Small Multifamily Investment Trends Report

Q3 2024

Topics

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

Cap Rates Climb Again as Originations Begin Rebounding

Key Findings

- Small multifamily originations were on pace for a modest 7.9% annual increase in 2024.
- Cap rates reversed a first-quarter decline, rising to 6.1%.
- Credit conditions remained conservative as debt yields rose to 9.9%.

State of the Market

Small multifamily continued to moderate through the midpoint of 2024, as strong demand and lending support from government-sponsored enterprises (GSEs) counterbalanced an elevated interest rate environment and rising property-level yields.

Although loan activity retreated slightly, distress has remained limited within the small multifamily subsector. According to Freddie Mac, 97.2% of its small balance multifamily loans were current through May 2024 — a decrease of about two percentage points from the end of 2022. The share of the outstanding loan balance that has either reached foreclosure or REO (real estate owned) was just 0.2%, signaling that lenders and borrowers are increasingly working together to cure non-performance.

While economic headwinds persist, more signs of a normalization underway have brightened the outlook for 2025 and beyond. The National Multifamily Housing Council's (NMHC) most recent Quarterly Survey of Apartment Conditions shows a growing share of multifamily practitioners reported higher sales volume and improved borrowing conditions compared to the previous three-month period.

Multifamily originations have also recently shown signs of improvement. According to Freddie Mac's 2024 Midyear Multifamily Outlook, they have now been projected to increase by a little more than 20% in 2024, provided monetary policy is loosened as expected this year. Already, small multifamily originations have seen a modest pickup in the first two quarters of the year, although uneven improvement can be expected for the remainder of 2024. Multifamily completions sit at a five-decade high, while rents increased 2.7% year-over-year through June 2024, signaling momentum is trending positive but has room to grow.

With a consensus of opinion building that the Federal Reserve will cut interest rates multiple times by year's end, a macroeconomic inflection that would accelerate a normalization could be on the horizon.

Lending Volume

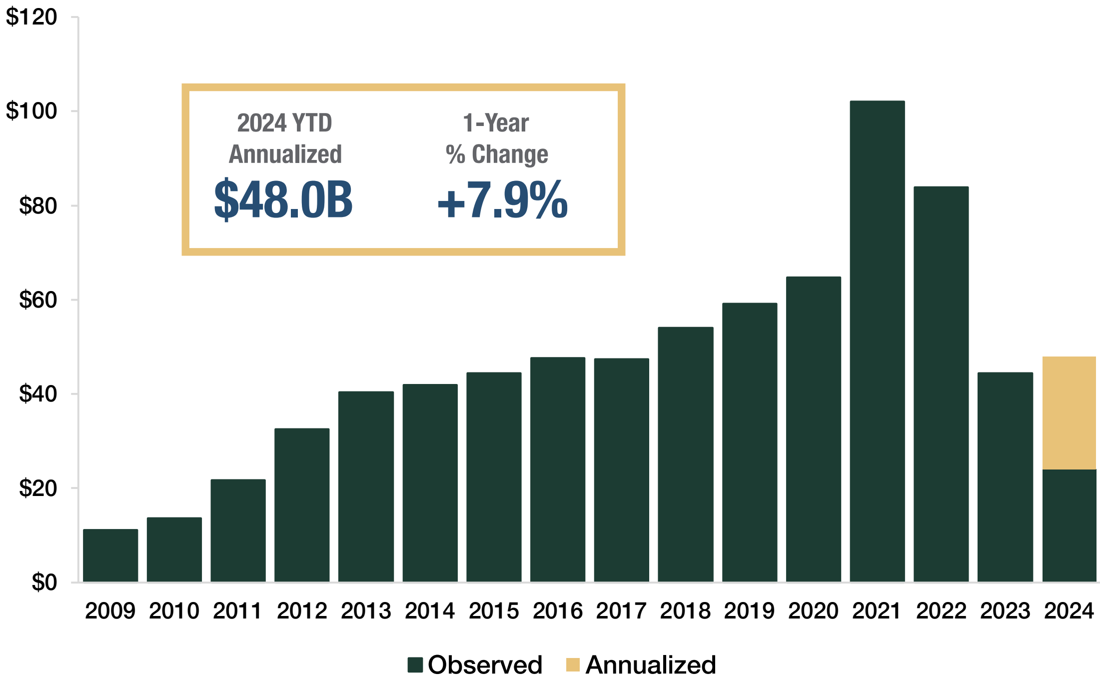
The $44.4 billion year-end 2023 estimate of new multifamily lending volume on loans with original balances between $1 million and $9 million — including loans for apartment building sales and refinancing — decelerated significantly from $83.9 billion in 2022 *(Chart 1)*. Thus far in 2024, originations appear to be

