery

## Key Findings

- An analysis of work from home trends finds that small multifamily properties may be less affected than larger properties because fewer tenants can work remotely.
- Small multifamily cap rates held at 5.2% in the third quarter, effectively unchanged from last quarter
- The refinancing share of originations rose as investors locked in rates ahead of potential monetary tightening and an expected rate rise
- Asset prices rose 2.9% from a year earlier and 7.7% over pre-pandemic highs

# State of the Market

Compared to one year ago, macroeconomic conditions are in a markedly better place. However, the recovery has not been without its fair share of challenges.

The total size of the U.S. economy eclipsed its 2019 peak in the second quarter of 2021, reaching $19.4 trillion (measured in inflation-adjusted, 2012 dollars). According to the Bureau of Economic Analysis' preliminary estimate, the U.S. economy grew at seasonally adjusted annual rate of 2.0% in the third quarter of 2021 — well below the 6.7% rate observed in the prior quarter. Looking ahead, the Congressional Budget Office forecasts the U.S. economy will expand by a healthy 5.0% in 2022, before settling back into the long-term trend of sub-2% growth.

Supply chain disruptions, labor shortages and rising inflation top the list of concerns keeping policymakers and business leaders up at night. According to the Bureau of Labor Statistics (BLS) Consumer Price Index, prices of goods and services are up an average of 5.4% from one year ago through September — the highest mark in more than a decade.

The multifamily sector is already demonstrating why it is often considered an ideal hedge against inflation headwinds. Unlike most other commercial leases that tend to have multi-year terms, most rental housing units' leases are one-year long, allowing landlords and property managers to absorb inflationary pressures by adjusting rents. According to RealPage, through August 2021, effective asking rents were up 10.3% from a year earlier.

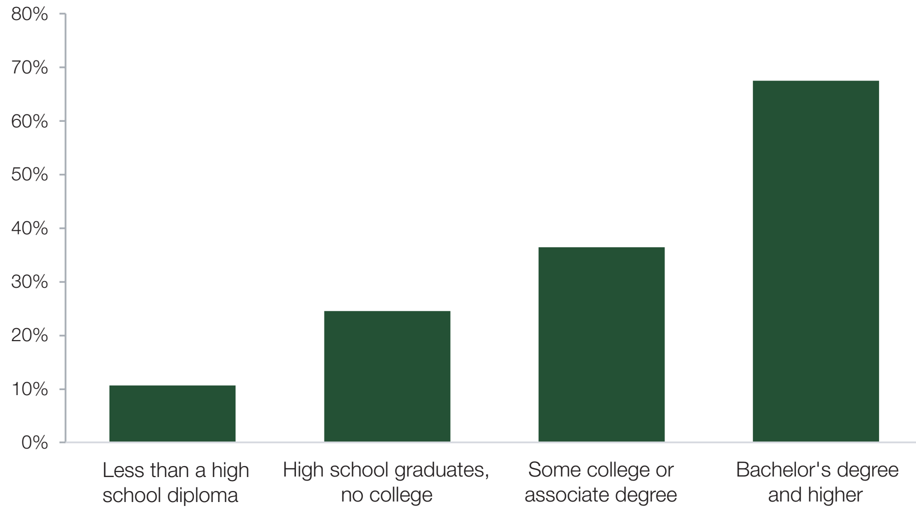
A longer-term uncertainty for the multifamily sector is how work from home (WFH) adoption will impact rental demand. The luxury of living close to work and having a shorter daily commute is an amenity that has historically commanded higher rents. The ability to work remotely allows workers to expand the number of markets and neighborhoods they consider when choosing where to live. As a result, remote-work tenants are less tied to one specific location and are less likely to pay a close-to-work rent premium.

CHART 1

**Percent Share of Workers Who Have the Ability to Telework**

Measured by Educational Attainment, Analysis Published June 2020

Source: U.S. Bureau of Labor Statistics' American Time Use Survey




Understanding where there are high concentrations of workers who are capable of transitioning into remote work may offer some clues about where rental demand may fall and where it is most likely to hold up. According to a recent BLS study, the ability to telework is most common among workers with a bachelor's degree or higher *(Chart 1)*. According to a Chandan Economics analysis of the U.S. Census Bureau's latest American Community Survey, 71.8% of householders in small multifamily properties (under 50 units) hold less than a bachelor's degree, well above the 58.7% observed in large multifamily properties (50 or more units).

