Multifamily's Imminent Down Cycle Is Overdue

Industry-leading experts agree 'it won't be an easy time,' but forecast continued resiliency in apartments.

By Paul Bergeron

The long-time, high-flying multifamily housing sector appears on the brink of hitting a down cycle that's "overdue" – if it's not already here – according to Phyllis Klein, senior vice president, head of agency production at Capital One.

Klein was part of a panel hosted by Investors Management Group, (IMG), which included three of the nation's leading experts in real estate investment and lending for a private event in Portland, Ore.

Joining her was Josh Bodin, senior vice president, head of securities trading at Berkadia and Neil Schimmel, IMG founder & CEO. It was moderated by Karlin Conklin, IMG Principal, co-president and COO, who led the group through issues such as inflation, leverage, cap rates and returns.

System Shocked by Interest Rate Run-Up

"The system is shocked by the major run-up in rates, and the market needs to settle," Klein said. "Multifamily is still the shining light in real estate with strong occupancies and future growth on the horizon. There are some clouds, but nothing [as challenging as past] cycles."

Bodin said the industry is "a little scarred from the Great Recession and hasn't absorbed the lesson that recession doesn't necessarily equal apocalyptic doom."

Schimmel said there is "certainly a correction in pricing ahead," and he expects transaction volume to remain cool through Q1-2023, then begin to pick up. "We're seeing a disconnect between buyers and sellers at the moment because interest rates have risen so fast."

Klein added, "Cap rates are beginning to adjust to where the Fed is headed. Interest rates of 6%+ don't fit with pricing at cap rates sub 4%. Sellers are trying to sell into a growth story, but some markets are moving backwards."

Fed policy is a blunt instrument, and the lag from when a rate hike occurs to when it is fully felt by the market is 12 months to 18 months.

Focus on Hyperlocal, Not National Data

To understand the overall resiliency score of an investment portfolio, Bodin stressed the importance of moving from rent growth and other data reported at the national level, and instead focusing on hyperlocal/micro geographic and demographic trends.

Klein and Schimmel added insights into which US metros have the confidence of agencies and investors.

“Vegas is entertainment; Orlando is tourism; Austin is tech,” Klein said. “These markets don’t have the economic diversification as, say, a Dallas or Phoenix.”

Schimmel added that markets such as Raleigh, Atlanta and Seattle have the economic diversification that results in a robust population and multifamily climate.

Klein also explained that lenders analyze credit card data to understand consumer behavior as it impacts market and housing trends.

“Where are people spending their entertainment dollars?” she said. “Who bought a U-Haul to move from point A to point B? We can harness this kind of data for the future.”

Rent Growth Should Moderate

For years, average rents have been rising faster than inflation and wage growth.

“National multifamily rent growth is moderating,” Klein said.

In August 2021 to August 2022, there was 10% growth. From July 2022 to August 2022, zero rent growth. From the start of the pandemic to present, there’s been a 22% increase in rent growth.

“We expect the economy and multifamily industry to continue their stellar growth, but at a more moderate pace,” Klein said.

Bodin sees average rent growth at around 1% higher than inflation and the long-term inflation average is 3% to 4%.

Bodin also sees the Federal Reserve taking an aggressive approach to rein in inflation. In the past, the Fed has generally balanced its rate approach to hit targets for inflation and unemployment.

But today, he explained the Fed is “looking almost exclusively at inflation. This explains why the Fed has raised rates so high, so fast.”

Between March 2020 and March 2022, the Fed Funds rate hovered near 0% before spiking to a current level near 3.25%.

No one believes that rates have topped out, with the broader consensus estimate for peak Fed Funds rate is 4.5% to 4.75% in 2023. Some experts predict the rate going to 5% in 2023 before trending down in 2024.

The Fed’s goal in raising rates is to encourage saving while discouraging borrowing and spending to slow inflation. The Fed Funds rate is fundamentally tied to the cost of borrowing through

credit card debt, home loans and other financing.

As an example, mortgage rates are set at approximately 3% above the Fed Funds rate. Earlier this year when the Fed Funds rate was near 0% and mortgage rates were near 3%, a buyer on a $2,500 budget could afford a $517,000 home. At a 6% mortgage rate, the same buyer could afford a $400,000 home.

A 'Reset,' Not A Deep Recession

While no one has a crystal ball, Conklin pointed, "[This] won't be an easy time. But with that said, we've all been through this before. We're prepared for the 'known unknowns' ahead."

According to Bodin, "We are moving into a 'garden-style recession' of unemployment increasing 1% to 2% to break the back of inflation.

"Don't fear the correction. It's simply fixing 10 years of easy money and bringing asset values in line with normal monetary policy."

Klein said that multifamily, from both the agency and owner/investor perspectives, offers a strong hedge against inflation.

"As long as you're operating in the right markets and have a smart asset management team in place, multifamily as an investment is a no-brainer," she said, also stating that the agencies refer to the current phase of the economic cycle as a "reset," not a recession.

"The pandemic reminded us that market disconnects happen very quickly," Bodin added.

Schimmel remains optimistic.

"I'm an opportunistic buyer through up and down markets," he said. "In the coming year, there will be good buying opportunities, especially as sellers need to recapitalize. You'll never see our team sitting on the sidelines."

Schimmel said that IMG's disciplined due diligence and underwriting process helps his investor group avoid risky properties and risky markets.

"It sets investments up for predictability," he said.

Conklin noted that "you're seeing high-leverage loans on properties right now," referencing bridge loans and other creative financing that became popular following the COVID-19 market disruption.

"IMG won't take on that risk. Lower-leverage Freddie and Fannie loans are the safest debt you can get."

Klein said that agency lenders are targeting "exactly" what IMG acquires and operates.

Just Remember 'The Jetson's'

According to Fannie Mae's website, more than 90 percent of the apartments it finances are "workforce housing" and are "affordable to families earning at or below 120% of the area median income (AMI) – the teachers, first responders, and service workers who are an essential part of their communities."

Bodin said that what he finds interesting is that "if you look back over the past several decades at some of the best sci-fi movies in pop culture, you'll find that an eerie number of their predictions around technology and innovation came true.

"Consider The Jetsons, the famous '60s sci-fi sitcom. Ever noticed where they lived? It was in an apartment.

"If we imagine what the future might look like in another 100 years, I think we can all agree that apartments will still be a fundamental element of society."