



Small Multifamily Investment Trends Report

Q1 2024

Topics

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



Cap Rates and Debt Yields Edge Up as Expense Ratios Normalize

Key Findings

- Small multifamily valuations fell 12.2% year-over-year.
- Cap rates ticked up again, rising slightly to reach 5.8% in the fourth quarter.
- Debt yields increased for the sixth consecutive quarter, reaching a nine-year high of 9.3%.





State of the Market

The first quarter opens a new chapter for small multifamily real estate after a year where this subsector demonstrated its strength and resiliency amid stiff economic headwinds. With expense ratios normalizing and occupancy rates at healthy levels, the subsector is well-positioned to capitalize on positive momentum in the financial markets in 2024.

Despite elevated interest rates, multifamily had a strong fourth quarter. According to [Trepp](#), the delinquency rate of multifamily loans in commercial mortgage-backed securities (CMBS) transactions stood at 2.6% through December — the best mark of any commercial property type other than industrial.

However, the economic environment continues to face challenges. Lending standards for small multifamily properties remain tight, and while cap rates ticked up in the fourth quarter, the combination of market conditions and historical precedent suggests they may still rise further.

Looking ahead, [financial markets](#) expect that the Federal Reserve will begin loosening its monetary tightening policy by its May 2024 meeting. When it begins lowering interest rates, the normalization of multifamily sector conditions will likely follow closely behind.

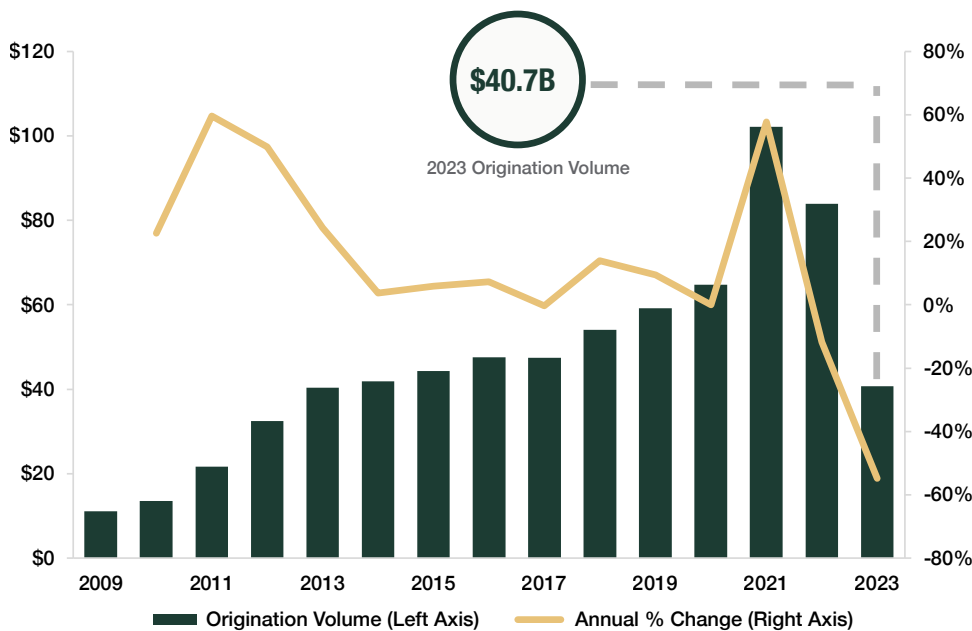


Lending Volume

The \$90.1 billion year-end 2022 estimate of new multifamily lending volume on loans with original balances between \$1 million and \$9 million¹ — including loans for apartment building sales and refinancing — represented a modest deceleration from 2021’s record

high of \$102.1 billion (Chart 1). Last year, however, the small multifamily originations market fully reset. The 2023 estimate was \$40.7 billion, marking the slowest year for new originations since 2012.

CHART 1
Estimated Small Multifamily Origination Volume
 In Billions \$, Through Q4 2023
 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 \$9.0 million and loan-to-value ratios above 50%.



