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Underwriting Assumptions Stabilizing for Prime Multifamily Assets

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For the first time since the Fed began raising interest rates in early 2022, underwriting assumptions for prime multifamily assets are beginning to stabilize. The average multifamily going-in cap rate increased by 23 basis points (bps) to 4.72% in Q1 2023. This follows increases of 39, 36 and 38 bps in the three preceding quarters and marks the first significant quarterly deceleration in cap rate expansion since the Fed began its latest round of rate hikes. Similarly, other metrics such as unlevered internal rate of return (IRR) targets, exit cap rates and rent growth also decelerated in Q1.

Figure 1: Historical Summary of Buyer Valuation Underwriting Survey for Prime Class A Multifamily Assets

Quarter	Survey Conducted	Asking Rent ($/SF/PM)	Average Annual Rent Growth Underwriting First 3 Years (%)	Unlevered IRR Target (%)	Going-in Cap Rate (%)	Exit Cap Rate (%)	Holding Period (Years)	Spread between going-in and exit cap rates
Q2 2019	July 2019	3.83	2.7	6.07	4.20	4.85	9.0	65
Q3 2019	October 2019	3.86	2.7	6.05	4.20	4.83	9.0	63
Q4 2019	January 2020	3.96	2.7	6.03	4.16	4.74	9.0	58
Q3 2020	October 2020	3.80	1.8	5.98	4.07	4.67	9.3	60
Q4 2021	January 2022	4.14	4.4	5.77	3.40	4.18	8.8	78
Q1 2022	April 2022	4.25	4.5	5.79	3.37	4.13	8.9	76
Q2 2022	July 2022	4.43	4.3	6.05	3.76	4.43	8.9	67
Q3 2022	September 2022	4.45	3.6	6.39	4.12	4.63	8.6	52
Q4 2022	December 2022	4.46	3.1	6.73	4.49	4.85	8.9	36
Q1 2023	March 2023	4.43	2.9	6.98	4.72	4.99	8.6	27
		%	%	bps	bps	bps	%	bps
Movement in Q2 2022		4.33	-0.2	25	39	30	-0.4	-9
Movement in Q3 2022		0.50	-0.7	35	36	21	-3.4	-15
Movement in Q4 2022		0.28	-0.5	33	38	22	3.5	-16
Movement in Q1 2023		-0.84	-0.2	26	23	14	-3.7	-9

Source: CBRE Research, Q1 2023.

