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WESTERN REAL ESTATE BUSINESS®

Connecting Real Estate in the West

UNDERWRITING MULTIFAMILY INVESTMENTS IN TODAY'S CLIMATE

Underwriting has drastically changed since the onset of the Fed interest rate hikes, causing multifamily investors to seek deals that reflect the new borrowing costs.

By Derek Graham

Multifamily investors were forced to reevaluate their strategies for the first time in two years after the most aggressive Fed interest rate hike in 30 years this June. A wave of cancelled deals swept the nation as interest rates spiked — negating prior underwriting and shrinking property values overnight.

With the Fed tightening further and the capital markets shifting, many investors are thought to be on hold…or waiting for the market to normalize.

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Odyssey acquired Nola on 50th, a 155-unit multifamily community in the Phoenix submarket of Arcadia in October.

DIV INDUSTRIAL BUYS 94 ACRES NEAR LAS VEGAS FOR 1.7 MSF LOGISTICS CENTER DEVELOPMENT

DIV Industrial, a newly formed institutional investor and developer of industrial real estate, has acquired 94 acres of land in Henderson, Nev.'s El Dorado Valley submarket for the development of El Dorado Valley Logistics Center. Terms of the acquisition were not released.

Construction is scheduled to begin this summer. The 1.7-million-square-foot El Dorado Valley Logistics Center will feature two buildings, ranging in size from 600,000 square feet to 1 million square feet, with 42-foot clear heights, flat floors and an ESFR sprinkler system.

El Dorado Valley Logistics Center in Henderson, Nev.

DIV's development partners include HPA Architecture and Kimley-Horn. Cushman & Wakefield's Alderson Tassi team, led by Donna Alderson and Greg Tassi, represented DIV in the site purchase.

El Dorado Valley Logistics Center is the first significant development project for DIV Industrial, which was established in late summer 2022 by real estate veterans Nicholas Ilagan and Jessica Quesada. The minority- and woman-owned firm is actively raising capital for its first fund, which will allow for more than $2 billion of industrial development and entitlement projects throughout the Western U.S.

CRE PLAYERS LOWER THEIR EXPECTATIONS FOR THE COMING YEAR

Sentiment turned negative for the first time in quite a while as the West's commercial real estate survey respondents cited inflation and rising interest rates for their rare pessimistic view.

By Nellie Day

A change is coming to commercial real estate, if the respondents to our annual broker and developer, owner, manager (DOM) CRE outlook surveys are to be believed. This breaks a long-standing streak of optimism dating back as far as this editor can recall.

Even before COVID, it seemed to become an annual tradition for our respondents to project the upcoming year would be better than the last. There would be more deals, more lending and more development. Total transaction volumes? Oh yeah, they'd be higher. Any plans to buy next year? You bet.

A pandemic, presidential elections, and ever-changing tax policies and building restrictions from states like California couldn't darken this group's rose-colored glasses — not since the Great Recession, anyway. This year,

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debt markets, as well as tenants becoming more prudent about their expansion plans."

Brad Umansky, president of Progressive Real Estate Partners in Rancho Cucamonga, Calif., and a broker participant, sees a few other challenges for the sector.

"The lack of quality available space, combined with the lack of new construction, is going to make it more challenging for tenants to expand and for brokers to lease space," he said. "Although investment activity has slowed in recent months, I believe now that we are past the mid-term election and long-term interest rates may be stabilizing, investment activity will pick up, especially as investors see the opportunity for rental growth."

Other respondents pointed to labor shortages and reduced spending/discretionary purchasing due to inflation as additional challenges for retail.

In an environment that's changing as quickly as this one has over the past few years, it's anybody's guess how the year will play out. There is strong evidence that interest rates will continue to rise, while it remains to be seen if it will curb inflation.

Every market produces opportunities and challenges — some more than others — and some depending on the sector or region. What we do know about this region, however, is that people favor it. The high quality of life, amenities and weather in many areas continue to attract residents, which continues to attract the services that comprise commercial real estate. The work-from-home phenomenon, business-friendly climate and lower pricing that some Western regions boast over other areas of the country may also be a boon to business, both theirs and ours. ■

UNDERWRITING MULTIFAMILY INVESTMENTS IN TODAY'S CLIMATE

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The key to any successful real estate transaction as interest rates continue to climb and multifamily rents begin to decline lies in careful underwriting. It's essential to know when to turn down a deal that's not in the investor's best interest.

