Yardi® Matrix

U.S. Multifamily Outlook

Summer 2023

Multifamily Rent Growth Positive, Slowing

Economy Headed for a Fall?

Higher Rates Vex Capital Markets

Yardi Matrix

Market Analysis

Summer 2023

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Multifamily Performance Strong Amid Flashing Yellow Lights

- Multifamily fundamentals remained healthy through the first half of the year, but doubts abound about the impact of interest rates on the economy and capital markets. Demand is holding up, fueled by ongoing robust job growth and strong consumer balance sheets. Yet the capital side of the industry is facing significant headwinds from higher mortgage rates.

- The economy continues to pump out jobs, despite the best efforts of the Federal Reserve, but for how long? Job growth is consistently ahead of consensus forecasts. Inflation is moderating but not fast enough to motivate rate cuts. Tightening bank credit signaled by the badly inverted yield curve will inevitably serve to cool growth in the second half of 2023.

- Rents resumed their upward climb in the spring as demand remains positive. We expect moderate 2.5% rent growth in 2023, with gains concentrated in Renter-by-Necessity units since affordability is a growing problem and new deliveries are focused on high-end Lifestyle units. Rapid growth in expenses is putting pressure on net operating income.

- New deliveries will be high through at least the end of 2024, as the 1 million units under construction come online. Deliveries should total 430,000 units in 2023 and more than 450,000 in 2024, with new supply concentrated in fast-growing Sun Belt metros. Starts are gradually declining because debt is more expensive and fewer banks are financing construction.

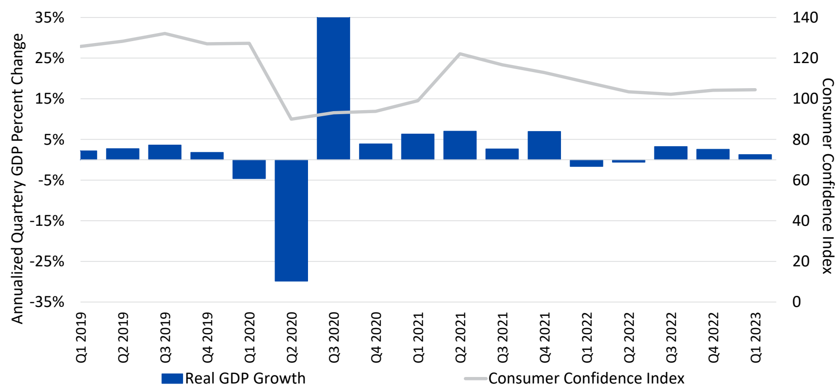
- Property values are down 15-20% from their peak and are still declining as the cost of capital has become significantly more expensive. Property sales halfway into 2023 are 70% below 2022 levels and will remain weak due to the uncertainty surrounding pricing, and the unwillingness of sellers to transact at new lower prices.

- The debt market is likewise struggling to cope with higher interest rates. Volume is down significantly, even among the government-sponsored agencies. Borrowers are resisting higher rates unless they have no choice. Defaults will rise over the next 24 months as owners attempt to refinance low-coupon loans at new higher rates.

Economy

The U.S. economy has been solid through the first half of 2023, especially such key metrics as job growth and consumer spending, but it often doesn't feel that way because commentary has been focused on inflation and possible downsides. Imminent recession forecasts have a "Waiting for Godot" quality because employment gains continue to surprise on the upside. Economic data coming out of the pandemic almost serves as a Rorschach test because interpretations vary so much. We expect economic growth to be weak in the latter part of 2023 and the first half of 2024 before rebounding in the second half of next year. We foresee flat to negative economic growth during that time, although at the same time the downturn should be shallow.

GDP Growth Slows, Consumer Confidence Steady



Source: Yardi Matrix; Moody's Analytics; U.S. Bureau of Economic Analysis

Seen in a vacuum, the employment numbers are stellar. The U.S. economy produced 1.6 million jobs through the first five months of 2023, 6.4 million since the beginning of 2022 and 25.7 million since the trough of the pandemic in April 2020, according to the Bureau of Labor Statistics. The unemployment rate has bumped along multi-decade lows in the 3.5% range. Yet those same numbers herald a tight labor market that has pushed inflation uncomfortably high.

There are several main reasons that growth is likely to cool, led by the tightening efforts of the Federal Reserve, which has raised policy rates by 5 percentage points since the spring of 2022 and is engineering a reduction in the money supply. That, along with the fragility of commercial banks in the wake of several high-profile bank failures, will begin to choke off credit, inevitably reducing economic activity. Commercial real estate is among the economic segments most affected, as transaction activity and mortgage originations have declined dramatically with the rate increases.

