LAKELAND CAPITAL

Staying Invested in Multifamily Through Market Cycle to Realize Long-Term Upside

Robust demand for affordable housing supports long-term upside in multifamily investments while flexible capital structure can mitigate near-term risks

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Key Insights

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Historic market volatility may have squeezed real estate transaction activity, but the long-term tailwinds driving robust demand for affordable housing remain firmly intact.

Multifamily investments offer significant upside through potential rent increases and property value appreciation versus static return profile of fixed income.

Investors staying on the sidelines might face a more costly entry point to multifamily market as competition for assets stands to increase once uncertainty fades.

Perhaps no other corner of the market felt the reversal of the low interest rate regime quite like real estate. Transaction activity has been squeezed significantly by lending rates that sit at the highest level in more than a decade. With market conditions still volatile, investors may naturally question whether they should add exposure to the asset class.

Looking specifically at the multifamily sub-sector, we believe that the powerful tailwinds fueling long-term returns–namely, a robust demand for affordable housing and lack of ready supply–remain firmly intact. Certainly not every geographic market will benefit equally. But we have identified select metro regions along the East Coast, which appear likely to support sustained rent growth.

We also strongly feel that investment managers can create optionality for investors through flexible capital structures that mitigate the risk of near-term market volatility. Moreover, a well-managed asset can generate steady cash flow that should bolster portfolios for investors with medium-to-long-term time horizons. Those that wait on the sidelines until the economic landscape becomes more settled, however, may find that the entry point has become more costly with acquisition prices being driven up by an increased competition for assets.

Historic Volatility Caused Market Reset

Real estate investment managers had to navigate a historically challenging market environment in 2023 as the Federal Reserve (Fed) extended its most aggressive tightening action since the early 1980's when double-digit inflation was still rampant.

The whipsaw change ushered in a sharp market reset following a prolonged period of very low interest rates. Fixed income suddenly offered higher yields not seen in decades, contributing to a widening gap between the bid ask of buyers (with a higher cost of capital) and sellers of real assets.

Investment managers also faced a more difficult time securing lending to finance property acquisitions. Higher interest rates caused banks to be more stringent with respect to both underwriting of sponsors and the level of proceeds to be committed, especially with a glut of issuance accounting for 40% of commercial real estate debt set to come due within the next two years.[1] Nearly two-thirds of banks reported tightening credit standards at least somewhat for multifamily lending.[2] This resulted in both fewer qualified buyers and a lower level of proceeds (and higher equity requirement) for those that did qualify.

Amidst so many market uncertainties, it was little surprise then that multifamily property sales tumbled to just $57.6 billion through November 2023 following $196.9 billion in 2022 and a record-high $228.3 billion in 2021.[3]

1. Freddie Mac. 2024 Multifamily Outlook. December 2023.
2. Federal Reserve. Senior Loan Officer Opinion Survey on Bank Lending Practices at Selected Large Banks in the United States. October 2023.
3. Yardi Matrix. 2024 U.S. Multifamily Outlook. Winter 2024.

Multifamily Remains a Compelling Long-Term Story

Although recent market volatility may have slowed investment activity, we remain confident that the structural tailwinds fueling long-term demand for multifamily residential properties will not only persist but intensify.[4]

The historic unaffordability of home ownership is one of the key factors supporting multifamily. In the past decade, the median sale value of U.S. homes has doubled, significantly outpacing a corresponding 50% rise in rents and 32% increase in consumer prices.[5] Compounding the sticker shock for potential home buyers is the increased cost of maintaining a mortgage following the surge in interest rates.

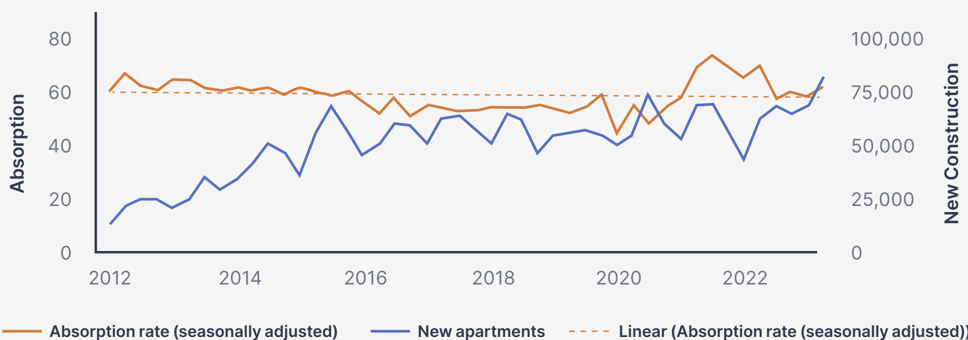
The fundamental need for affordable housing has certainly not gone unnoticed by property developers. Importantly though, the absorption rate of new apartments remains steady despite an influx of supply. We also expect that elevated supply levels will begin to moderate given the considerable administrative and cost pressures to bring new projects online, not to mention the logistical challenges of finding suitable building locations in already crowded urban areas.