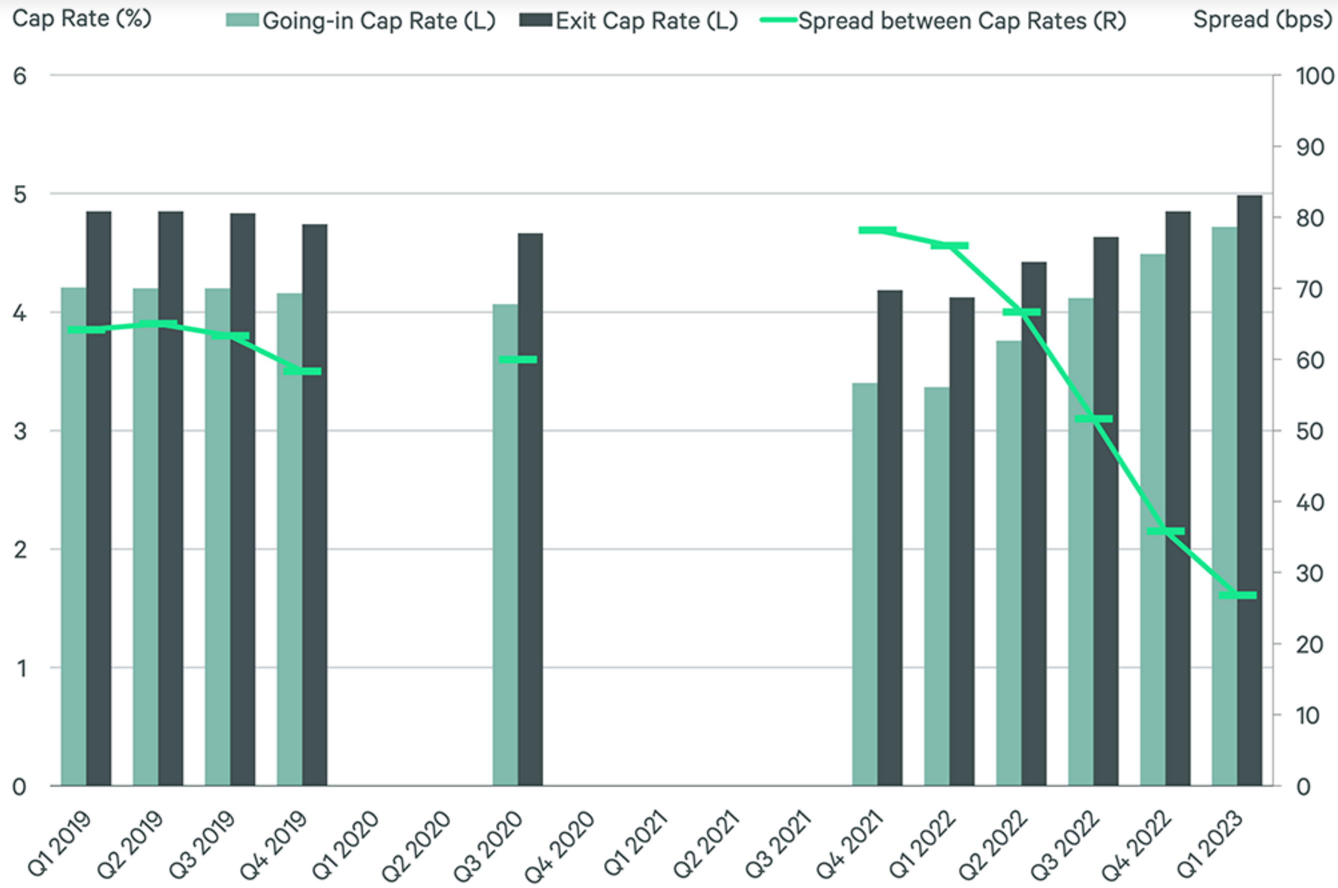
Note: Survey was not conducted for six quarters throughout the COVID-19 pandemic due to lack of trendable market activity and price discovery. Data in the above table is from the 10 most recent surveys.

Market	Submarket	Multifamily Subtype	Asking Rent ($/SF/PM)	Average Annual Rent Growth Underwriting First 3 Years (%)	Unlevered IRR Target (%)	Going-in Cap Rate (%)	Exit Cap Rate (%)	Holding Period (Years)
Austin	Downtown	High Rise	4.00	3.5	5.75 - 6.25	4.00 - 4.50	4.25 - 4.75	10
Boston	Downtown	High Rise	5.95	3.5	6.50	4.25	4.75	7 - 10
Seattle	Downtown	High Rise	5.00	3.5	6.50 - 6.75	4.25	4.50	7 - 10
Philadelphia	Center City	High Rise	4.25	3.0	6.25 - 7.00	4.75 - 5.25	5.00 - 5.50	7 - 10
Chicago	River North	High Rise	4.35	3.5	6.50 - 6.75	5.10 - 5.35	5.00	7
Houston	Inner Loop/Uptown	Mid Rise	2.38	3.0	6.50 - 7.00	4.75 - 5.00	5.00 - 5.25	5 - 7
Miami	Downtown/Brickell	High Rise	3.50	3.0	6.75 - 7.00	4.50 - 4.65	5.50 - 5.65	7 - 10
New York	Manhattan	High Rise	7.50	3.5	7.00	4.75 - 5.00	4.50 - 4.75	10
San Francisco	South of Market	Mid Rise	5.22	2.5	6.50 - 7.50	4.75 - 5.25	5.00 - 5.50	10
Washington, D.C.	West End	High Rise	5.05	3.0	7.00 - 7.50	5.00 - 5.50	5.00 - 5.75	7 - 10
Atlanta	Midtown	High Rise	3.52	2.0	7.00 - 7.75	4.50 - 4.75	4.75 - 5.00	7 - 10
Dallas	Intown Dallas	High Rise	3.99	0.9	7.00 - 8.00	4.25 - 4.50	4.50 - 5.00	7 - 10
Denver	Downtown	High Rise	3.45	3.0	7.50	4.25 - 4.75	4.75 - 5.00	5 - 10
Los Angeles	West Los Angeles	Mid Rise	5.00	2.5	7.50	4.50 - 5.25	5.50	7 - 10
Phoenix	South Scottsdale	Mid Rise	3.25	2.00 - 4.00	7.50 - 7.75	4.75 - 5.00	4.75 - 5.00	10
Average			**4.43**	**2.9**	**6.98**	**4.72**	**4.99**	**8.6**