CHART 1

Estimated Small Multifamily Origination Volume

In Billions $, Through Q2 2024

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 million and loan-to-value ratios above 50%.

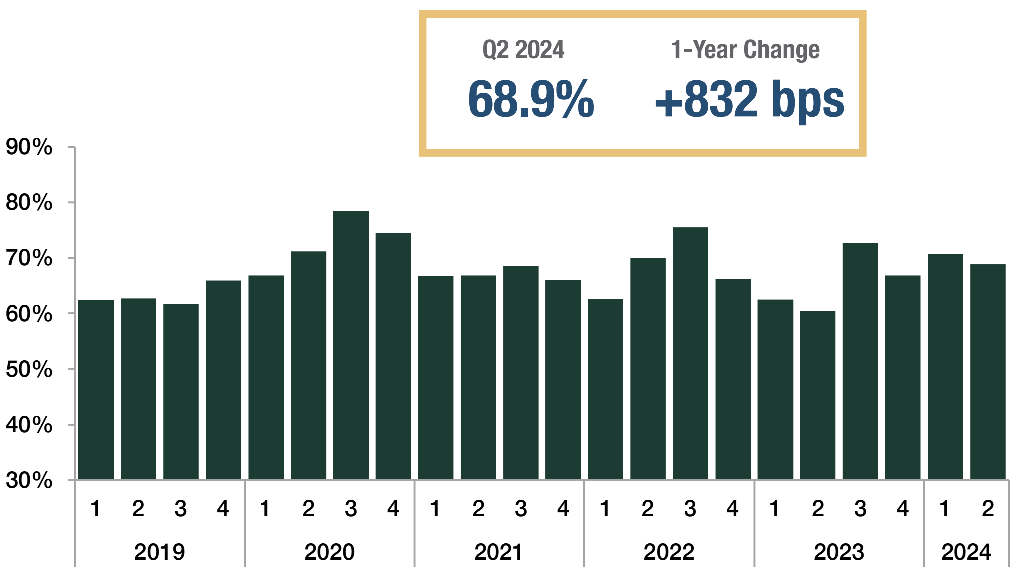
stabilizing and rebounding modestly. Through the second quarter, small multifamily originations are on an annualized pace to reach $48.0 billion in 2024, an increase of 7.9% over last year's volume.

Several factors have weighed down origination volumes in 2023 and 2024, including challenges brought on by high interest rates, sellers adjusting to the realities of lower asset valuations, and macroeconomic uncertainties. Additionally, loan extensions, a common feature of the current lending environment, have simultaneously suppressed both new originations and distress.