Furthermore, rising construction prices have made it all but impossible to profitably deliver new affordable product, in contrast to luxury product, without significant subsidy and local buy-in, making the shortages and rent pressure all the more acute within the affordable segment.

After hitting a record high in 2022 following two years of double-digit percentage increases, multifamily rent growth slowed in 2023 amid mounting economic uncertainty but still remained positive. Meanwhile, Freddie Mac projects a 2.5% increase in 2024, which it states is slightly below an annual average of 2.9% going back to 2000. CBRE forecasts rent growth for the year of 1.2%.[6]

We feel that specific metro regions may be better positioned to support sustained rent growth owing to unique local conditions. In the year through October 2023, for example, Boston recorded a 2.8% increase in multifamily rents versus a 0.7% uptick in the national average.[7] Norfolk also beat the benchmark with a 2.9% rise, whereas Atlanta and Orlando saw rents decline by just over 3% apiece.

Figure 1 — Demand remains strong despite influx of supply



Source: U.S. Census Bureau. Survey of Market Absorption of New Multifamily Units. Data is calculated from 2012 to 2023, based on privately financed, nonsubsidized, unfurnished rental buildings in budlings with five units or more. Percentages are computed using unrounded data. Dotted line indicates linear trend line of absorption rate (seasonally adjusted).

4. For more on our views, please read our recent research "Multifamily Leads the Way in Real Estate."
5. Federal Reserve Bank of St. Louis. Median Sales Price of Houses Sold for the United States; Consumer Price Index for All Urban Consumers: Rent of Primary Residence in U.S. City Average; Consumer Price Index for All Urban Consumers: All Items in U.S. City Average.
6. CBRE. U.S. real estate market outlook 2024. December 2023.
7. CoStar. Apartment Monthly Rent Report. October 2023.

Flexible Capital Structure Facilitates All-Weather Investment Approach

Prudent investment managers should be mindful of prevailing market conditions, while still finding ways to come off the sidelines and take advantage of opportunities to acquire properties when they occur.

We favor utilizing a flexible capital structure with lower leverage and longer-term fixed rate debt when acquiring multifamily properties. We believe this is an all-weather approach that can mitigate near-term risks and ensure managers are not forced to dispose properties during disadvantageous market environments. Although it may take some upside off the table and risk incurring prepayment penalties on the debt versus a more aggressive approach trying to time the market, we are comfortable with the trade-off of being able to stay active throughout the cycle with extra downside risk protection.

Although returns from an investment property may be driven in large part by sale proceeds, we also feel that a well-managed asset should still be able to generate strong cash flow even if external conditions delay the eventual exit. The investment manager, acting as the sponsor of the deal, can rightly be expected to generate maximum value through a persistent, hands-on approach to delivering operational and physical improvements to the property.

It is also worth noting that multifamily investments boast significant upside, stemming from both potential property value appreciation as well as rent increases. This is an important point to bear in mind for investors considering fixed income as an alternative to multifamily in a buy-and-hold strategy. Although yields have increased, the return profile of a traditional bond held to maturity will remain static and look less attractive later when accounting for inflation.

Competition for Assets Will Increase

Investors who stay on the sidelines not only miss out on potential opportunities now but also risk facing a more costly entry point to the market once uncertainty eases and competition increases.

A recent brokerage survey showed that 79% multifamily investors reported their current investment pipeline was either the same or less active compared with a year ago. In a sign that many might be preparing to pile back into the market, the same survey showed nearly two-thirds of respondents believed the best buying opportunities were either right now or likely six months away.[8]

Competition for assets also stands to increase as the broader market searches for ways to deploy uninvested funds. The amount of dry powder in commercial real estate reportedly topped $400 billion in October 2023.[9] Just as we feel that private capital could provide a backstop to multifamily investments in times of severe volatility, we also expect that it will fuel increased competition for assets when the landscape becomes more settled.

8. Cushman & Wakefield. Sunbelt Multifamily Advisory Group Year End Review 2023.
9. JLL. Dry powder for investment. January 2024.

What We're Watching Next

Investors are right to consider the risks in the real estate market in light of recent volatility. But we believe they should also look beyond the near-term noise and consider the upside, particularly in the case of the multifamily sub-sector where long-term, structural supports remain firmly intact.

We feel that current volatility in multifamily is unlikely to turn into any period of significant distress due in part to the abundance of private capital on the sidelines and overall interest in the market. Investment managers who can effectively operate well-chosen assets in metro regions poised to sustain rent increases should be insulated from any near-term challenges.

Transaction activity should also start to pick up, in our opinion, once the Fed provides more clarity on when it will ease interest rates. That creates an imperative for multifamily investment managers to capitalize on the lull now and utilize connections to target a deep pipeline of opportunities and get the right properties under contract at the right price.

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