Economic Trends Favor the Multifamily Market

Rising rates, low housing inventory and a vibrant economy should propel demand for rental properties

By Adam S. Finkel

With a seemingly more hawkish Federal Reserve chairman, Jerome Powell, in place, coupled with a humming economy, many are anticipating a continued rise in interest rates. Some fear that will lead to higher cap rates for commercial real estate, lower property valuations, and an eventual slowdown in deal volume for the multifamily sector, which has been the favorite asset class for investors and lenders in recent years.

Contrary to popular belief, however, gradually rising interest rates are likely to continue strengthening the multifamily sector and also benefit investors with exposure to this asset class — along with commercial mortgage brokers who are involved in lining up financing. The single-family housing market has been in a slump and there is no sign of anything changing in the near term.

Rising interest rates, along with rapidly increasing construction costs, will continue to be headwinds for the owner-occupied housing sector in general, keeping the demand for rental housing strong. As interest rates climb upward, so do mortgage payments, making homes increasingly less affordable for consumers. This causes some would-be homeowners to remain renters for longer periods of time because they can no longer afford the home they want to purchase.

In addition, higher mortgage payments can negatively affect an existing homeowner's debt-to-income (DTI) ratio, making it more challenging for them to qualify for financing on their ideal home. DTI constraints have been especially prohibitive for a millennial generation saddled with more student debt than any other in history.

Housing-market constraints

A research paper published by Freddie Mac last year stated that the "increasing interest rate environments we identified are almost always accompanied by reductions in mortgage originations, home sales, and housing starts across the board." In addition, a tight supply of single-family homes has helped boost property values over the past several years, placing the dream of homeownership even further out of reach for many first-time buyers.

According to a recent report from the National Association of Realtors, the median price of a single-family home is $50,000 more than it was in 2016. Fewer home sales generally warrant lower levels of new construction, keeping supply constrained and encouraging values to remain elevated. Homebuilders are fighting increased costs of materials, along with shortages of qualified trade workers, with no immediate end in sight.

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In fact, delivery of new properties across all asset classes remains below historical averages, even as the overall population continues to grow. Conversely, owners of commercial real estate are benefiting from exceptionally low vacancy rates and increasing rents — especially in the apartment sector.

Cap-rate increases

It is common knowledge among mortgage brokers and many others in the commercial real estate industry that rising interest rates force cap rates higher. There are numerous studies published every year, however, that show no correlation between increasing interest rates and increasing cap rates, at least in the near-to-medium term. (This is not the case when looking at longer periods of time spanning several decades.)

In fact, rising interest rates often coincide with an improving economy, which tends to benefit real estate performance. Melissa Reagen, head of research for the Americas at TH Real Estate, an affiliate of Nuveen (the investment-management arm of TIAA) articulated it nicely. "If interest rates are rising because of stronger economic growth, as is currently the case, real estate demand will also likely be growing," Reagen said. "If interest rates are increasing gradually, and are likely to remain at, or below, long-term averages, as is currently expected, real estate would likely be well positioned to benefit in such an environment."

Even if (or when) cap rates do begin to drift upward, the effects will likely be lessened from increased rent and net operating income (NOI) growth. Mathematically, a 5 percent growth in NOI will offset a 25 basis-point increase in the cap rate to maintain the same property value. A property with $1 million in NOI priced at a 5 percent cap rate, for example, offers a value of $20 million. If the NOI grows to $1.05 million and the market cap rate increases to 5.25 percent, the property still holds its $20 million value.

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Demographics and financing

Positive demographic trends and consumer tastes have had, and will continue to have, a significant impact on the multifamily market. The estimated 75.4 million millennials as of April 2016 are now the largest generation in U.S. history, eclipsing the baby boomers by half a million people, according to U.S. Census Bureau data.

The millennial generation, based on the Pew Research Center's definition, includes those born between 1981 and 1997. They are now hitting their peak spending and consumption years. They are holding off on marriage, having kids later in life and moving more frequently than past generations, all of which leads to a propensity to rent.

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On another front, despite murmurs of possible moves to change how government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac are structured and operate, the gridlock in Washington, D.C., has proved challenging to garner any kind of momentum leading to actual legislation. This past November, the Federal Housing Finance Agency (FHFA) announced that multifamily lending caps for Fannie Mae and Freddie Mac will be set to $35 billion for each agency in 2019.

Furthermore, loans for properties meeting certain affordability or energy-savings metrics, will be applied toward the agencies' uncapped production. These parameters are intended to further the strategic goal of the FHFA, which is to provide liquidity for the multifamily market without hindering the participation of private capital. In addition, there has been an uptick in market participation by other lenders — including banks, credit unions, life insurance companies as well as alternative lenders like debt funds, which are mainly involved in financing unstabilized or transitional assets.

The U.S. economy has been strong, with consistently positive quarterly numbers. Unemployment is at its lowest level in decades and consumer spending is on the rise. These are the positive trends influencing the rise in interest rates, and they are headwinds that bode well for real estate sectors such as multifamily, industrial and office.

With the GSEs providing relatively cheap, nonrecourse financing, and other lenders becoming increasingly competitive in the multifamily space, the foundation is set for continued velocity in the apartment sector, which should keep investors and other finance professionals — such as commercial mortgage brokers — busy for the next few years. ■

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