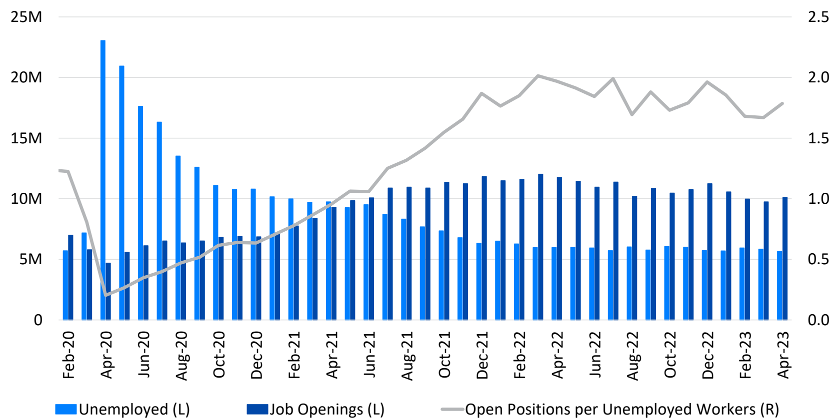
Another sign of a coming slowdown is the badly inverted yield curve, which has historically been an accurate harbinger of recessions because it correlates to tightening of credit. The yield on the 3-month Treasury bill has been higher than the yield of the 10-year Treasury for about eight months. The size of the gap, more than 1.5 percentage points, is extraordinarily high.

That the economy has resisted many typical recession signals is a testament to the strength of consumer balance sheets, which benefited from a huge amount of excess savings built up during the pandemic. Other positives for consumers include record-high home equity, low home mortgage rates in recent years that cut debt-service payments, and suddenly interest-bearing bank accounts. All these factors have enabled households to spend on consumer goods. However, the $2.5 trillion of excess savings built up has ebbed to under $1 trillion, and has mostly disappeared for lower-income households, which is likely to put a crimp on consumer spending in coming months.

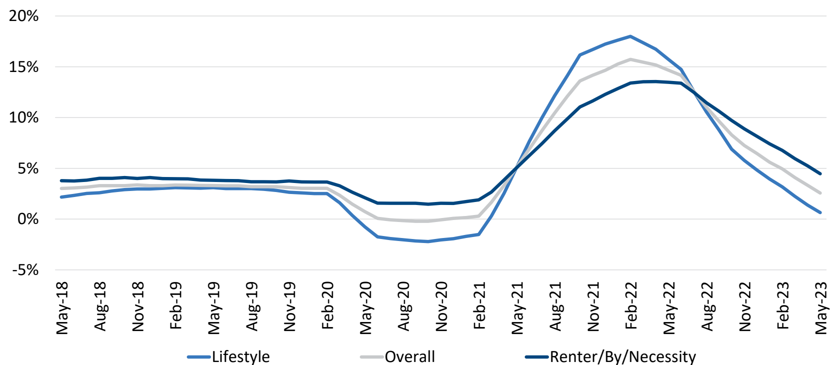
Despite our forecast of a slowdown, we expect it to be shallow based on several mitigating factors. For one thing, employment remains strong despite increasing job layoffs and job openings. Unemployment is likely to rise, but the increase will be tempered due to "labor hoarding." Many companies are coming off a period in which they found it difficult to recruit and retain workers, and they are cognizant of the long-term labor shortage in the U.S. stemming from declining birth rates and reduced immigration. Therefore, they will be reluctant to cut too many workers too quickly.

Consumer spending has kept pace with pre-pandemic growth forecasts, indicating that consumers will spend if they have jobs and feel confident about their own circumstances, even if surveys show they are pessimistic about the larger economy.

The economy's biggest roadblock is inflation, which is slowly receding. The consumer price index was 4.1% in May, down from 8.6% a year ago, but remains well above the Fed's 2.0% target rate. Housing and wage growth are decelerating, and energy prices are stable, so it appears the feared wage-price spiral will not materialize. However, Fed chair Jerome Powell has made it clear he won't cut rates until inflation is at the target rate. With so many mixed signals, interest rates are likely to remain in the 5% range for some time and the Fed is not likely to change policy until growth slows enough to break inflation.



