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Investors Search for Value-Add, Secondary Markets: Is the Era Over?

Investor demand for multifamily assets has been insatiable in recent years, culminating in record-high property sales and prices in 2021. Yardi Matrix tracked $215 billion of U.S. multifamily property sales in 2021, trading for an average of $192,100 per unit, both all-time highs. In past cycles, frenzied transaction activity has portended bubbles that were burst by downturns. Which leads to a question: Are we headed for another crash?

The past never repeats itself exactly. Unlike some previous cycles, pricing growth in recent years has been accompanied by record-high rent increases. To determine whether today's high prices are justified by income growth, we analyzed repeat sales over the last decade in Matrix's database of 83,000 properties. We found 4,500 multifamily properties in the U.S.—about 5.3%—sold at least three times over the last decade. The compound annual growth rate (CAGR) for the repeat-sale properties averaged 17.7% nationally. The study showed:

- Rents rose rapidly during the cycle, but not as much as price appreciation. Multifamily rent growth in 2021 was unprecedented—up 14% for the year, per Yardi Matrix—but rent growth has been above the long-term average for at least a half-decade (other than 2020 during COVID-19 lockdowns).

- Investors will pay a premium for strategically located value-add properties. Investors were laser-focused on secondary markets and areas with strong in-migration—particularly Texas, the Southeast and Southwest—where demand and rent growth are increasing faster than the rest of the nation. Relatively few properties in gateway markets made the list of repeat sales, in part because acquisition yields in those markets are already high and provide less room for upside.

- Investors' sweet spot appeared to be smaller assets geared toward working-class residents that have the potential for high rent growth because those properties have relatively low rents and are in markets with above-trend rent growth.

To be sure, the study does not purport to reflect the entire multifamily market. Properties held for the short term and sold repeatedly are skewed to B/C-quality assets since high-quality assets with stable cash flows are more likely to be bought by investors to hold for the long term. Nonetheless, there is value in understanding investor demand and pricing trends.

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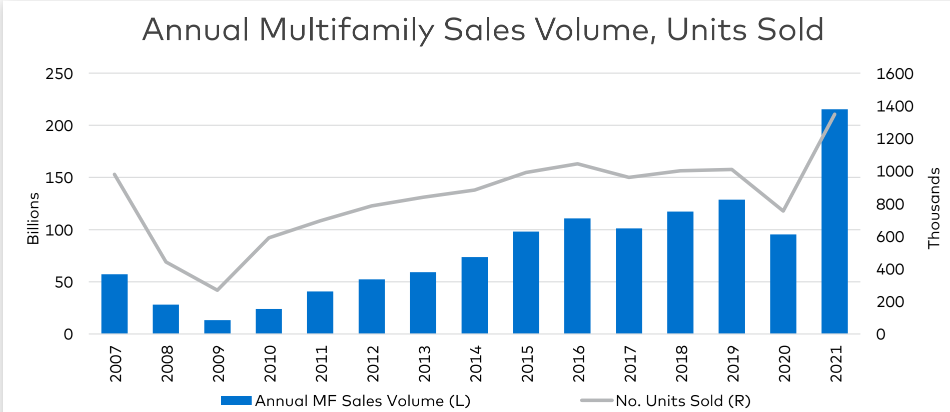
Era of Rapid Growth

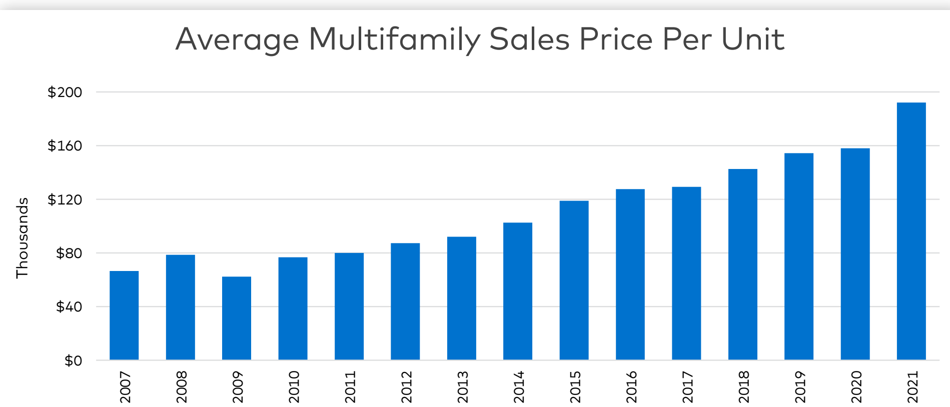


Source: Yardi Matrix

Investment in multifamily has grown steadily since the Great Recession, fueled by the sharp increase in capital, as investors look for assets with stable cash flows, high dividends and prospects for yield. Transaction activity bottomed at $13.3 billion in 2009 and increased steadily to a new high of $128.7 billion in 2019. After a one-year pandemic-related decline to $95.5 billion in 2020, deal flow roared back in 2021 to a record $215.3 billion, a 67.3% increase from the prior high point in 2019 (all data cited is from Yardi Matrix, which tracks properties with 50 or more units in 162 markets). Last year also set new high-water marks for the number of properties sold (6,488) and the total number of units traded (1.34 million).