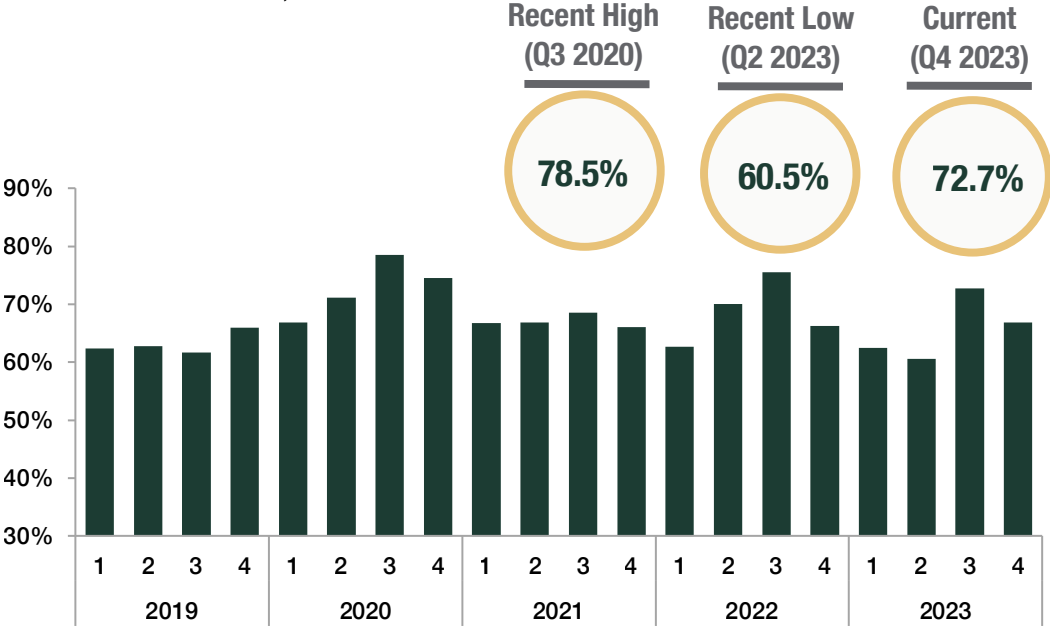
The major factor contributing to declining origination volumes last year was sustained high interest rates, which impacted the market in two ways. First, it widened the bid-ask spread — the difference between what a buyer is willing to pay and what a seller is willing to accept. With costs of capital rising, potential buyers are requiring larger discounts. At the same time, a lack of multifamily sector distress has meant that few owners are motivated to sell if they do not receive an offer close to their perception of fair value. As a result, there was a sharp decline in apartment sales in 2023.

High interest rates also reduce the incentive for investors to pursue cash-out refinancing. When interest rates are favorable, borrowers often use accrued equity in their properties to finance subsequent acquisitions. However, in today’s higher-rate environment, a cash-out refinancing would likely result in a voluntary increase in debt servicing costs. After reaching a high of 75.6% in the third quarter of 2022, the refinancing share of originations fell for three consecutive quarters, reaching a low of 60.5% in the second quarter of 2023 (Chart 2).

Subsequently, the refinancing share of originations has started to normalize, averaging 72.7% and 66.8% in the third and fourth quarters of 2023, respectively — potentially signaling that borrowers are no longer willing to wait for a rapid return to accommodative interest rates.