Source: Yardi Matrix; Moody's Analytics; U.S. Bureau of Labor Statistics



Source: Yardi Matrix

Rents

Multifamily rents continued to increase through the first half of 2023, despite challenges that include slowing demand, growing issues with affordability, slower population growth and competition from a large amount of new supply. We anticipate that rents will continue to increase modestly over the course of the year as demand has firmed, albeit at a more moderate rate in line with historical growth levels.

Through the first five months of 2023, U.S. asking rents rose $17, or 0.9%, with year-over-year growth falling to 2.6%. We expect continued deceleration, with rent growth of 2.5% for the full year. The average U.S. rent reached an all-time high of $1,716 in May. Outsized gains that were seen on the metro level in recent years are a thing of the past. Among major metros, Central New Jersey is forecast to lead the nation in rent growth at 3.7%. Other large metros forecast to have the most rent growth in 2023 are Austin and Albuquerque (3.3%), Charlotte, Salt Lake City, Birmingham, Ala., and Tucson (3.2%) and Oklahoma City (3.1%).

Household formation, which drove the 22% cumulative growth in U.S. asking rents over 2021 and 2022, has slowed but remains positive. Households grew at a rapid rate after the pandemic as job growth boomed, young adults moved out of their parents' homes, and work-from-home prompted renters to form their own households to gain more living space for offices, children and pets. Although some pandemic demographic trends are moderating, the desire for more space that created household decoupling appears to have staying power which should drive apartment demand.

Multifamily demand is also boosted by the sharp drop in home sales, which keeps renters in apartments. Low in-place mortgage rates are discouraging homeowners from selling homes, keeping inventory low and single-family prices high. High mortgage rates also create an affordability hurdle for first-time buyers and middle-income families looking to trade up. Home mortgage rates rose to 6.5% in March 2023, up 230 basis points from March 2022, increasing monthly mortgage costs by 29% and raising ownership costs by 20%, according to the Harvard Joint Center of Housing Studies. The research shows that homeownership has become unaffordable to 2.5 million families.

2023 Forecast Rent Growth by Metro

Metro	Forecast 2023 Rent Growth
National	2.5%
Central NJ	3.7%
Austin	3.3%
Charlotte	3.2%
Salt Lake City	3.2%
Raleigh	3.0%
Nashville	2.9%
Indianapolis	2.9%
Baltimore	2.9%
San Jose	2.9%
Seattle	2.8%
Boston	2.8%
Kansas City	2.8%
New York	2.7%
Los Angeles	2.6%
Houston	2.4%
Miami	2.4%
San Francisco	2.4%
Wash D.C.	2.3%
Chicago	2.1%
Dallas	2.1%
Orlando	2.1%
Atlanta	2.0%
Denver	2.0%
Philadelphia	1.8%
Phoenix	1.5%

Source: Yardi Matrix

Regional migration that fueled an explosion of demand in Sun Belt states in 2020 and 2021 has slowed. The inflow to states such as Florida, Texas and Arizona by households looking for jobs and less expensive housing continues, but it has returned to levels more consistent with long-term trends. Metro-level rent growth is rotating out of some of the Sun Belt markets that produced the biggest gains during the pandemic. Recent year-over-year growth is the highest in markets where increases have been more consistent, including Indianapolis and Kansas City in the Midwest and New York City and Boston in the Northeast.

Supply growth is a factor in the regional shift in rent growth. Some of the fastest-growing markets such as Austin (17.1% increase in supply forecast by year-end 2024), Miami (14.2%), Raleigh-Durham (13.5%) and Charlotte (12.8%) are generating supply pipelines that will add more than 10% to stock in the next two years. While healthy demand will enable those units to get filled over time, the short-term impact will be strong competition for renters in the high-end Lifestyle segment. Data bears out this trend, as asking rents in Renter-by-Necessity properties rose 4.5% year-over-year through May but only 0.6% for high-end Lifestyle properties. The boom in new supply of Lifestyle units means this trend will continue for at least another year or two.

Rents will also be constrained by affordability, as a growing number of households are paying more than 30% of their income on rent. This can be addressed with more supply, but at the same time states and municipalities are passing rent control and limits to development that will backfire if allowed to be implemented.

Source: Yardi Matrix

Supply

The strong performance of multifamily and long-term need for housing has produced an unprecedented construction boom, as more than 1.0 million units were under construction in the first half of 2023. That total includes nearly 400,000 in the lease-up phase. The under-construction count is unusually high, in part due to elevated construction completion times, as projects are taking longer because of factors that include labor and material shortages and slowing municipal approval processes. The pandemic eroded the number of construction tradespeople. Workers who retired are often not being replaced because younger workers are less interested in construction trades than previous generations and immigration has declined.

