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Multifamily Investor Demand To Continue Evolving in 2023

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Multifamily transaction activity slowed sharply in the second half of 2022, though perhaps not as much as feared, while investor demand continued to gravitate toward the Sun Belt.

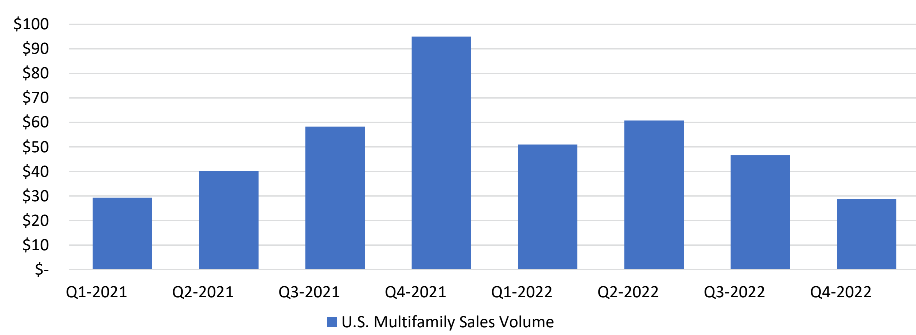
Those trends are continuing into 2023. Deal flow is stalled by pricing uncertainty and multifamily investors are increasingly focused on markets with growth in jobs and population. Whether and how much deal flow picks up in 2023 will depend to a large degree on stability in the capital markets.

U.S. multifamily sales totaled $187.0 billion in 2022, down 16.1% from $222.9 billion in 2021 (all data cited comes from Yardi Matrix's database). Despite the decrease, 2022's transaction volume was the second-highest annual total ever. Sales activity became more difficult as 2022 unfolded and the Federal Reserve pushed short-term interest rates up by 400 basis points, including an unprecedented four straight months of 75-basis-point increases. The Fed's actions produced a sharp rise in commercial mortgage rates, which have a significant impact on pricing.

The impact on transactions was apparent in quarterly activity. First-half volume totaled $111.7 billion—$50.9 billion in the first quarter and $60.8 billion in the second quarter—and then volume decelerated to $46.6 billion in the third quarter and $28.7 billion in the fourth quarter.

Investor demand was so strong that the market was on pace for another record year before the capital markets disruption. First-half 2022 volume was 60.4% above the first half of the 2021 record year. But volume in the second half of 2022 was 51.8% below the same period in 2021, with fourth quarter 2022 volume 70% below 4Q 2021.

Multifamily Sales Drop in Second Half 2022



Source: Yardi Matrix

Rising mortgage rates—which have increased since 1Q 2022 by roughly 200 basis points for fixed-rate loans and more than 400 basis points for floaters—have led to an increase in capitalization rates, which in turn has pushed property values down by 15-25%. The pricing uncertainty has created a large bid-ask spread between buyers, who are taking higher financing costs and projections of an economic downturn into account, and sellers, who are loath to accept what they perceive as a discount.

Capital Flows to Sun Belt

The flow of capital continues to trend toward the Sun Belt, which captured the top six metros for sales volume in 2022. Atlanta led metros in multifamily transaction volume in 2022 with $11.4 billion, followed by Phoenix ($10.5 billion), Dallas ($10.1 billion), Houston ($9.7 billion), Miami ($6.6 billion) and Orlando ($6.2 billion). Each metro is in a state that has recorded above-trend population growth in recent years, a trend exacerbated by the growth of post-pandemic work-from-home practices.

2022 Multifamily Transactions by Region

Region	Sales Volume	YoY % Change
Midwest	$16,485.19	10.6%
Northeast	$22,485.60	18.0%
Southeast	$71,169.36	-20.3%
Southwest	$41,097.49	-23.5%
West	$35,741.55	-22.1%

Source: Yardi Matrix

Secondary and tertiary markets accounted for $153.0 billion of apartment sales in 2022, compared to $34 billion in gateway markets (New York, Boston, Washington, D.C., Miami, Chicago, Los Angeles and San Francisco). On a year-over-year basis, gateway market sales declined only 7.6%, compared to -18.4% for secondary and -16.1% for tertiary markets.