CHART 2
Refinancing Share of Small Multifamily Lending
Through Q4 2023

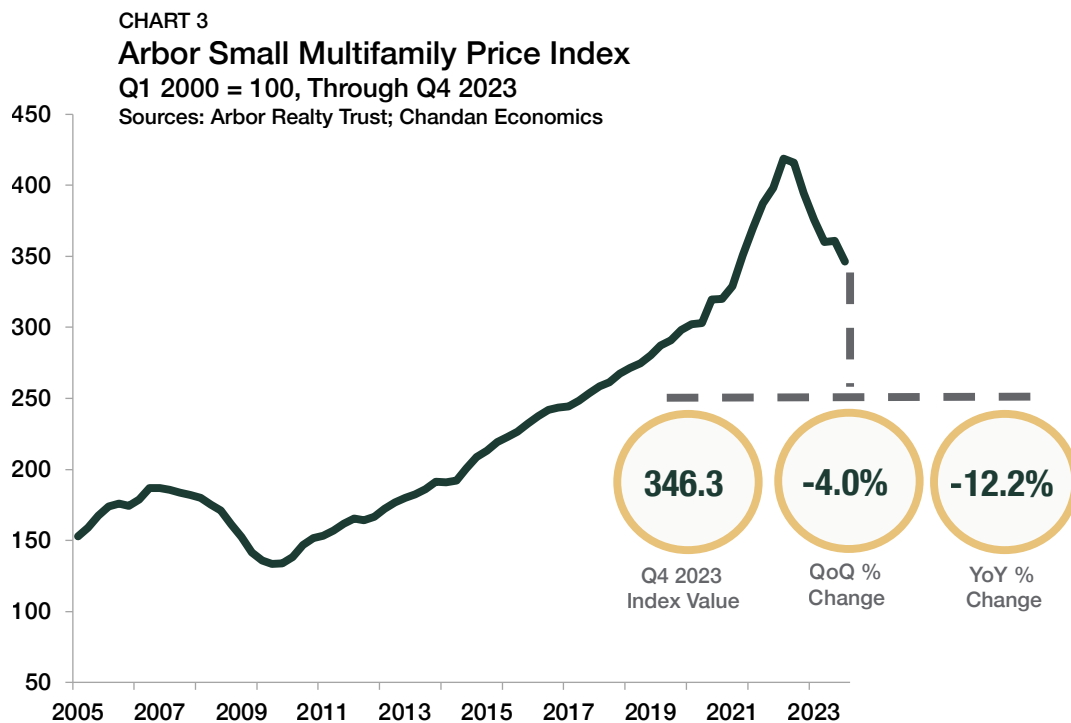
Sources: Freddie Mac; Chandan Economics



Arbor Small Multifamily Price Index

As measured by the Arbor Small Multifamily Price Index², through the fourth quarter of 2023, small multifamily asset valuations were down 12.2% from a

year earlier (*Chart 3*). Meanwhile, quarter-over-quarter, prices fell by 4.0% in the final three-month period of the year.



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 \$9 million. For the full methodology, visit arbor.com/asmpi-faq.



Valuation declines in the small multifamily sector occurred as cap rates edged higher and property-level incomes remained effectively flat last year, according to [Yardi Matrix](#).

Freddie Mac noted in its [2024 Multifamily Outlook](#) that the “stabilization of the interest rates, all else equal, should help buyers and sellers find the middle ground to get transactions done.” However, the report also cites slower-than-usual rent growth and sustained high interest rates as factors that could continue suppressing valuations in 2024.