Loans by Purpose

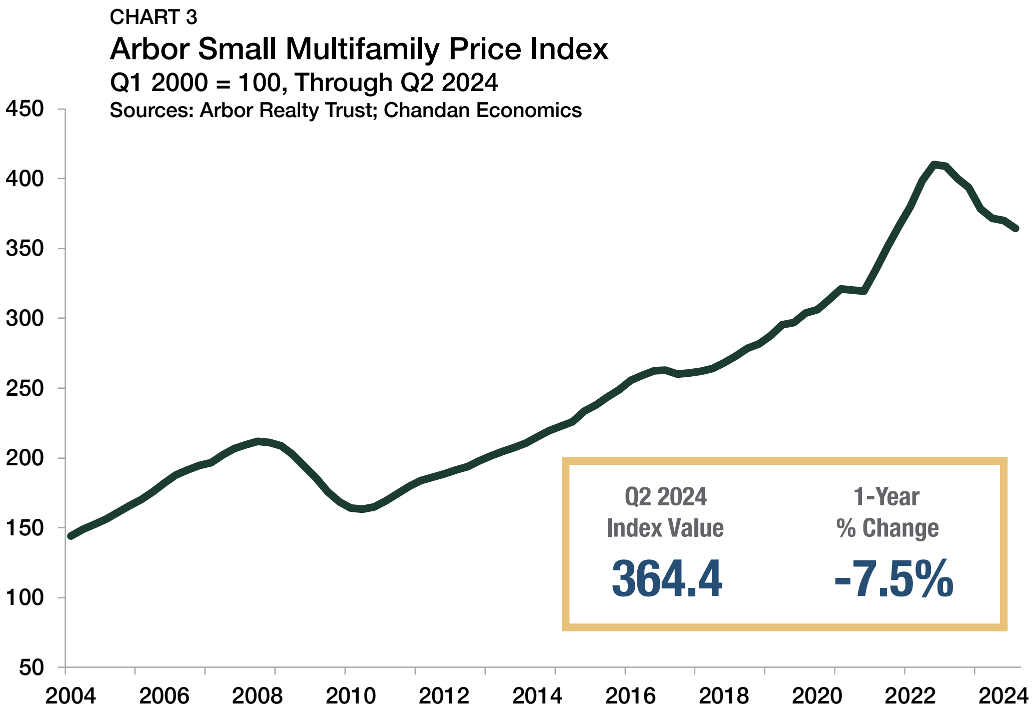
High interest rates have been reducing the incentive for investors to pursue cash-out refinancing. After hitting a high of 75.6% in the third quarter of 2022, the refinancing share of originations fell for three consecutive quarters, reaching a low of 60.5% in the second quarter of 2023 *(Chart 2)*. However, the refinancing share of originations, which was 68.9% in the second quarter of 2024, has normalized over the past four quarters, ranging between 66.8% and 72.7%.

CHART 2
Refinancing Share of Small Multifamily Lending
Through Q2 2024
Sources: Freddie Mac; Chandan Economics



Arbor Small Multifamily Price Index

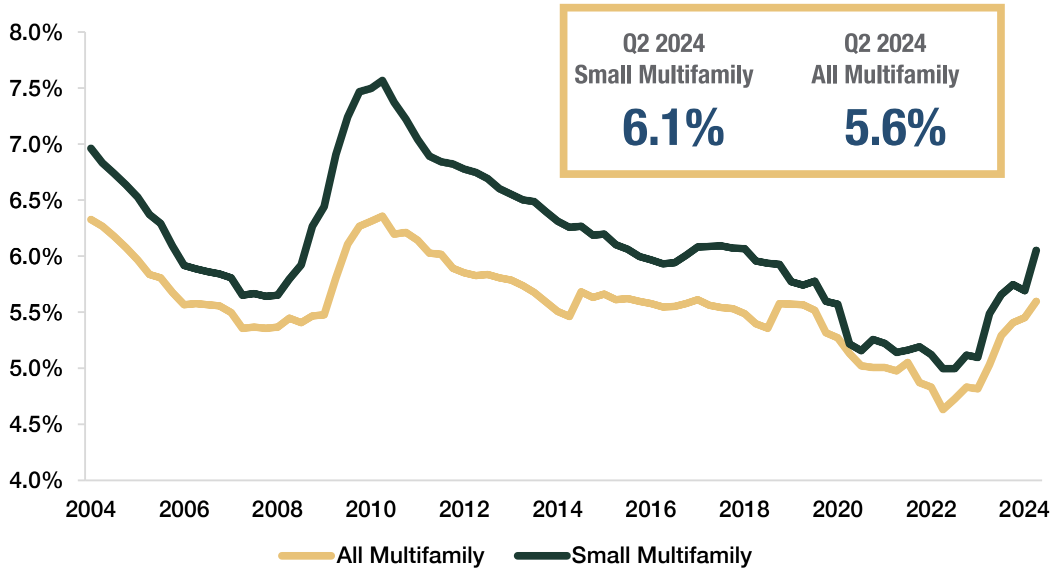
The Arbor Small Multifamily Price Index showed that asset valuations were down 1.5% year-over-year through the second quarter of 2024 and down 11.2% from their 2022 peak *(Chart 3)*. The second-quarter price decline was driven entirely by rising cap rates — as operating incomes, expense ratios, and occupancy rates all improved within the sector. Despite these declines, valuations were about 19.0% higher than pre-pandemic levels.