Matrix expects 430,000 multifamily units to be delivered in the U.S. this year, an increase of 2.8% of stock. This new product represents a 15% increase over the 366,000 units (2.4% of stock) that came online in 2022. The increase in supply will put pressure on operators, but the impact will not be spread evenly across markets.

Deliveries will be focused in 10 to 15 of the fastest-growing markets. Metros expected to produce

the most deliveries in 2023 include Austin (22,310 units), Dallas (21,769), Miami (18,571), Atlanta (15,611), New York City (15,510) and Phoenix (13,592). Markets with the highest percentage increases in stock are concentrated primarily in the South and Southeast. Those include Austin (8.2%), Salt Lake City and Jacksonville (6.4%), Charlotte (5.8%), Raleigh-Durham (5.7%), Miami (5.4%) and Nashville (5.0%).

Concerns about the robust expansion of supply could be short-lived since growth is likely to slow after the current round of projects is completed. Tightening of bank lending standards—combined with rising costs of construction materials, labor and land—has made new projects harder to pencil. Construction debt starts at 8%, most senior lenders limit proceeds to 60% or less of total costs, and junior construction debt carries rates in the mid-teens. That puts a crimp on new projects for companies that don't come to the table with a significant amount of capital.

Even so, new construction activity has been relatively unaffected so far by the Federal Reserve's cycle of rate hikes. In the first quarter of 2023, Matrix identified 135,000 multifamily construction starts, the most for any first quarter since we started tracking the data. That comes on the heels of 581,000 starts in 2022, which was the most for any calendar year, and 514,000 in 2021.

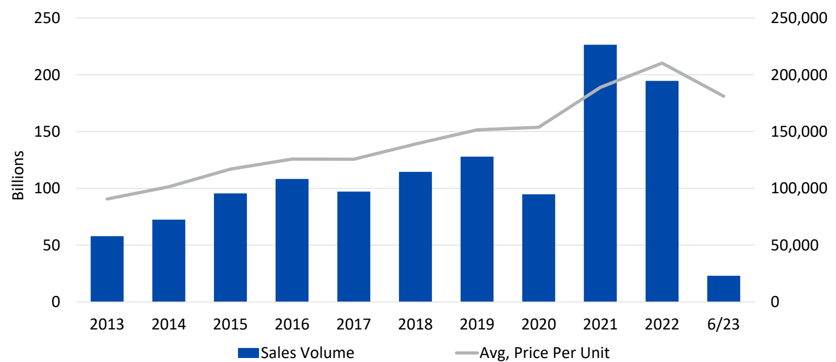
Although construction is extremely sensitive to pricing and availability of capital, many of the projects that are getting underway now have been in the works for a year or more. And while big-picture trends indicate a short-term glut of supply in some markets, many developers see strong fundamental drivers for their projects and are moving forward. Thus, starts may remain strong in coming months. Eventually, though, the high cost of debt and waning bank interest will lead to a reduction in starts.

2023 Forecast Supply Growth by Metro

Metro	2023 Forecast Deliveries	% Change	UC as of 6/23
National	430,975	2.8%	1,084,782
Austin	22,310	8.2%	60,557
Dallas	21,769	2.6%	57,986
Miami	18,571	5.4%	43,649
Atlanta	15,611	3.1%	39,633
New York	15,510	2.6%	38,842
Phoenix	13,952	4.2%	36,226
Houston	12,192	1.7%	32,265
Los Angeles	12,130	2.6%	32,617
Charlotte	11,768	5.8%	30,904
Wash D.C.	11,114	1.9%	31,391
Denver	10,795	3.5%	37,939
Raleigh	9,895	5.7%	28,674
Northern NJ	9,873	3.9%	26,147
Orlando	9,855	3.9%	26,666
Tampa	9,333	3.9%	16,695
Nashville	8,467	5.0%	23,489
Chicago	8,429	2.2%	14,447
Seattle	7,592	2.7%	27,906
Salt Lake City	7,349	6.4%	18,569
Jacksonville	7,280	6.4%	14,656
San Antonio	7,149	3.3%	16,166
Boston	6,957	2.7%	13,661
San Francisco	6,684	2.3%	18,304
SW Florida Coast	5,709	6.8%	12,043
Philadelphia	5,619	1.6%	18,377

Source: Yardi Matrix

Our baseline forecast also assumes that a mild downturn in the economy will serve to depress construction starts in the second half of 2023 through 2024. Starts could drop even more if the economy falls into a recession. For now, new supply completions will remain robust through 2024, and possibly another year or two beyond that.



