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Despite recession risks, multifamily outlook remains strong

BY LORETTA CLODFELTER

Multifamily rents have soared in recent years, but as the economy shows signs of downturn, it remains unclear how much higher rents will go in the future. According to Derek Graham, principal and founder of private real estate investment firm Odyssey Properties Group, the outlook for multifamily real estate overall remains strong, notwithstanding the prospect of recession.

"As we emerge out of a record-breaking past two years for multifamily real estate performance, there is skepticism on the economic horizon," said Graham in an interview with IREI. "Year-end rent growth for 2022 remains considerably higher than the long-term average, yet the majority of markets have already peaked and will experience little to no additional growth through the end of 2022."

Graham noted that if, as many experts predict, the United States experiences a moderate recession throughout 2023 and 2024, that would likely result in a mild decrease in multifamily occupancy and overall rents evening out. "Although select markets with elevated supply may experience modest rent declines, national multifamily fundamentals can be expected to normalize as they return to pre-pandemic levels," said Graham. "In fact, by 2024, rent growth is anticipated to return to its 3 percent to 4 percent long-term average."

Apartment rents have risen significantly in the past few years. Nationally, rents have increased 25 percent over pre-pandemic levels, noted Graham, and in some high-growth markets are up over 50 percent. "However," he added, "the accelerated rent growth sparked by the pandemic is seen to have peaked and begun to level."

Year-over-year rent growth remains elevated – up 7.5 percent – though that is less than half the year-over-year growth registered in first quarter 2022.

“With rent as a percentage of household income reaching a 25-year high, this unsustainable growth has resulted in considerable affordability issues, which is why rent growth is now tempering,” added Graham. “Despite this leveling off, we anticipate no shortage in demand for rental housing. The recent rise in mortgage rates has driven the delta between the average monthly mortgage payment and average monthly rent to an all-time high. This dynamic, combined with the U.S still facing a severe housing shortage, will continue to drive the steady demand for multifamily housing.”

The rising interest rate environment has had an effect on valuations in the multifamily sector.

“Rising interest rates have undoubtedly impacted cap rates, and therefore values across the multifamily sector,” said Graham. “The speed and magnitude of the rate increases is unlike anything the U.S. economy has seen in recent history. As a reference point, in our experience as a multifamily sponsor operating on a national basis, we acquired a property in early 2021 using 10-year fixed rate agency debt at 2.78 percent. That same loan today starts at 5.70 percent. Most floating rate loans are tied to SOFR, which has increased from 0 percent at the end of 2021 to 3.90 percent today.”

Graham indicated multifamily investors are seeing currently available debt that is 300 basis points more expensive than it was a year ago, which has forced cap rates to decompress considerably. The rise in cap rates and interest rates have not been equivalent, however. “Value-add deals were being marketed at 3.25 percent to 3.75 percent cap rates in fourth quarter of 2021,” said Graham. “Today, comparable properties are being offered at 4.75 percent to 5.25 percent. Based on these metrics, multifamily values are estimated to have peaked in January 2022 and fallen 25 percent since.”

With the shifting economic landscape, investors in the multifamily sector may need to re-evaluate some of their recent investments.

“Underwriting practices by multifamily investors were enthusiastically aggressive over the past two years,” said Graham. “As the economy moves into a new environment characterized by uncertainty, investors must stress-test their underwriting with realistic downside scenarios to evaluate the resiliency of any asset they are looking to purchase.”

He added that the contrast between expert and novice investors will become more apparent as the sector’s heightened performance levels off, and poor investment decisions may not be as forgiving.
“Thoroughness in analysis, careful underwriting and a wide breadth of market knowledge will define successful investments in the years to come,” noted Graham.