Source: CBRE Research, Q1 2023.
Note: The statistics are estimates of current buyer underwriting assumptions for the highest-quality asset in the best location of a particular market. The quoted prime rents reflect the level at which top-tier relevant transactions are being completed. Estimates are based on the expert opinion of local CBRE investment professionals.

Since Q1 2022, the average going-in cap rate has expanded by 136 bps to 4.72% and now eclipses the pre-pandemic average by 51 bps. Though further expansion is expected, underwriting assumptions for prime multifamily assets will likely peak in the second half of 2023. Even as expansion for going-in cap rates has been more dramatic than exit cap rates, a positive spread has remained between both, though the margin is slimmer than ever at 27 bps.

Figure 3: Historical Comparison of Going-In & Exit Cap Rates

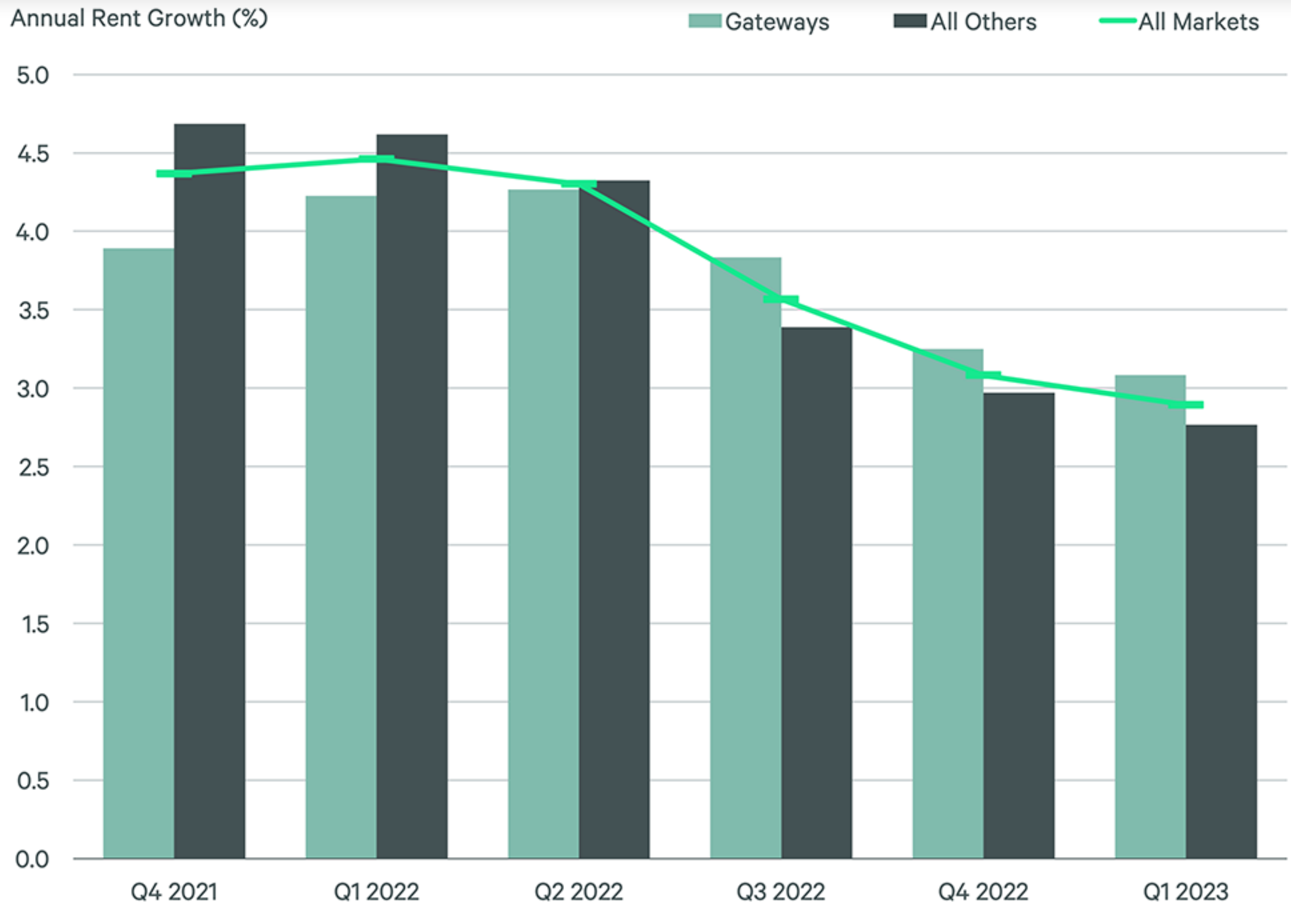


Source: CBRE Research, Q1 2023.

Note: Survey was not conducted for six quarters throughout the COVID-19 pandemic due to lack of trendable market activity and price discovery.

