Cap Rate Anxiety Dragging Down Multifamily Market

October 30, 2022 | Jarred Schenke, Bisnow Atlanta (https://www.bisnow.com/author/jarred-schenke-5711) (mailto:jarred@bisnow.com)

The Federal Reserve's move to quickly hike interest rates this year has injected a heavy dose of uncertainty into one of the most reliable commercial real estate investments over the past decade: multifamily.

Despite a national housing shortage that has driven historic rent growth (https://arbor.com/blog/top-u-s-multifamily-rent-growth-markets-q2-2022/#:~:text=Share%3A,quarterly%20growth%20rate%20on%20record) this year, lenders, developers and investors have paused deal-making because of the drastic change in the math underlying purchases and loans.

“We are one of those that are sitting on the sidelines because [of] pricing and the cap rates," said Vicki Lundy Wilbon (https://www.bisnow.com/tags/vicki-lundy-wilbon), the president of Integral Group (https://www.bisnow.com/tags/integral-group), an Atlanta-based mixed-income housing developer. "We’ve gotten to the point that it is not a time that we are eager and ready."

Multifamily sales transactions fell 17% in the third quarter nationally, according to data provided by MSCI, (https://www.bisnow.com/tags/msci) although they are still up 25% year-to-date over 2021.

Industry leaders said at *Bisnow's* Southeast multifamily conference in Atlanta this month that they are highly cautious about entering into new deals until they get a sense of where interest rates will top out. Inflation was still up more than 8% year-over-year as of September (https://www.bls.gov/cpi/), and another 75-basis-point increase is expected at the Fed's next meeting Nov. 1.

"We don't have clarity looking out six months," said Matt Lineberger, a regional sales manager at Lima One Capital. "I just don't think anyone in the marketplace does. I know you never do, but it's different right now because you don't really know how fast and where it lands."

The reversal in the capital markets was as swift as it was dramatic. Overall commercial real estate sales hit a record $809B last year, shattering the previous record of about $600B set in 2019, according to MSCI (https://www.wsj.com/articles/covid-19-fuels-best-ever-commercial-real-estate-sales-11643115601). The Mortgage Bankers Association predicted an even more active year in 2022 (https://www.bisnow.com/national/news/economy/commercial-and-multifamily-lending-may-surpass-1t-for-the-first-time-in-2022-111899).

As inflation hit 40-year highs and stayed elevated, the Fed embarked on a campaign of increases that took its benchmark rate from 0.25% in March to 3.25% today. Fed watchers expect the rate to eclipse 4% (https://www.bloomberg.com/news/articles/2022-09-16/fed-seen-raising-to-4-in-2022-and-signaling-higher-for-longer?sref=xjLu1klR) by the end of the year.

“It's a lack of trust, because we were all told that this inflation is transitory (https://www.cbsnews.com/news/interest-rates-inflation-federal-reserve-transitory/) and it's going to kind of go away,” Bobby Khorshidi (https://www.bisnow.com/tags/bobby-khorshidi), president of short-term real estate lender Archway Capital, said at the event, which was held at the Hyatt Regency Atlanta. “And it was that belief that led to this sort of knee-jerk reaction in terms of how fast rates went up. So I already had trouble trusting politicians, and now it's even more."

The Fed's actions are impacting buildings' capitalization rates, or the expected rate of return on a real estate (https://www.investopedia.com/terms/c/capitalizationrate.asp) investment.

While cap rates remain below pre-pandemic levels of more than 4%, reaction to market volatility and higher borrowing costs pushed cap rates by 72 basis points over the past six months, CBRE reported (https://www.cbre.com/insights/briefs/investors-tighten-underwriting-for-prime-multifamily-assets-more-slowly-in-q3).

The fluctuation in cap rates is causing buyers to second-guess the price they're willing to pay for apartments, especially with lenders being more aggressive on their underwriting on both rent growth and capital expenditure projections, panelists said.

"We're still seeing that the market has a lot of price discovery going on," said Brett Duke, the chief operating officer for Dallas-based apartment developer and investor Atlantic Pacific Real Estate Group.

Investors who paid for apartments at historically low cap rates over the past year will likely have to hold onto their assets longer, which opens the door for life insurance companies and big pension funds to buy more in the sector, said Rod Mullice (https://www.bisnow.com/tags/rod-mullice), managing partner with Atlanta-based Windsor Stevens Holdings, which has been pivoting to developing for-sale townhomes in Atlanta.

"I think of deals you need to hold [will be] five-plus years," Mullice said. "The real estate private equity market, who you know has to return money to their investors in five years, may not be the best partner. Now life insurance companies may be the best partner, single-vehicle pension funds may be the best partner."

Interest rate hikes have had a chilling effect on housing overall. While the U.S. economy grew by 2.6% in the third quarter, residential investment fell by 26%, according to the Bureau of Economic Analysis (https://www.bisnow.com/national/news/economy/us-gdp-makes-an-upward-turn-cre-still-facing-serious-challenges-116061). Apartment demand fell by more than 82,000 units in the third quarter, according to RealPage (https://www.realpage.com/analytics/us-apartment-demand-plunges-3rd-quarter/), the largest drop in demand in the firm's database, which spans 30 years.

But not everyone has been sitting on the sidelines in the current economy.

RADCO Cos (https://www.bisnow.com/tags/radco-cos). CEO Norm Radow (https://www.bisnow.com/tags/norm-radow), who leads one of the Southeast's most prolific commercial real estate investment firms, said his past couple of apartment purchases were done using floating-rate debt since no banks were willing to give fixed-rate loans.

Radow said he believes the Fed will reverse the interest rates in the near future, so he is willing to take short-term pain and refinance when rates fall back to earth.

“The minute inflation looks like it’s under control ... treasuries go back to where they were in July,” he said. “So I think that we’re looking at perfect timing with the lease-up finish for the year. I'm willing to go negative for a year knowing I've got such a good value. I will just capitalize that negative interest carry for that period of time.”

Even though there is concern that the Fed will keep interest rates elevated to ensure inflation can reach its target range of 2%, Portman Residential (https://www.bisnow.com/tags/portman-residential) Vice President Brittani Sanders said she thinks the cap rate increase will be a short-term problem.

“It’s extremely hard to guess where cap rates are going to be, but at the same time, we do believe that this is going to be relatively short-lived, so I think you just have to fight really hard to get your deals capitalized and to get them out of the ground,” she said. “I do think you’re going to start to see movement probably towards the middle or the latter end of next year. You’ve just got to be ready to position yourself to, once things do open back up, to hit the ground running, to be the first to deliver.”

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