Re-Evaluate Strategies

As a multifamily investment firm operating on a national basis, we have experienced these effects firsthand. Odyssey was pursuing the acquisition of a value-add multifamily property this past summer. However, we were forced to reexamine our underwriting and re-source a viable lender after the second consecutive unexpected rate hike of 0.75 percent on July 27. We were looking to utilize a bridge loan at the time, but in response to the rate increase, most bridge lenders backed out of the market entirely. This left few to no lenders available to move forward with a purchase. Based on the higher rates and the lack of liquidity in the debt market, the property could no longer support the previously agreed upon value and we elected not to move forward with the transaction.

Constructed in 1979, Nola on 50th features 12 buildings on 5.6 acres of land and offers a mix of studios, one- and two-bedroom units.

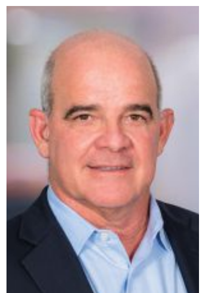
Taking the current macroeconomic climate into heavy consideration, underwriting for multifamily investments has changed drastically since the onset of the rate hikes. It has been characterized by adjusting debt assumptions to reflect the new cost of capital, modifying exit cap rate assumptions to align with the upward trend in purchase cap rates and tempered rent growth projections. While the first multifamily rent decrease in years may cause some pause, the market is simply exiting a period of outpaced upward rent growth. Forecasted increases are now nearing normal levels of 3 percent to 4 percent per year rather than 10 percent to 15 percent.

Moving into 2023, multifamily investors are seeking deals at prices that reflect the new borrowing costs. Yet, most sellers are clinging to yesterday's values. There are some highly transactional owners that are willing to meet the market, as well as others that might need to sell. However, the majority are still operating successful portfolios, implementing healthy rent increases, maintaining high occupancy and are therefore reluctant to sell at a discount to values from earlier this spring.

Amenities at Nola include a pool and spa, two laundry facilities, a fitness center, grilling station and dog park.

Diligence, Persistence Pay Off

The key to successful acquisitions in this environment is leveraging relationships and market insight to identify properties that deliver on underserved needs in targeted submarkets seeing persistent or growing demand. For example, our team identified the Phoenix market as one that provided strong fundamentals despite the volatility of interest rates. This conclusion was reached after consistently tracking more than 20 markets nationally and implementing a revised underwriting approach reflective of current market conditions. Odyssey acquired Nola on 50th, a 155-unit multifamily community in the Phoenix submarket of Arcadia in October. Since the company owned three other properties in the metro — one in Arcadia — we were intimately familiar with the submarket and equipped with a proven value-add strategy.



Graham

The Phoenix multifamily market remained one of the most resilient and sought-after rental markets in the nation throughout the pandemic. Rents are now up roughly 45 percent over pre-COVID levels, and occupancy is near 96 percent. The region consistently ranks as one of the top markets for business performance, job growth, livability and friendly culture. Although the Phoenix metro is projected to receive 27,000 new multifamily units over the next four quarters, only 291 units are slated for delivery in the Arcadia submarket. The need for high-quality multifamily housing will also remain strong for the foreseeable future as 30-year mortgage rates continue to rise and median single-family residential monthly mortgage payments in Arcadia hover above $5,600.

The current lender pool is now primarily made up of the agencies, Freddie Mac and Fannie Mae, in addition to banks and life insurance companies. Bridge lenders are still active, but at rates that are highly unattractive to many. Financing costs for bridge loans have also increased with both spreads and the SOFR index on which they lend. They have gone from roughly 4 percent to between 6 percent and 8 percent in today's market.

Many assume today's multifamily investors are "pencils down." A more accurate depiction may be that the current market volatility exceeds their comfort levels. As market volatility begins to settle, however, a strategy that involves consistent tracking and practical underwriting can allow investors to move forward when opportunities arise that appropriately reflect the increased cost of capital.

Derek Graham, Principal and Founder at Odyssey Properties Group in Hermosa Beach, Calif.