Cap Rates & Spreads

In the second quarter of 2024, small multifamily cap rates averaged 6.1%, reversing the previous quarter's declines *(Chart 4)* with an increase of 36 basis points (bps). After cap rates in the sector reached an all-time low of 5.0% in the third quarter of 2022, property-level yields increased in six of the following seven quarters, climbing a total of 105 bps during that time. The second quarter mark was the first time since 2018 that cap rates eclipsed 6.0%. Rising cap rates have been a double-edged sword for small multifamily. On the one hand, cap rate increases have negatively impacted asset valuations. At the same time, they have improved the return profile for prospective investors.

CHART 4
Small Multifamily Cap Rates
Through Q2 2024
Source: Chandan Economics



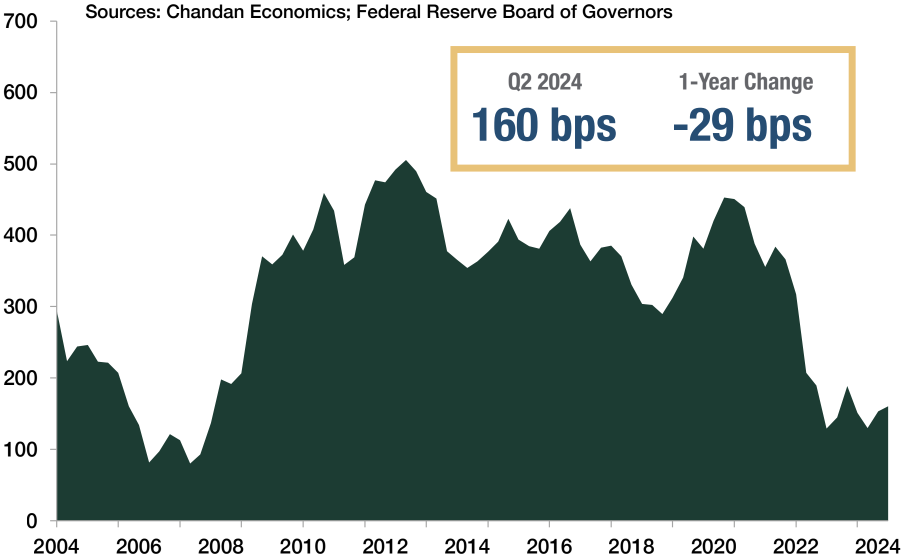
The small multifamily risk premium, best measured by comparing cap rates to the yield on the 10-year Treasury, approximates the additional compensation that investors require to account for higher levels of risk. This risk premium widened by a marginal seven bps in the second quarter of 2024 to reach 160 bps *(Chart 5)*. The increase arrived as 10-year Treasury yields averaged 4.5% between April and June — up from 4.2% in the first quarter of the year.