Taking these above trends together suggests that small multifamily properties may be less affected by an impact from WFH because a smaller portion of these tenants can work remotely. They are therefore more likely to be locationally tied to their place of work.

As the report details, small multifamily assets continue to retain the stability that has become a defining hallmark for the sector. Small multifamily asset pricing continues to set new highs, and annual origination volume is on pace to do the same through the end of 2021. Cap rates have settled near record lows, and risk premiums are in line with their pre-pandemic levels. The small asset multifamily sector benefits from a unique set of stabilizing tailwinds as market demand for affordable, market-rate units remains robust and sector-level liquidity continues to be abundant.

# Lending Volume

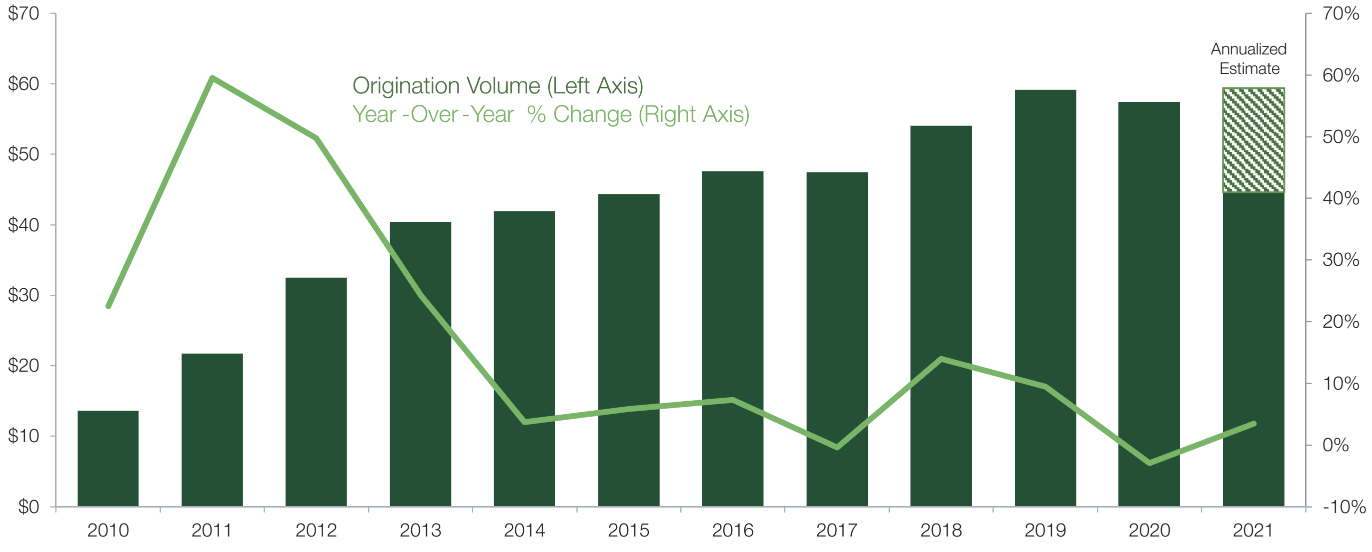
Annualized 2021 estimates of new multifamily lending volume on loans with original balances between $1 million and $7.5 million[1] — including loans for apartment building sales and refinancing — are on pace to finish the year at $59.4 billion *(Chart 2)*. The current estimate would represent a modest annual increase of about $2.0 billion from last year's total, or a 3.4% growth rate. According to Chandan Economics, small multifamily originations reached an all-time high of $59.2 billion in 2019. If current annualized estimates hold up through the fourth quarter of this year,

CHART 2

**Estimated Small Multifamily Origination Volume**

In Billions $, Through Q3 2021

Source: Chandan Economics




[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%.