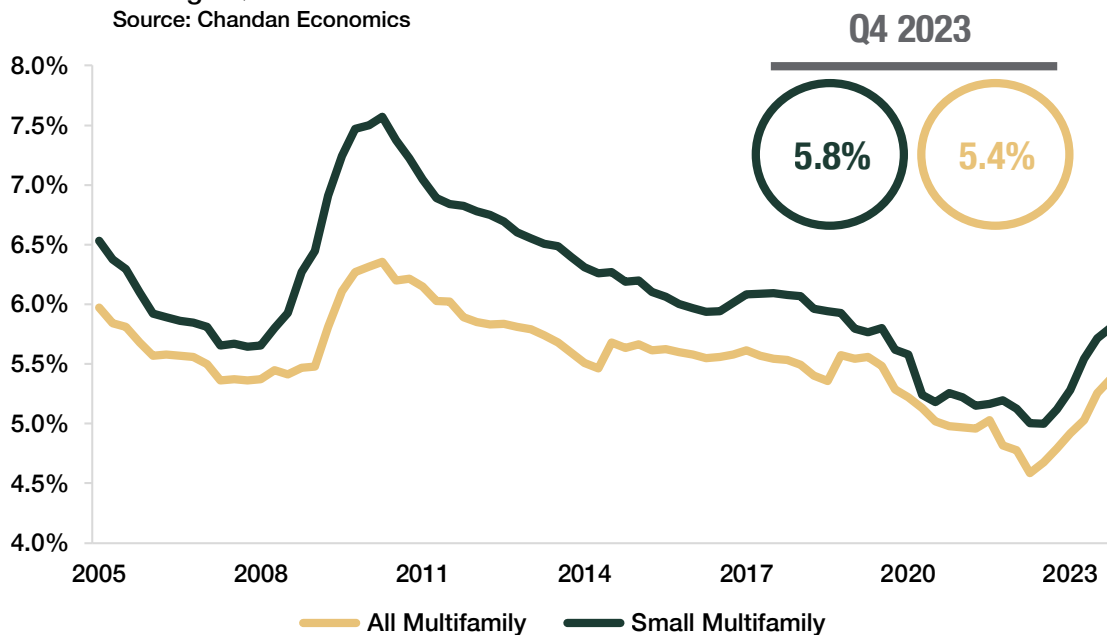


Cap Rates & Spreads

Although 10-year Treasury yields started sinking in December 2023, they averaged a lofty 4.5% over the course of the fourth quarter, a 16-year high. As the so-called “risk-free” rate of return has risen, so too have market yields, including cap rates for small multifamily properties. In the fourth

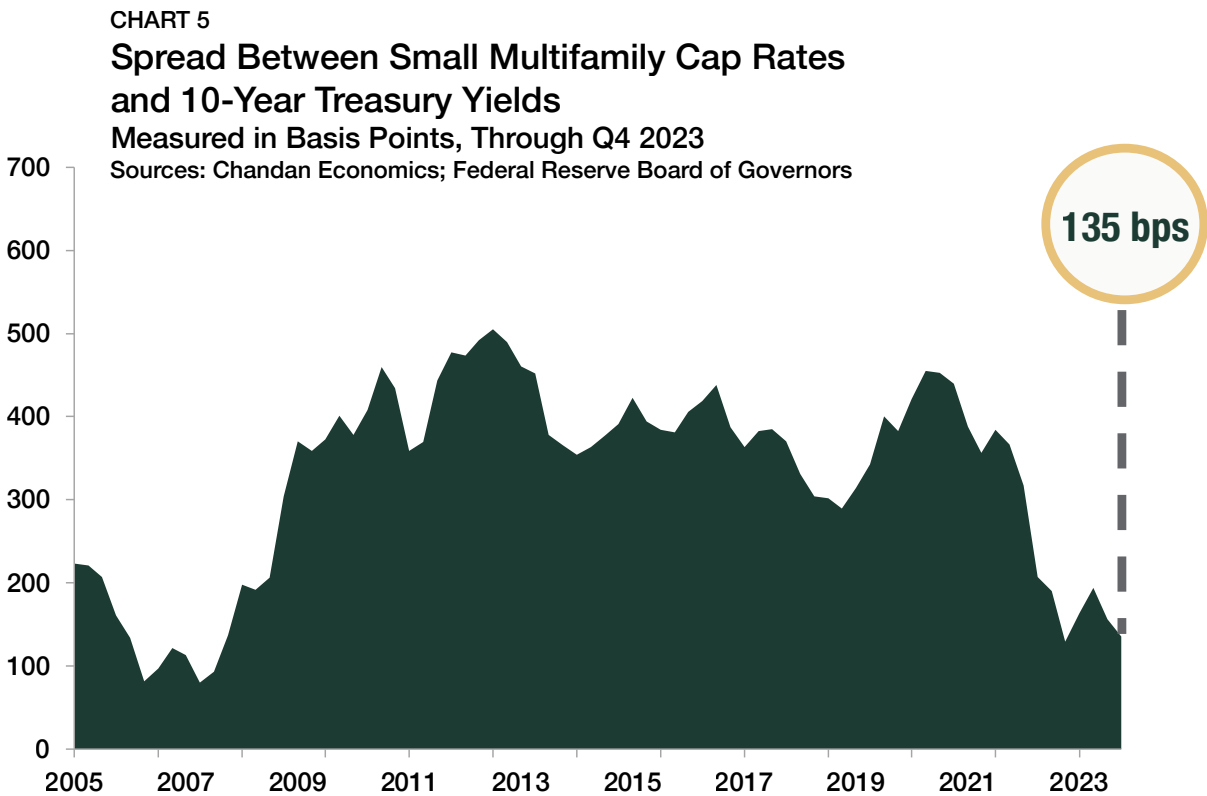
quarter of 2023, small multifamily cap rates averaged 5.8%, reaching their highest point since mid-2019 (Chart 4); after falling to an all-time low of 5.0% in the third quarter of 2022, they subsequently rose in five consecutive quarters.