CHART 5

Spread Between Small Multifamily Cap Rates and 10-Year Treasury Yields

Measured in Basis Points, Through Q2 2024

Sources: Chandan Economics; Federal Reserve Board of Governors



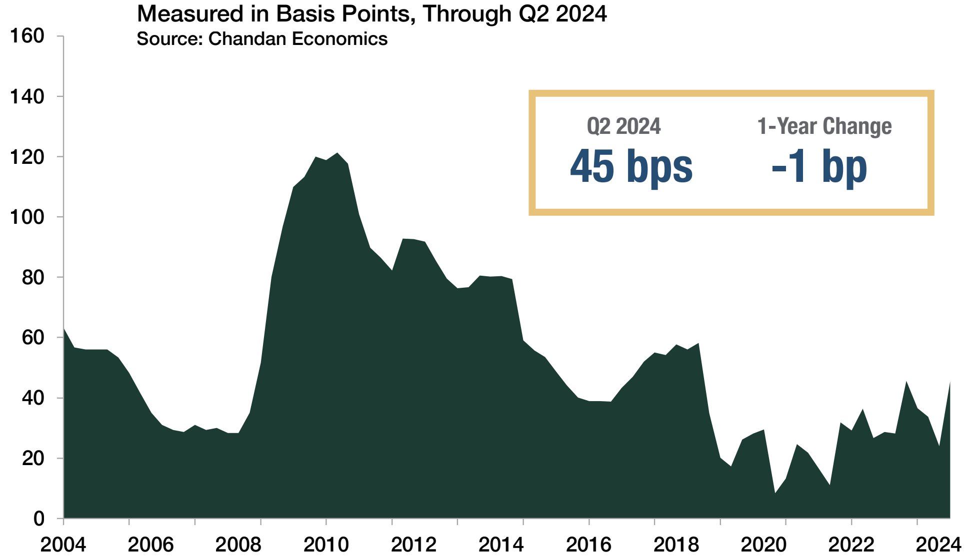
Despite the slight increase, the risk premium remained well below pre-pandemic trends. Between 2015 and 2019, the small multifamily risk premium averaged 370 bps — more than double the current spread. Meanwhile, the cap rate spread between small multifamily assets and the rest of the multifamily sector, a measure of the risk unique to smaller properties, increased by 21 bps during the second quarter to reach 45 bps *(Chart 6)*.