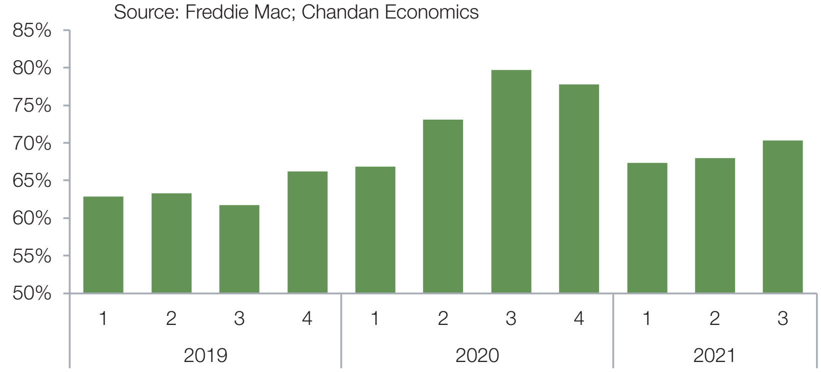
2021 will narrowly eclipse the 2019 high watermark by 40 basis points (bps).

CHART 3

**Refinancing Share of Small Multifamily Lending**

Through Q3 2021

Source: Freddie Mac; Chandan Economics




Refinancing activity has fallen considerably from its 2020 peak, though it remains elevated compared to pre-pandemic conditions. The refinancing share of multifamily lending ticked up to 70.3% in the third quarter of 2021, rising from 67.3% and 68.0% in the first and second quarters of this year, respectively *(Chart 3)*. Still, the third-quarter reading sits well below the 79.7% peak observed in the third quarter of 2020.

The refinancing share of originations rose as investors locked in rates ahead of potential monetary tightening and an expected rate rise. The Federal Open Market Committee's median forecast for 2022's year-end federal funds rate jumped from 0.1% at the June meeting to 0.3% in September. Multifamily asset owners with higher debt servicing costs than prevailing market interest rates are likely recognizing the closing window for locking in lower rates, leading to a rush in refinancing demand.

# Arbor Small Multifamily Price Index

As measured by the Arbor Small Multifamily Price Index[2], small multifamily asset valuations continued to improve in the third quarter of 2021, notching solid quarterly and annual gains of 2.3% and 2.9%, respectively *(Chart 4 and Chart 5)*.

Compared to the crisis-low point reached in the second quarter of 2020, asset valuations are up by a healthy 12.2%. Moreover, valuations are up by 7.7% over where they were at the onset of the pandemic.

CHART 4

**Arbor Small Multifamily Price Index**

Q1 2000 = 100, Through Q3 2021

Source: Arbor Realty Trust; Chandan Economics

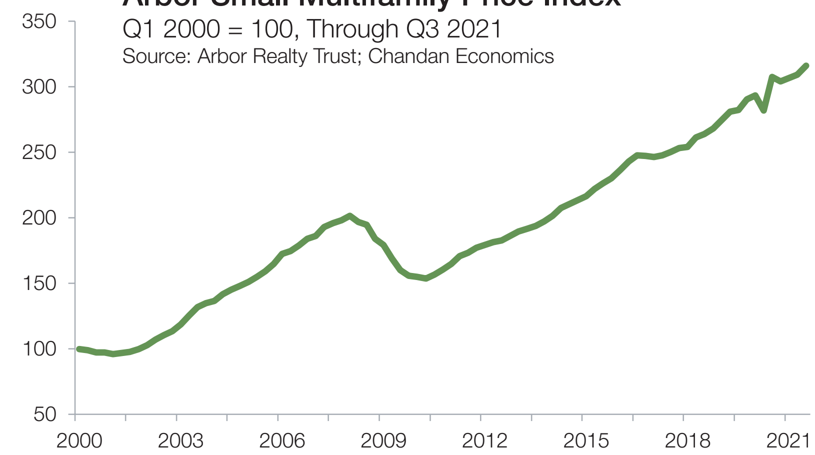
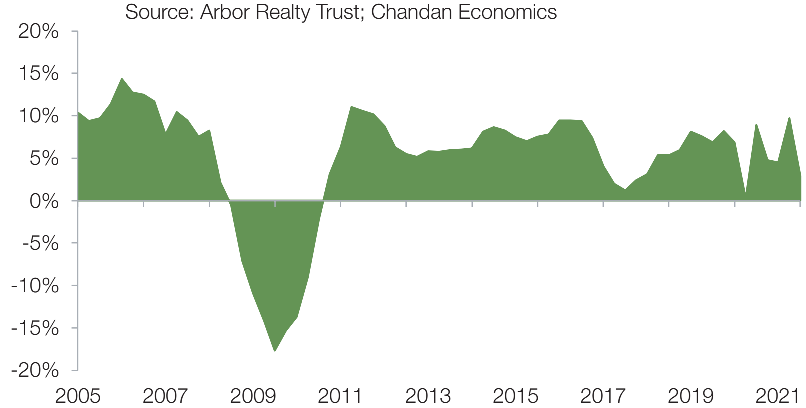