Source: Yardi Matrix

Capital Markets

The capital markets, long the strength underpinning the multifamily market, are turning into an Achilles heel. Property fundamentals are strong, but the increase in capital costs has injected pricing uncertainty into the market and made it difficult to complete a transaction of any kind. Property sales and mortgage origination volume are both down sharply and distress is on the rise.

After the past two years of record deal volume, property sales are down dramatically, according to Yardi Matrix. Only $23.0 billion of sales were completed through mid-June, a pace that is about 70% lower than the $194.7 billion transacted during the full year in 2022 and even lower than the $226.5 billion recorded in 2021, Matrix research shows. After years of rapid increases, the average price per unit is dropping, as well. The average per-unit price of properties sold through May 2023 was $181,000, down more than 15% from the $210,000 average in 2022.

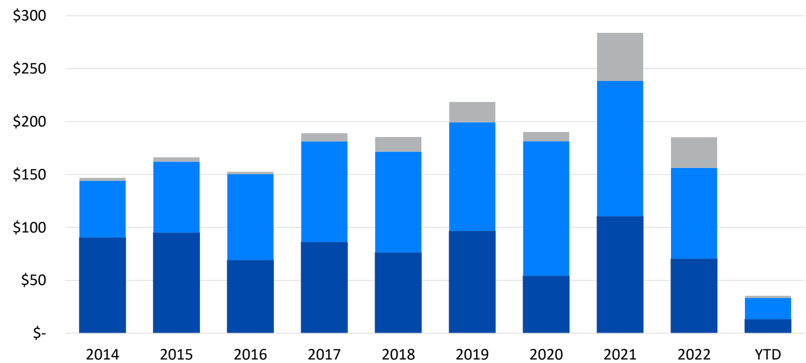
The biggest hindrance to deal flow is the rapid and steep decline in property values stemming from the increase in interest rates and slowing rent growth. With mortgage rates rising to 6-10% (depending on the term and rate type) from 3-5% before the Fed's rate hikes started, the 4-5% cap rates paid by most buyers in recent years no longer make sense. Capital for multifamily remains plentiful, but there is little clarity on what acquisition yields should be now. Buyers do not want to offer yesterday's prices and sellers do not want to sell at today's bids. Unless sellers have a compelling reason to sell, such as an ownership event or distress, most are sitting tight and waiting.

The same dynamic is true in the debt market. The high cost of debt has quashed most transaction activity and reduced demand. Most lender categories remain interested in multifamily originations, except for commercial banks that are consciously reducing originations for commercial real estate, either because of regulatory pressures or to decrease concentrations in the sector.

Other types of lenders have seen volume curtailed more because of low demand than a lack of availability. Borrowers are looking at the mortgage rates offered and saying, "no thanks," unless they have no alternative. Most fixed-rate coupons are 6-8% while variable-rate loan coupons start at 8% and carry expensive hedging costs. CMBS volume through mid-June was $13.2 billion, down 73.1% year-over-year, while collateralized loan obligation volume was only $2.1 billion, down from $24 billion a year ago, according to Commercial Mortgage Alert (CMA). Demand for bonds backed by real estate is extremely weak.

Multifamily has the government-sponsored enterprises (GSEs) to fall back on, but they, too, are off their usual pace. Fannie Mae, Freddie Mac and Ginnie Mae issued $20.1 billion of bonds through mid-June, compared to $55.4 billion in the first half of 2023. For the first time in memory, the GSEs are extremely unlikely to meet their annual allocation, which in 2023 is $75 billion. The weighted average coupon for GSE loans securitized through June 2023 is 6.0%, more than double the 2.9% average coupon in 2021 and 3.2% average rate in 2022. Because volume is so weak, the agencies changed their production mandate for mission-driven affordable and green loans to half of originations, as opposed to a specific number of units.

Securitization Volume Plummets in 2023



Source: Commercial Mortgage Alert; 2023 Data Through: 6/23

More worrisome, the sharp increase in interest rates has left many loans underwater as property values decrease and borrowers are unable to pay off maturing loans without putting up extra cash. If mortgage rates stay at 6% or higher, more than one-third of CMBS loans maturing by year-end 2024 could not be fully refinanced without debt-service falling to dangerously low levels, according to an analysis by Trepp.