CHART 6

Spread Between Small Multifamily and All Multifamily Cap Rates

Measured in Basis Points, Through Q2 2024

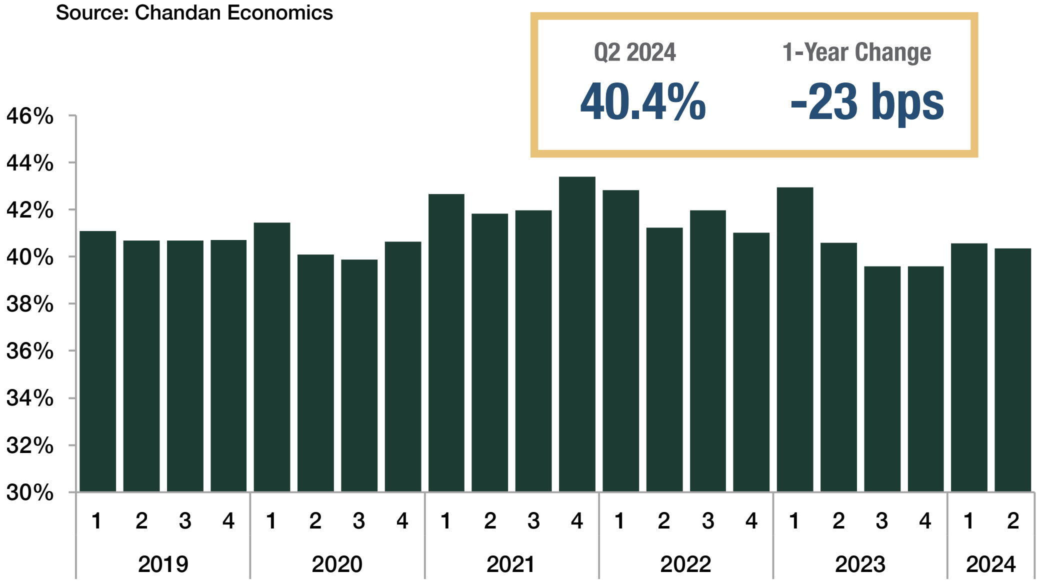
Source: Chandan Economics



Expense Ratios

Expense ratios, measured as the relationship between underwritten property-level expenses and effective gross income, have remained stable in recent quarters. In the second quarter of 2024, expense ratios in small multifamily properties receiving financing averaged 40.4%, a slight decline from the 40.6% observed during the prior quarter *(Chart 7)*. Expense ratios peaked at 43.0% in the first quarter of 2023, coinciding with a steep rise in property insurance prices. However, expense ratios have quickly normalized. In the past five quarters of available data, expense ratios ranged in a tight window between 39.6% and 40.6%.

CHART 7
Small Multifamily Expense Ratios
Through Q2 2024
Source: Chandan Economics



Occupancy Rates

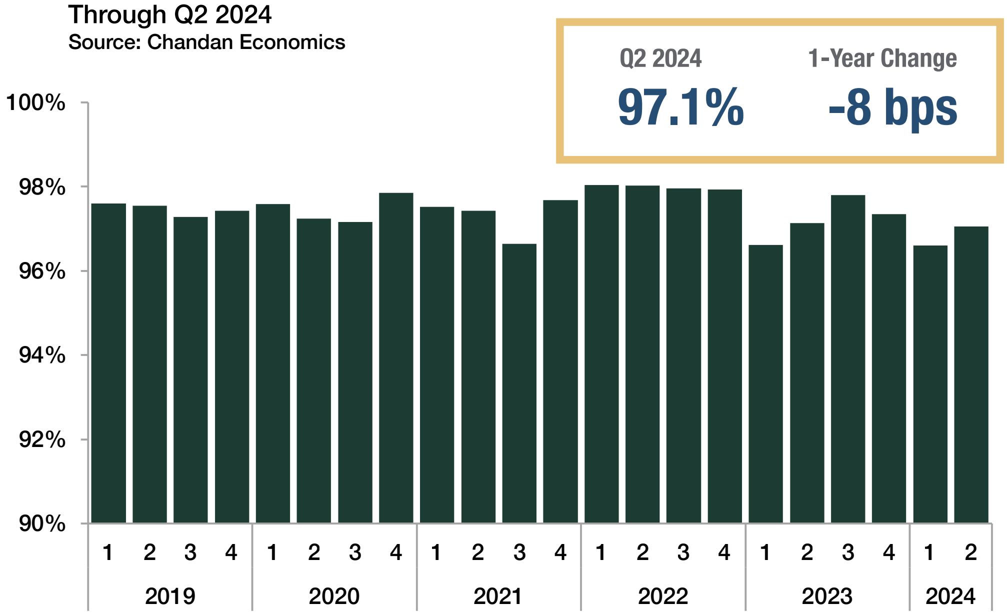
Occupancy rates within small multifamily properties that received financing during the second quarter averaged 97.1% *(Chart 8)*. After posting slight declines in the prior two quarters, the average was a notable improvement of 45 bps, putting occupancy rates directly in line with where they were a year ago.

CHART 8

Small Multifamily Occupancy Rates

Through Q2 2024

Source: Chandan Economics



Small multifamily occupancy rates routinely best the rest of the multifamily sector. Occupancy rates in small multifamily properties track about 2% higher than the rest of the sector, an anomaly that may be driven by the interpersonal relationships between many landlords and their tenants.

According to a recent report by the Terner Center for Housing Innovation at UC Berkeley, a majority of small multifamily property owners reported that at least half of their rental units were being leased at below-market-rate rents, primarily to retain quality tenants.