CHART 5

**Arbor Small Multifamily Price Index**

Year-Over-Year % Change, Through Q3 2021

Source: Arbor Realty Trust; Chandan Economics

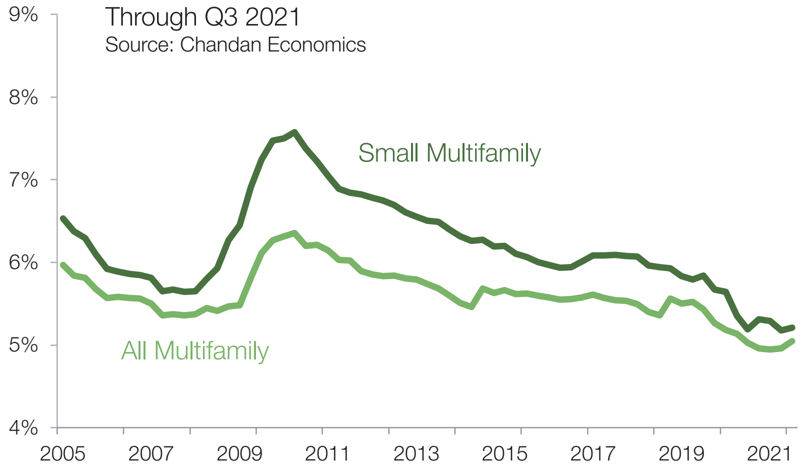



[2] The Arbor Small Multifamily Price Index (ASMPI) uses model estimates of small multifamily rents and compares them against small multifamily cap rates. The index measures the estimated average price appreciation on small multifamily properties with 5 to 50 units and primary mortgages of $1 million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

# Cap Rates & Spreads

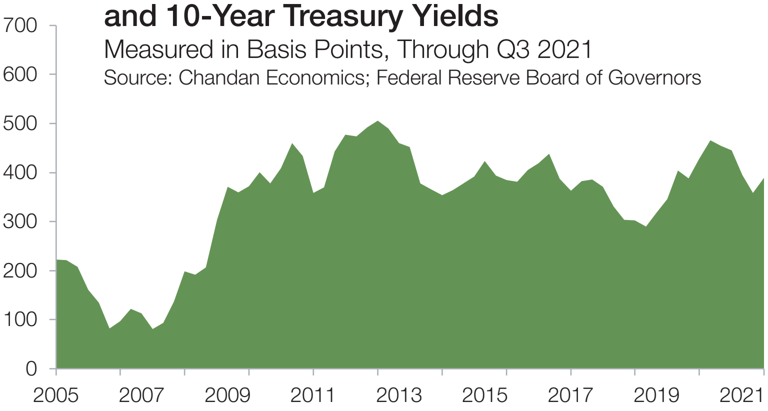
National average cap rates for small multifamily properties were effectively flat in the third quarter of 2021, remaining at 5.2% *(Chart 6)*. Small multifamily cap rates compressed considerably during the post-Great Recession expansion, declining from a cyclical high of 7.6% in 2010 to their current range near 5.2%. Since the second quarter of 2020, small multifamily cap rates have sat in a narrow range between 5.2% and 5.4%.