Loan defaults will rise in coming quarters, though for now they remain low, still below 1% for most categories of multifamily lenders. Signs of distress are growing, as some borrowers are starting to hand back keys and CMBS special servicing rates are increasing. For many multifamily operators with underwater mortgages, the first choice will be to forestall paying off maturing loans by negotiating extensions with lenders. In this cycle, that course of action will be costly. Loan servicers say that some borrowers come to the table expecting a free extension, but they quickly realize that they must pay additional equity or reserves, higher interest rates, or some other concessions to get lenders to bite.

Given the patterns of distress in past downturns, the default rate will rise over the next 18-24 months as property owners sort out problem loans. The biggest question is how much farther prices will drop. If capitalization rates rise to reflect 6% debt plus an additional risk spread, prices are likely to decline 20-30% from their peaks, wiping out a good deal of equity.

While there will be some rough patches ahead, and operators must cope with rising costs such as labor, taxes and insurance, multifamily has strong long-term fundamental demand drivers and solid liquidity from investors and lenders. Those attributes should enable it to withstand market conditions better than other commercial property types.

Definitions

Lifestyle households (renters by choice) have wealth sufficient to own but have chosen to rent. Discretionary households, most typically a retired couple or single professional, have chosen the flexibility associated with renting over the obligations of ownership.

Renter-by-Necessity households span a range. In descending order, household types can be:

- A young-professional, double-income-no-kids household with substantial income but without wealth needed to acquire a home or condominium;
- Students, who also may span a range of income capability, extending from affluent to barely getting by;
- Lower-middle-income ("gray-collar") households composed of office workers, policemen, firemen, technical workers, teachers, etc.;
- Blue-collar households, which may barely meet rent demands each month and likely pay a disproportionate share of their income toward rent;
- Subsidized households, which pay a percentage of household income in rent, with the balance of rent paid through a governmental agency subsidy. Subsidized households, while typically low income, may extend to middle-income households in some high-cost markets, such as New York City;
- Military households subject to frequency of relocation.

These differences can weigh heavily in determining a property's ability to attract specific renter market segments. The five-star resort serves a very different market than the down-and-outer motel. Apartments are distinguished similarly, but distinctions are often not clearly definitive without investigation. The Yardi® Matrix Context rating eliminates that requirement, designating property market positions as:

Market Position	Improvements Ratings
Discretionary	A+ / A
High Mid-Range	A- / B+
Low Mid-Range	B / B-
Workforce	C+ / C / C- / D

The value in application of the Yardi® Matrix Context rating is that standardized data provides consistency; information is more meaningful because there is less uncertainty. The user can move faster and more efficiently, with more accurate end results.

The Yardi® Matrix Context rating is not intended as a final word concerning a property's status—either improvements or location. Rather, the result provides reasonable consistency for comparing one property with another through reference to a consistently applied standard.

To learn more about Yardi® Matrix and subscribing, please visit www.yardimatrix.com or call Ron Brock, Jr., at 480-663-1149 x2404.

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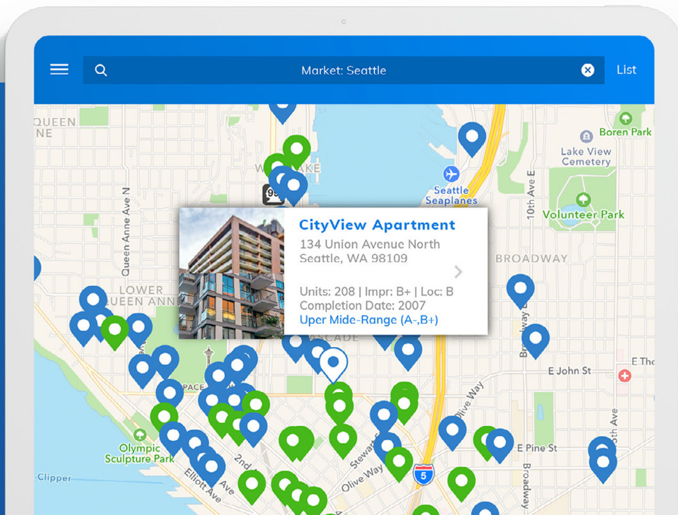
- Leverage improvement and location ratings, unit mix, occupancy and manager info
- Gain complete new supply pipeline information from concept to completion
- Find acquisition prospects based on in-place loans, maturity dates, lenders and originators
- Access aggregated and anonymized residential revenue and expense comps



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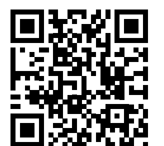

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