Leverage & Debt Yields

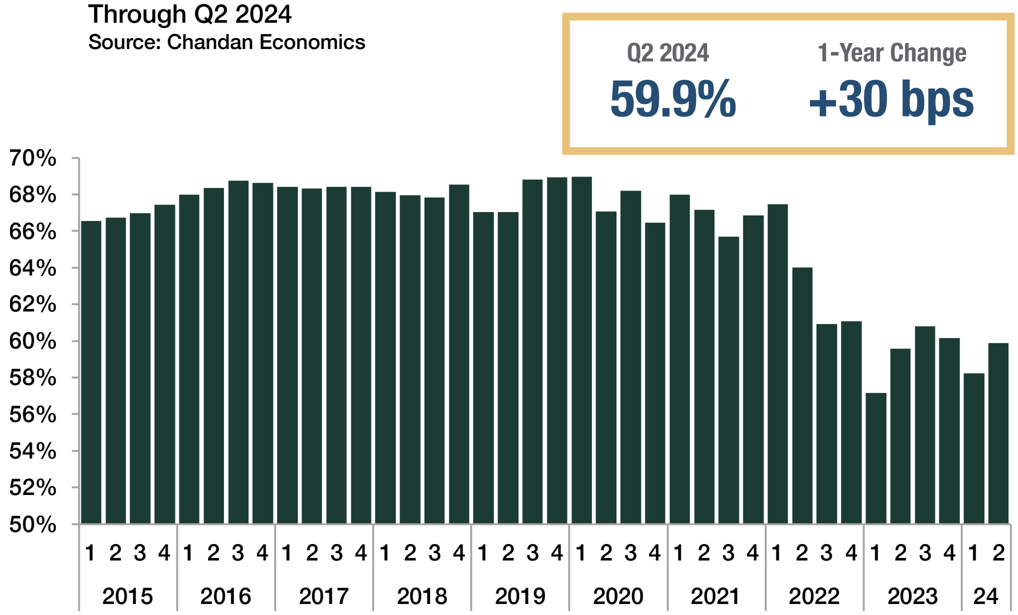
Debt underwriting standards remained tight through the first quarter of 2024. Loan-to-value ratios (LTVs) slid by 179 bps from the previous quarter, settling at 57.9% *(Chart 9)*. However, the upward movement in the second quarter only erased declines from the first three months of the year, with average LTVs down 29 bps from year-end 2023. Small multifamily LTVs remain below pre-pandemic levels and down 9.1 percentage points from a peak of 68.9% in 2019.