CHART 4
Small Multifamily Cap Rates
Through Q4 2023
Source: Chandan Economics



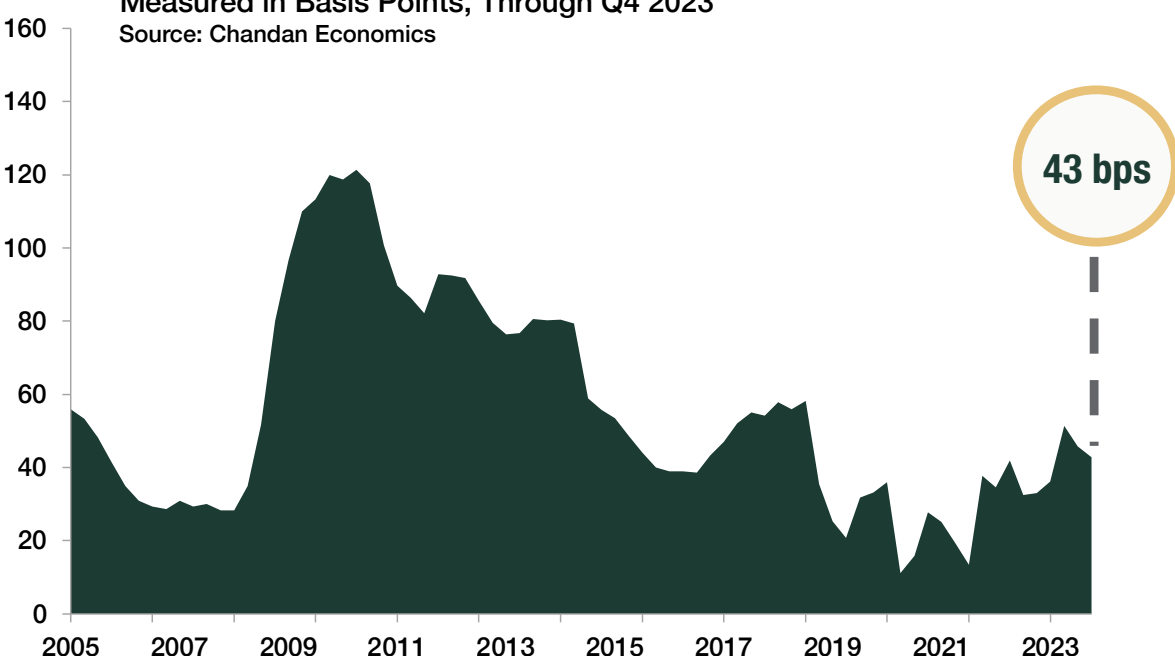
For the most recent reading, small multifamily cap rates jumped nine bps between the third and fourth quarters of 2023. Moreover, small multifamily cap rates are 68 bps higher than they were at this time last year.

The small multifamily risk premium, best measured by comparing cap rates to the yield on the 10-year Treasury, approximates the additional compensation that investors require to account for higher levels of risk. This risk premium compressed 21 bps in the fourth quarter of 2023 to land at 135 bps (*Chart 5*). While cap rates have risen, the ascent has not matched the pace of increase of Treasury yields, leading to the risk premium compression.



For 2024, a rising risk premium from current levels is a reasonable baseline outlook. Since 2000, the small multifamily risk premium has fallen below 135 bps in only eight of 96 quarters. Further, between 2016 and 2021, the small multifamily risk premium averaged 378 bps while never dropping below 290 bps or rising above 455 bps. Meanwhile, the cap rate spread between small multifamily assets and the rest of the multifamily sector, a measure of the risk unique to smaller properties, fell just three bps during the quarter to finish at 43 bps (Chart 6).