Underwriting assumptions of annual rent growth for the first three years of prime multifamily deals have also declined over the past two quarters. The types of markets driving rent growth appear to have changed. Gateway markets now have higher average rent growth expectations, as opposed to early 2022 when all other markets had higher rent growth assumptions. Though gateway markets suffered the most during the pandemic because of outmigration, some such as Boston and New York have bounced back strongly as people return. The long-run average for rent growth assumptions is approximately 3%, slightly higher than the 2.9% expected as of Q1 2023. As markets stabilize, rent growth assumptions likely will drift lower but eventually settle near the long-run average.

Figure 4: Average Annual Rent Growth Underwriting First 3 Years (%)



Source: CBRE Research, Q1 2023.

Multifamily investors remain cautious in the current environment, though many markets are seeing little additional degradation of their fundamentals. Once interest rates stabilize, there should be an increase in activity by buyers, sellers and lenders.

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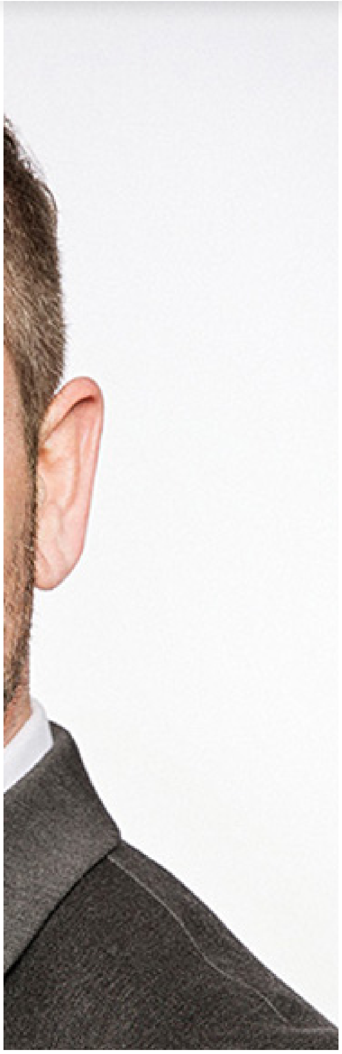

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