Pricing has also been growing rapidly. After bottoming at $62,344 in 2009, the average price per unit has increased each year, making a big jump to $192,105 in 2021. The average price per unit climbed 21.6% in 2021, the biggest one-year such move in decades.

The rapid growth in pricing reflects a combination of factors: the exceptional amount of liquidity in real estate and multifamily, the extremely strong rent growth, the low cost of financing as interest rates bottomed and debt costs were near historical lows, and the optimism about the sector's prospects in the next few years. The extraordinary movement in pricing is likely to be threatened going forward by the increase in interest rates and questions about the economy, which have already prompted a slowdown in investment activity and will likely end the period of appreciation.



Source: Yardi Matrix

Capital Migrates to Southeast, Southwest

To get an understanding of where and how investors spend their money, we searched the sales history of 83,605 properties in the Matrix national database, examining the period between January 2012 and December 2021, corresponding with the recovery from the recession. All told, more than 4,500 properties were sold at least three times. Two assets changed ownership seven times during the period, nine properties sold six times, and 58 properties traded five times.

By location, the clear winner when it came to repeat sales was the South, where 1,858 properties were sold three or more times. The top two metros on the list were Dallas (366 properties) and Atlanta (324 properties). Investors are motivated by the potential growth of low-cost and business-friendly markets in the Southeast and Southwest, and are voting with their wallets. Texas, Florida and Arizona have led the country in in-migration for decades, trends exacerbated by the pandemic.

Market	# Properties Sold	CAGR
Dallas	366	17.1%
Atlanta	324	21.0%
Phoenix	219	20.9%
Houston	192	16.3%
San Antonio	89	9.5%
Tampa	81	16.0%
Charlotte	75	18.1%
Jacksonville	74	16.4%
Denver	73	13.0%
Raleigh	72	12.5%
Las Vegas	69	19.8%
Orlando	67	16.9%
Austin	67	12.8%
Miami Metro	51	13.6%
Greenville	45	18.5%

Source: Yardi Matrix

Texas claimed three of the top five metros for the most repeat sales, with Houston (192) and San Antonio (89) joining Dallas. Rapidly growing Phoenix was third with 219 repeat sales. By state, the story was much the same, with Texas (571 properties), Georgia (390), Florida (328), Arizona (251) and North Carolina (190) in the top five.

Of the seven Matrix gateway markets, only Miami (51 properties) and Los Angeles (36) were in the top 20 in repeat sales, even though these metros have the largest number of properties. Only 85 properties in the Northeast traded three or more times during the last decade. There could be different reasons for the lack of repeat sales in the gateways and the Northeast. Acquisition yields in those locales are, on average, lower, providing less potential for the outsize returns sought by value-add investors. What's more, rents are already relatively high, providing less room for above-trend rent growth.

High-cost coastal states with gateway metros such as California and New York have long had negative domestic migration, a woe worsened by the pandemic. Service workers who lost jobs in the early stages sought more affordable housing, and retail and hospitality have yet to fully recover. Gateway markets also have lost knowledge workers who are taking advantage of work-from-home policies to work remotely in the suburbs or other metros entirely.

Value-Add Bent

To get an idea about pricing, we calculated the annual growth rate for each property sold three or more times, and broke it down by property size, quality and location. There was a clear trend of higher CAGR for smaller, relatively lower-quality properties, with a very weak correlation to metro or region. Higher growth was related to properties with value-add qualities—apartment buildings that could be renovated, rents increased and then quickly resold.

Yardi Matrix's database places properties in five quality categories. The top two—discretionary and upper-mid-range—are referred to as Lifestyle, generally higher-quality properties with renters who could afford to buy homes but prefer to rent. The other three categories—lower mid-range, workforce-upper and workforce-lower—are part of the Renter-by-Necessity (RBN) grouping, generally properties that are older or in less favorable locations than Lifestyle. More than three-quarters of the properties sold at least three times during the last decade are categorized as RBN. The CAGR of repeat-sale RBN properties was 20%, as opposed to 11% for Lifestyle properties.