CHART 6
**Small Multifamily Cap Rates**
Through Q3 2021
Source: Chandan Economics




The small multifamily risk premium, a measure of additional compensation investors require to account for higher levels of risk, is best measured by comparing cap rates to 10-year Treasury yields. The small multifamily risk premium averaged 389 bps in the third quarter of 2021, up from 359 bps the previous quarter, as Treasury yields dipped by 27 bps and cap rates increased by a marginal 3 bps *(Chart 7)*.

CHART 7
**Spread Between Small Multifamily Cap Rates and 10-Year Treasury Yields**
Measured in Basis Points, Through Q3 2021
Source: Chandan Economics; Federal Reserve Board of Governors



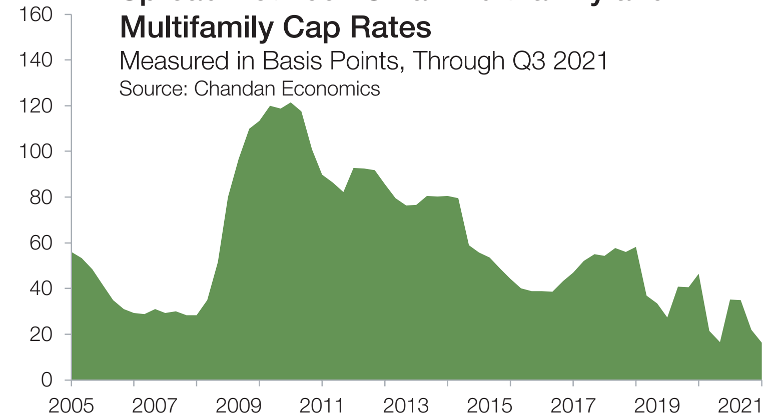
After reaching as high as 466 bps in the second quarter of 2020, risk premiums slid for four consecutive quarters, reflecting a normalization of risk pricing.

CHART 8

**Spread Between Small Multifamily and All Multifamily Cap Rates**

Measured in Basis Points, Through Q3 2021

Source: Chandan Economics




The cap rate spread between small multifamily assets and the rest of the multifamily sector, a measure of the risk of smaller properties, declined to 16 bps in the third quarter of 2021 *(Chart 8)*. The "small" versus "all" multifamily cap rate spread hit an all-time high of 121 bps in 2010, and the current reading represents a new all-time low.

Over time, the yield structure of small assets has come to look more like the rest of the sector as liquidity has improved and technological adoptions have added operational efficiencies. Further, the renter-by-necessity profile of small multifamily renters will likely be perceived as a more reliable source of demand as the impact of WFH adoption and suburban flight are absorbed into the multifamily sector.

# Leverage & Debt Yields

Loan-to-value ratios (LTVs) on newly originated small multifamily loans fell sharply during the pandemic, from a high of 70.9% at the end of 2019 to a low of 66.4% at the end of 2020 *(Chart 9)*. In 2021, with the small multifamily sector already in recovery mode, credit risk measures have been slow to return to their pre-pandemic conditions. Through the third quarter of 2021, small multifamily LTVs averaged 66.5%, marking the second straight quarter of declines and returning the metric to just 9 bps over its 2020 low.

Debt yields for small multifamily loans rose by 17 bps to 8.0% in the third quarter of 2021, undoing some of the post-shutdown reversion seen over the previous two quarters *(Chart 10)*.