CHART 6
Spread Between Small Multifamily and All Multifamily Cap Rates
Measured in Basis Points, Through Q4 2023
Source: Chandan Economics

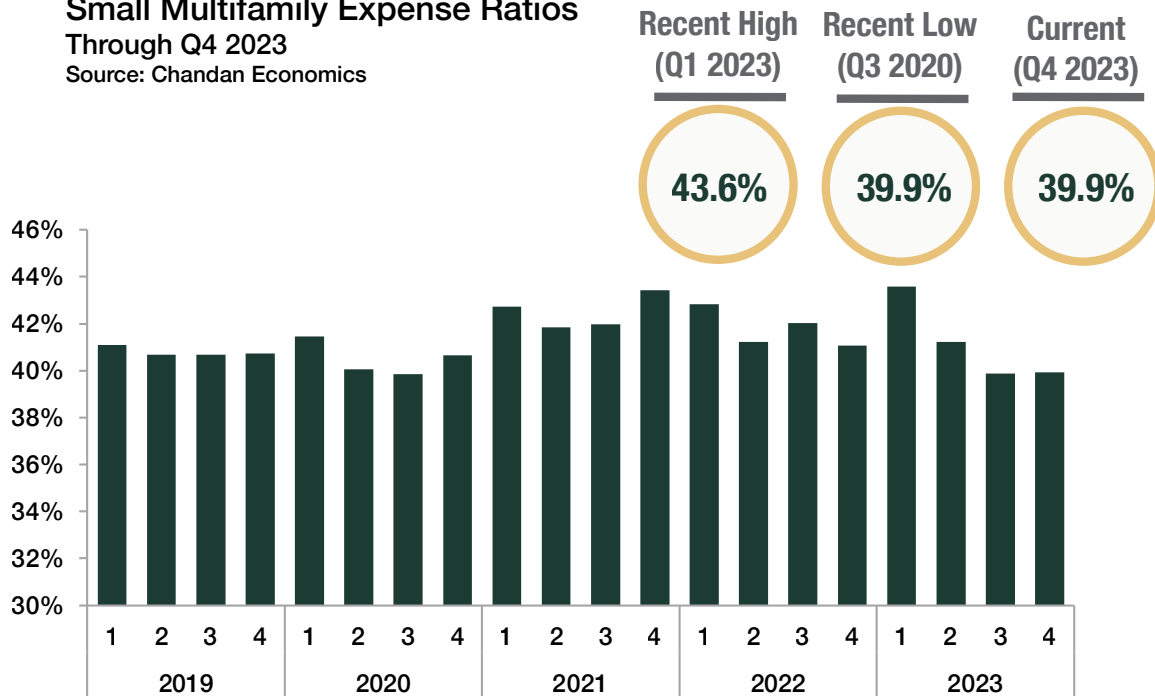


Expense Ratios

Expense ratios, measured as the relationship between underwritten property-level expenses and effective gross income, have stabilized in recent quarters. Expense ratios hit a peak in the first quarter of 2023 (43.6%), driven by increases in vacancies

and operating expenses (*Chart 7*). However, improvement has come quickly as expense ratios fell in both the second and third quarters, settling down at 39.9%. During the fourth quarter of 2023, expense ratios held flat, remaining at 39.9%.

CHART 7
Small Multifamily Expense Ratios Through Q4 2023
 Source: Chandan Economics