CAGR by Unit Size, Lifestyle

# Units in Building	CAGR
Total	11.3%
0-99	9.9%
100-149	13.4%
150-199	13.0%
200-249	10.8%
250-299	11.3%
300-349	10.0%
350-399	10.6%
400+	11.3%

Source: Yardi Matrix

CAGR by Unit Size, RBN

# Units in Building	CAGR
Total	19.6%
0-99	19.9%
100-149	24.2%
150-199	18.9%
200-249	18.0%
250-299	17.0%
300-349	17.4%
350-399	17.4%
400+	16.0%

Source: Yardi Matrix

The study also found that returns declined as property size increased. RBN properties with fewer than 150 units had a CAGR of more than 20%, while the CAGR of properties with 400-plus units was 16.0%. The trend was less pronounced in Lifestyle properties, but the highest CAGR in that category (13.4%) was in buildings with 100-199 units, while properties with more than 200 units had CAGRs in the 10-11% range.

CAGR by Property Size

No. of Units	CAGR	No. Buildings
0-99	19%	574
100-149	23%	483
150-199	18%	389
200-249	16%	404
250-299	15%	275
300-349	14%	202
350-399	15%	165
400+	14%	257

Source: Yardi Matrix

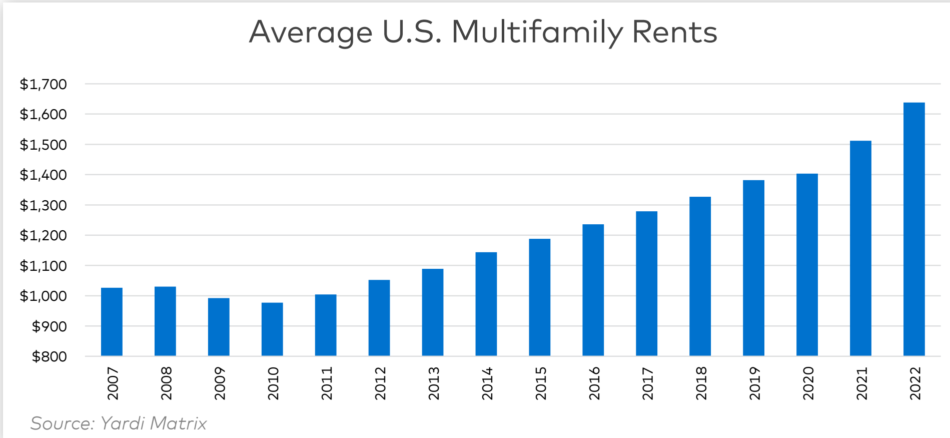
Regionally, the Midwest (21.8%) had the highest CAGR for repeat sales and the Northeast (15.1%) had the lowest, but in both cases the sample size was small. CAGR by metro was also inconsistent because of the huge disparity in property sales. Among metros with 20 or more repeat property sales, Cincinnati (28.4%) had the highest returns, followed by Pensacola, Fla. (23.9%). Among major metros, Atlanta (21.0%) and Phoenix topped the list for CAGR. States with the highest average CAGR were Ohio (28.1%), Georgia (25.9%) and Michigan (23.6%). Only 12 New York City properties sold at least three times, for a 16.2% CAGR.

CAGR by Region

Region	CAGR	# Buildings
South	18.2%	1858
West	17.8%	629
Midwest	20.8%	177
Northeast	15.4%	85
National	17.7%	

Source: Yardi Matrix

Is the Market Too Frothy?



Multifamily has benefited from a surge in investment capital, as investors of all stripes have increased allocations to commercial real estate. Multifamily and industrial have been the main beneficiaries of that capital inflow, along with some niche sectors such as self-storage, single-family rentals, student housing and data centers.

The competition for assets has pushed acquisition yields of stable and well-located properties to drop to all-time lows, with high-quality multifamily properties trading in the 3% range and the average capitalization rate about 4.5%. That has led many investors to a value-add strategy, buying older properties that can be renovated and rents raised, which is demonstrated by this report.

Has the market has become too frothy, as in 2005-07, before the global financial crisis? The rapid growth in prices is a parallel, but there are differences. For one thing, property-level leverage is nowhere near as aggressive as it was in the mid-aughts. Another difference is that before the financial crisis, deals were underwritten with large pro-forma rent increases and optimistic exit capitalization rates. Rent growth today is much stronger than in past cycles. The average U.S. multifamily rent has grown 28% since 2017 and 54% since 2012.

Even so, prices have grown much faster than rents. The average sales price per square foot of properties in our repeat sales study grew 51% since 2017 and 120% since 2012. The tight pricing was in part aided by the long-term downward slide of interest rates, which reduced borrowing costs to historical lows in 2021. Multifamily loan coupons generally were between 2.5% and 4% in 2021 through early 2022. The average cap rate of apartments in the institution-dominated NCREIF Property Index was 4.0% as of 1Q22.