CHART 9

Small Multifamily LTVs

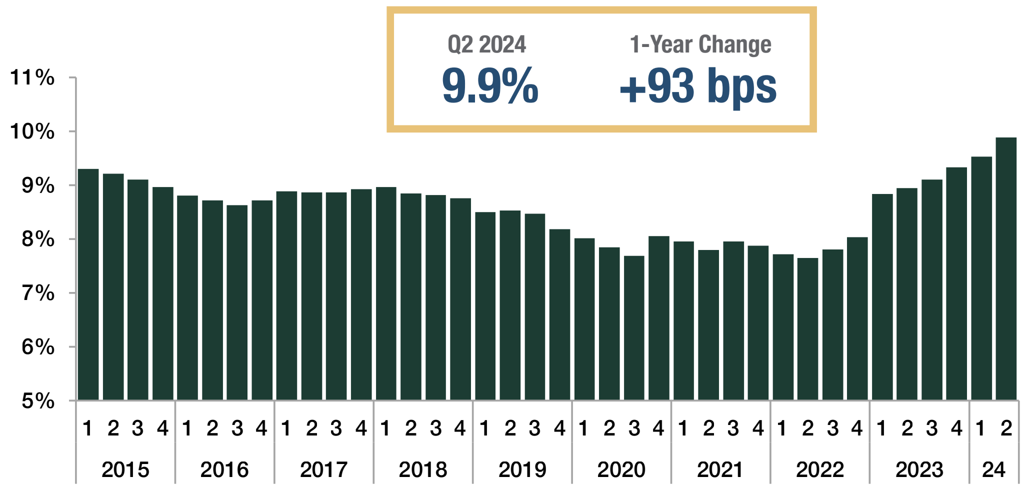
Through Q2 2024

Source: Chandan Economics



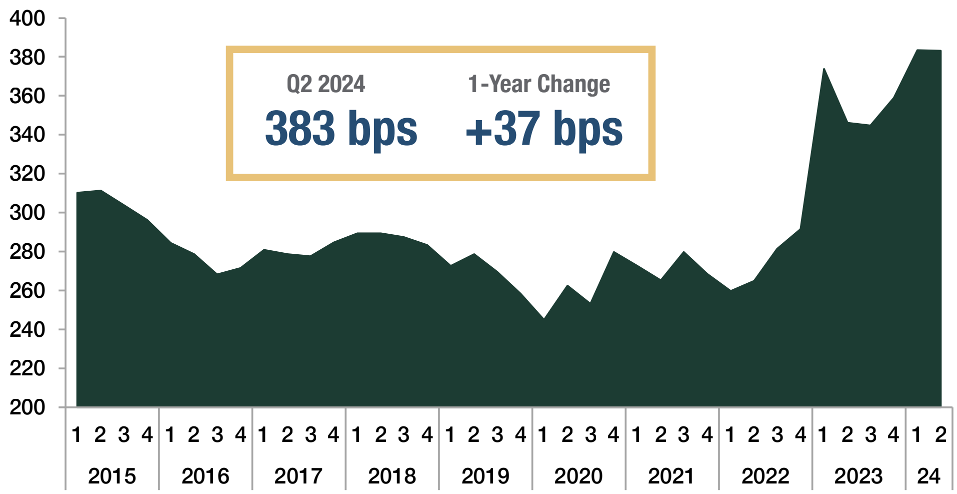
Average debt yields for small multifamily loans continued to ascend, reaching 9.9% *(Chart 10)*. Small multifamily debt yields have risen in each of the past eight quarters, reaching their highest point in over a decade.

CHART 10
Small Multifamily Debt Yields
Through Q2 2024
Source: Chandan Economics



While cap rates and debt yields are both higher than one year ago, debt yields have increased more substantially than cap rates. The spread between debt yields and cap rates remained at 383 bps in the second quarter of 2024, holding at its widest point since 2013 *(Chart 11)*.

CHART 11
Spread Between Small Multifamily Debt Yields and Cap Rates
Measured in Basis Points, Through Q2 2024
Source: Chandan Economics



The inverse of debt yields, the debt per dollar of net operating income (NOI), for small multifamily loans fell again in the second quarter of 2024. Small multifamily borrowers secured an average of $10.12 in new debt for every $1.00 of property NOI, down $0.38 from the previous quarter and $1.05 from the same time last year.

Outlook

The small multifamily subsector continues to post gains and show growth amid a challenging macroeconomic environment. Between the liquidity provided by the GSEs, the increasing frequency of loan extensions, and the expectation that financial market conditions will soon improve, the small asset class remains on solid footing and distress should remain contained.

In the past decade, there have been 3.5 million more household formations than new housing unit completions. The ongoing housing shortage in the U.S. will result in above-average multifamily demand levels for the foreseeable future. If the Federal Reserve moves to cut interest rates this year, it will further help bridge gaps between buyers and sellers, accelerating the small multifamily sector's normalization.

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Arbor Realty Trust, Inc. (NYSE: ABR) is a nationwide real estate investment trust and direct lender, providing loan origination and servicing for multifamily, single-family rental (SFR) portfolios, and other diverse commercial real estate assets. Headquartered in Uniondale, New York, Arbor manages a multibillion-dollar servicing portfolio, specializing in government-sponsored enterprise products. Arbor is a leading Fannie Mae DUS® lender, Freddie Mac Optigo® Seller/Servicer, and an approved FHA Multifamily Accelerated Processing (MAP) lender. Arbor's product platform also includes bridge, CMBS, mezzanine, and preferred equity loans. Arbor is rated by Standard and Poor's and Fitch. In June 2023, Arbor was added to the S&P SmallCap 600® index. Arbor is committed to building on its reputation for service, quality, and customized solutions with an unparalleled dedication to providing our clients excellence over the entire life of a loan.

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