2022 Multifamily Transactions by Market Type

Market Type	2022 Volume	YoY Change
Gateway	$33,964.46	-7.6%
Secondary	$111,503.74	-18.4%
Tertiary	$41,510.99	-16.1%

Source: Yardi Matrix

On a regional level, sales were highest in the Southeast at $71.2 billion, followed by the Southwest ($41.1 billion), West ($35.7 billion), Northeast ($22.5 billion) and Midwest ($16.5 billion). However, the Northeast (18.0%) and Midwest (10.6%) saw activity rise in 2022 compared to 2021, while sales were down year-over-year by at least 20% in the Southeast, Southwest and West.

Multifamily investors are increasingly favoring markets that not only provide population and job growth but also have less political risk. Large coastal states have more areas subject to rent controls and are more likely to pass new laws that impact investors' bottom lines. Los Angeles, for example, passed a local ballot initiative last year that will create a new "mansion tax" of 4-5% on property transfers above $5 million. Sharp rent growth has made rent control a nationwide issue, even in Florida, where Orange County legislators passed a rent control measure. However, a Florida court invalidated the law, which remains on appeal.

Volatility Key to 2023

The investment market will start 2023 the way it ended in 2022, with relatively few deals. Buyers are cautious, facing higher financing costs and downgraded projections of future rent growth. Cap rates averaged 5.0% at year-end 2022, up from the low- to mid-4% range at the beginning of the year, per Matrix. Meanwhile, most apartment owners are holding on to properties unless there is a reason to sell, such as a death, the dissolution of a partnership or a capital event like a maturing mortgage that creates a need for restructuring.

Top 20 Metros by Sales Volume 2022

Metro	2022 Volume	YOY % Change
Atlanta	$11,364.14	-29.4%
Phoenix	$10,542.02	-23.6%
Dallas	$10,104.81	-33.7%
Houston	$9,742.51	-12.5%
Miami	$6,627.45	-30.5%
Orlando	$6,197.81	7.1%
New York	$6,034.61	218.2%
Washington DC	$5,968.96	-34.8%
Los Angeles	$5,867.94	8.1%
Denver	$5,096.39	-46.1%
Charlotte	$4,813.84	-9.9%
Seattle	$4,414.94	-3.4%
Tampa	$4,254.99	-19.5%
Nashville	$3,941.68	6.8%
Raleigh	$3,934.93	-26.7%
Chicago	$3,762.73	2.1%
Boston	$3,379.27	-7.7%
Philadelphia	$3,242.17	29.6%
Las Vegas	$3,093.24	-31.9%
Austin	$2,976.92	-35.8%

Source: Yardi Matrix

Indeed, the biggest question the market faces is not whether we will see more distressed assets but by how much distress will increase. Banks have become conservative with the prospect of a widely projected economic downturn, so borrowers are facing both rising rates and less leverage.

Scenarios that will lead to distress in 2023 include properties that were financed at historically low rates in recent years coming up for maturity at higher prevailing rates; properties whose interest rate cap has expired and are now facing a large jump in debt-service payments; and properties that have a downturn in performance.

Distress may be limited by the strong income growth of recent years and ongoing steady demand for apartments. Even so, value-add investors have raised tens of billions of dollars to take advantage of potential recapitalizations. Indeed, despite the sector's issues, many investors view multifamily as a safer place to park capital than other investment products or other commercial property classes such as office or retail.

Strong investor demand will provide some buffer for multifamily until market volatility declines. Surveys show market players expect capital conditions to improve in the second half of 2023, which would unleash more sales activity, but that is by no means certain. The 10-year Treasury rate has recently come down to 3.6% from its peak of 4.25% last fall, as bond investors expect the economy to weaken and the Fed to reverse its aggressive inflation stance. While lower rates would boost transactions by reducing mortgage costs, if rates decline because of an economic downturn, demand would likely weaken.

As most economic scenarios contain mixed blessings for deal flow, volatility may be the most critical factor for transaction activity. Transaction activity will pick up when market conditions return to some semblance of stability and market players believe they can underwrite with a higher level of certainty than exists today.

—Paul Fiorilla, Director of Research, Yardi Matrix

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