Now, however, the 10-year Treasury rate is up significantly: It was just over 3% in early May after being below 2% through most of 2020 and 2021. Borrowing costs have increased commensurately, with most mortgage coupons between 4% and 6%, depending on leverage, sponsor and terms. The Federal Reserve is expected to continue to raise rates throughout the year to curtail decades-high inflation, so rates are likely to move higher rather than lower.

Property transactions have slowed as investors and sellers take in the new landscape. In some cases, buyers that had planned to use leverage of 70% or more are finding that financing is drying up. Anecdotally, acquisition yields have yet to move more than marginally, but movement is inevitable given the increasing cost of capital and uncertainty about future economic growth.

History has shown that investors' perception of future rent growth is a bigger driver of the direction of acquisition yields than interest rates. In other words, if investors believe rents will continue to grow at recent robust levels, they will keep buying at low yields with a lower premium over Treasury rates. But today's economy seems poised for slower growth with a not-insubstantial chance of recession over the next two years due to inflation, rising energy prices and the war in Ukraine, which could dampen investor sentiment about future rent growth at the same time the cost of capital rises.

Given that leverage levels in recent years have remained relatively conservative compared to the period before the global financial crisis and the supply-demand imbalance in the U.S. housing market has produced extremely high occupancy rates, multifamily has good prospects relative to other segments of the economy and real estate. Even so, there are enough red flags that investors should take the possibility of a downturn seriously and underwrite debt and equity with caution.

—Paul Fiorilla, Director of Research, Yardi Matrix, and Anca Gagiuc, Senior Associate Editor

Appendix: Examples of Properties Traded Multiple Times

Individual properties with the highest frequency of sales over the last decade illustrate the trends suggested by the data. Looking at the top 10 assets in this ranking, we noticed another (predictable) finding. All of them are value-add opportunities built between 1964 and 1986 in stable markets with moderate to high liquidity: Phoenix (three), Dallas-Fort Worth (three), Atlanta (three) and Winston-Salem-Greensboro, N.C. (one). Some of the most-sold assets include:

- Urban 128 in Phoenix was sold seven times. The vintage-1986 asset filed for bankruptcy in the wake of the Great Recession in 2010 and was sold for $1.1 million, or $8,594 per unit, a 75% discount from its 2005 sales price. The property sold in 2012 for nearly $1.6 million, or $12,156 per unit. In 2019, it was sold for $8.7 million, or $68,164 per unit, a 461% increase over seven years. Occupancy at the 128-unit property was 91.1% in 2022, but it was as high as 99.3% in 2018. The average asking rent has increased 70.8% since 2018.
- The 93-unit Pines of Southlake in Atlanta also traded seven times over the last decade. The 50-year-old property was sold for $1.45 million after defaulting on its debt in 2012. The buyer, a Wells Fargo Bank partnership, immediately resold it to a private investor for nearly $1.2 million, or $12,887 per unit. The property's most recent sale was in 2019, when it traded for $10.5 million, or $112,903 per unit, appreciating by 472% over the decade. Occupancy stood at 95.7% in April 2021. The asking rent increased by 61.3% between 2018 and 2022.
- Regency 59 is a 58-unit property built in 1963 that was sold six times during the last decade. During that time, the sales price increased from $630,000 ($10,862 per unit) in 2012 to $4.7 million ($80,460 per unit) in 2021, up 567%. Occupancy has hovered between 60% and 70% since 2018, likely due to its location close to a highway. Rents at the property increased by 52.7% between 2018 and 2022.

CAGR by State

State	Repeat Prop Sales	CAGR
Ohio	48	28.1%
Georgia	390	25.9%
Michigan	22	23.6%
Arkansas	21	21.2%
Arizona	251	20.8%
Nevada	73	19.6%
Alabama	66	17.3%
Virginia	35	16.9%
Florida	328	16.8%
South Carolina	102	16.7%
California	135	16.1%
Tennessee	73	16.0%
Indiana	30	15.6%
Missouri	26	15.6%
Texas	571	15.4%
Delaware	2	15.4%
North Carolina	190	15.1%
Kansas	18	14.7%
Utah	4	14.2%

State	Repeat Prop Sales	CAGR
Washington	47	14.1%
Iowa	2	14.1%
Oregon	19	13.9%
Idaho	3	13.7%
Colorado	91	13.7%
New York	18	13.6%
Illinois	23	12.4%
Kentucky	29	12.0%
Oklahoma	37	11.8%
Rhode Island	1	10.7%
Minnesota	8	9.5%
Louisiana	12	8.3%
Mississippi	4	8.0%
Maryland	23	7.6%
New Mexico	6	7.6%
Pennsylvania	10	7.4%
New Jersey	15	7.1%
Massachusetts	7	6.9%
Connecticut	9	1.8%

Source: Yardi Matrix

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