Occupancy Rates

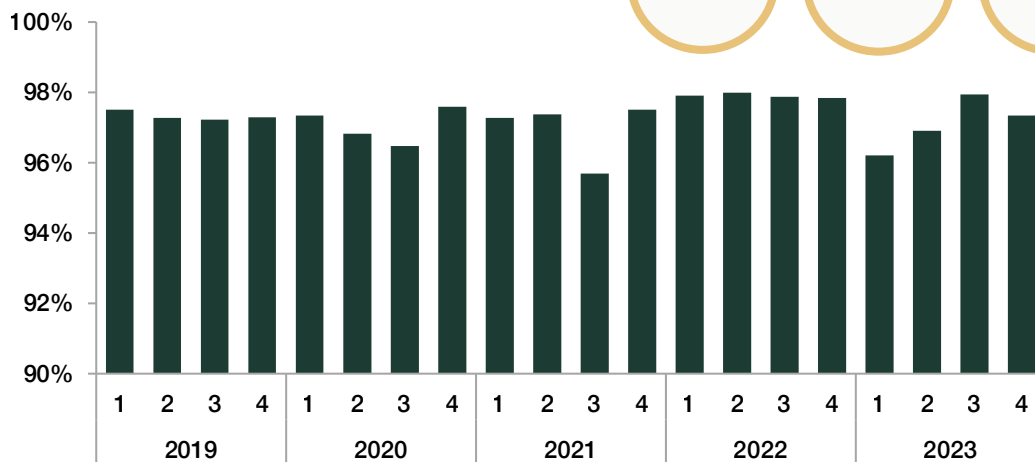
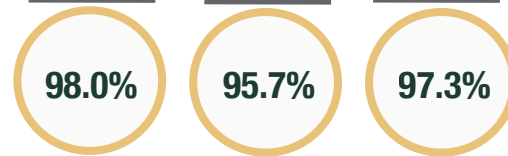
Occupancy rates within small multifamily properties receiving financing in the fourth quarter averaged a healthy 97.3% (Chart 8). While average occupancy rates declined 60 bps quarter-over-quarter, they remained up by 113 bps from the first quarter of the year. Further, the fourth-quarter average is directly in line with the five-year average for the sector.

CHART 8
Small Multifamily Occupancy Rates
 Through Q4 2023
 Source: Chandan Economics

Recent High
 (Q2 2022)

Recent Low
 (Q3 2021)

Current
 (Q4 2023)



Leverage & Debt Yields

Debt underwriting standards remained tight through the fourth quarter of 2023. Loan-to-value (LTVs) ratios slid by 89 bps between the third and fourth quarters, settling at 59.7% (Chart 9). Small multifamily LTVs have sat in a narrow range between 58.4% and 60.2% since the middle of 2022. Further, there has been no momentum to push LTVs back above the 67% levels seen before the Federal Reserve began raising interest rates in early 2022.

CHART 9
Small Multifamily LTVs
 Through Q4 2023
 Source: Chandan Economics

Recent High
 (Q4 2019)

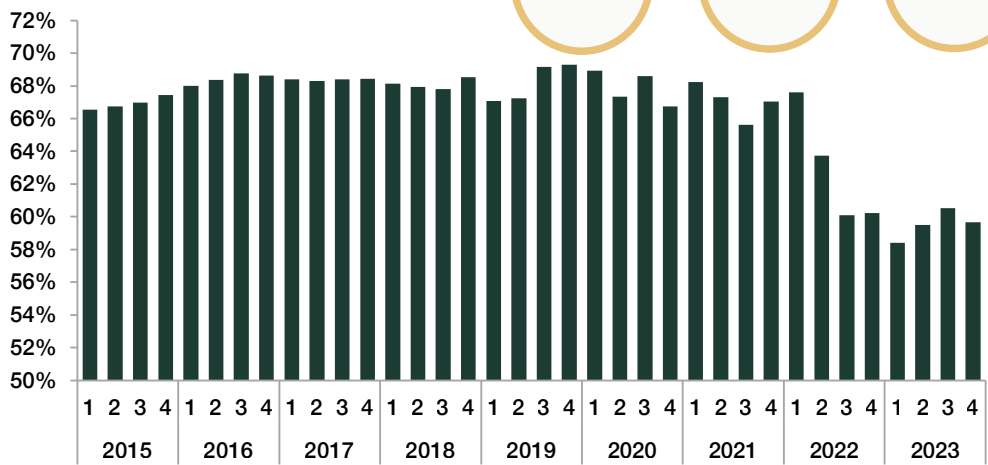
69.3%

Recent Low
 (Q1 2023)