CHART 9
**Small Multifamily LTVs**
Through Q3 2021
Source: Chandan Economics

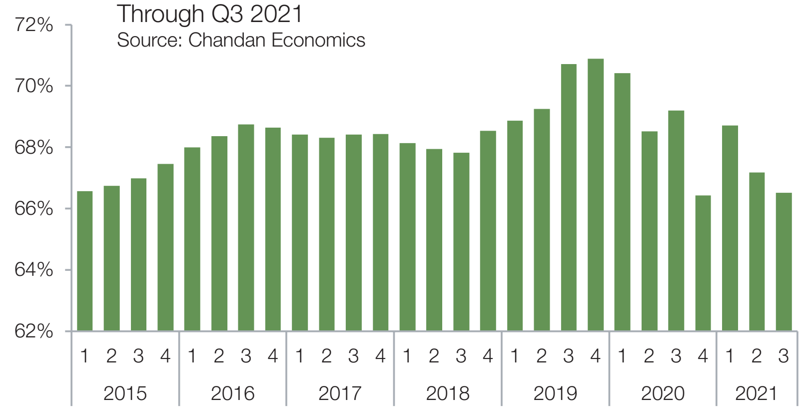
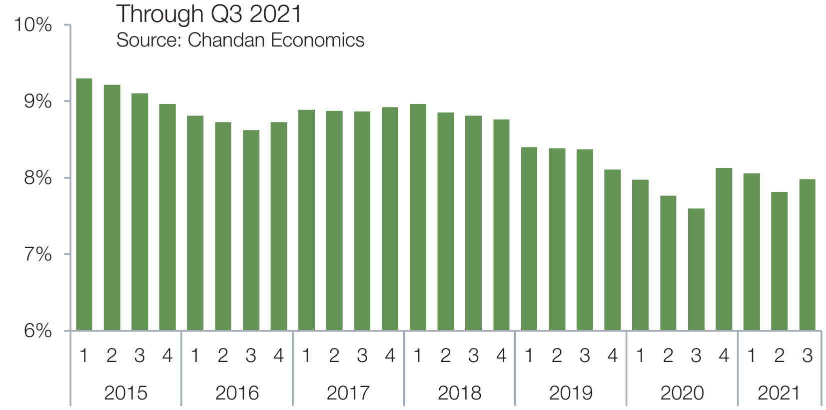



CHART 10
**Small Multifamily Debt Yields**
Through Q3 2021
Source: Chandan Economics



Debt per dollar of NOI, the inverse of debt yields, fell for small multifamily loans in the third quarter. Small multifamily borrowers were securing an average of $12.52 in new debt for every $1 of property NOI, down 28 cents from the previous quarter.

The entrenchment of lower LTVs and higher debt, in part, reflects tighter underwriting standards as lenders sought to reduce relative risk within their portfolios. However, as lenders become increasingly convinced of the small multifamily sector's return to health, underwriting standards are likely to see some easing.

The latest Federal Reserve Senior Loan Officer Opinion Survey (SLOOS) signals that an easing of underwriting standards may already be underway. Surveyed in the second quarter of 2021, a net 18.1% of senior loan officers reported easing underwriting standards for multifamily lending — a major shift from the same period one year earlier when a net 64.3% reported a tightening of underwriting standards. If underwriting standards continue to ease, it is likely that LTVs would rise and debt yields would fall from their current levels.

# Outlook

Heading into the third quarter, the major uncertainty for the small multifamily sector was the timing of the national eviction moratorium's conclusion and how its end would impact evictions. While the national eviction moratorium has since been lifted, many statewide moratoria are still in place. As a result, long-term developments remain to be seen.

The look ahead is one of gradual progress for the small multifamily sector. Most indicators for the sector are in recovery or fully recovered. WFH adoption and increased demand for suburban housing options may prove to have a marginal impact on multifamily demand. However, small multifamily properties, which cater to moderate-income households who are more likely to rent by necessity, are well-insulated from downside pressures.

On the horizon, there could be more upward pressure on cap rates than there has been over the past decade. Higher levels of inflation are passing through to higher rents, boosting property-level incomes. Additionally, the Federal Reserve is signaling that it will begin a monetary policy tightening cycle over the next year — a development that should push up benchmark interest rates. If benchmark interest rates do rise, small multifamily buyers are likely to respond by increasing their required acquisition cap rate. At the same time, agency support and a high degree of market liquidity may limit the amount of observed upward pressure on yields. All else equal, small multifamily continues to boast solid operating fundamentals, a deep pool of liquidity and a reliable tenant base that signal a generally positive outlook for the market.

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