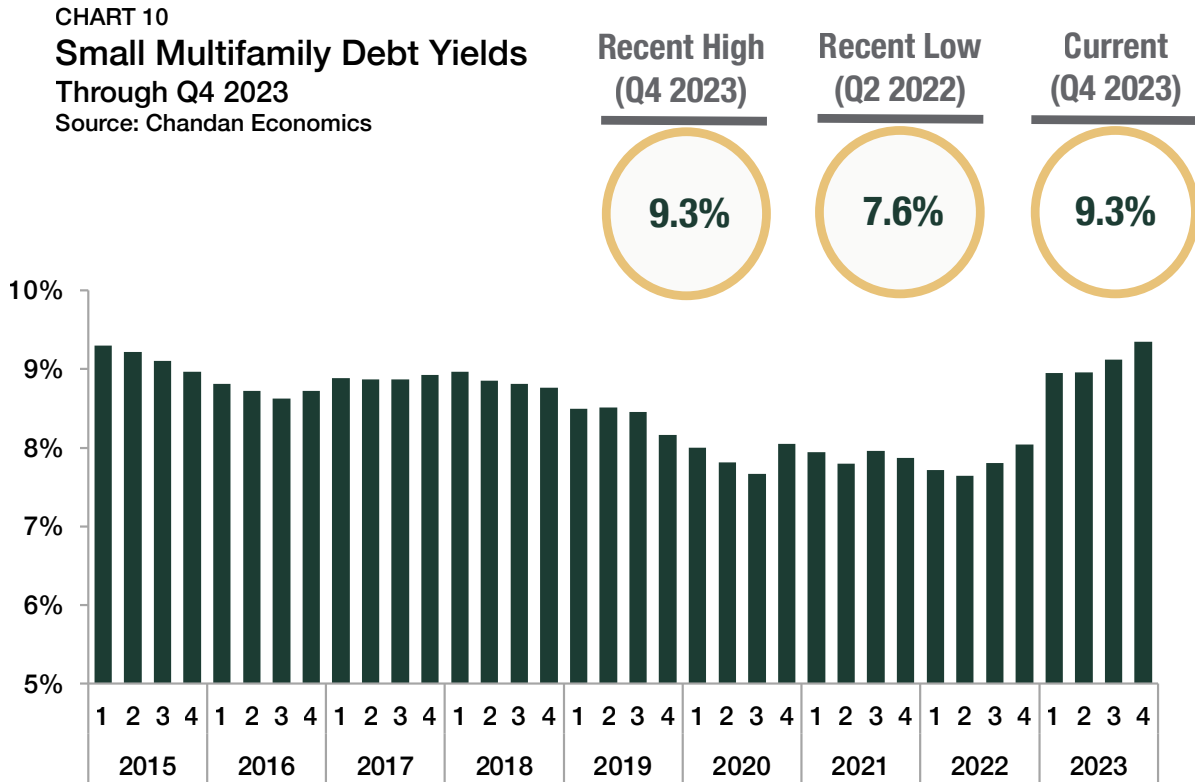
58.4%

Current
 (Q4 2023)

59.7%



Average debt yields for small multifamily loans continued ascending in the fourth quarter of 2023, reaching 9.3% (Chart 10). Small multifamily debt yields have risen in each of the past six quarters and are up to their highest point in nine years. While both cap rates and debt yields have risen over the past year, debt yields have increased more substantially. Between 2015 and 2022, the spread between debt yields and cap rates averaged 277 bps, ranging from a low of 242 bps to a high of 311 bps. In 2023, this spread has held above 340 bps in every quarter and finished the year at 354 bps.



The inverse of debt yields, the debt per dollar of net operating income (NOI), for small multifamily loans fell again in the fourth quarter of 2023. Small multifamily borrowers secured an average of \$10.70 in new debt for every \$1.00 of property NOI, down \$0.27 from the previous quarter and reaching its lowest level since 2014.





Outlook

With inflation easing, strong job growth, and interest rate cuts expected as early as spring, this quarter's outlook for small multifamily includes a healthy dose of optimism. As we enter the new year, multifamily housing continued to demonstrate strength, maintaining the best investment prospects of any major commercial real estate property type, according to the [2024 ULI-PwC Emerging Trends in Real Estate Report](#). The small multifamily subsector prospects look bright, too, as its fundamentals, including tenant demand and liquidity support, remain sturdy. With the Federal Reserve potentially kicking off a series of interest rate cuts, small multifamily investors should anticipate an uptick in activity this spring as more buyers come off the sidelines.

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