Multifamily: Too Much of a Good Thing?

Investment Strengths Signaling Some Underwriting Risk

CoStar Group

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Multifamily investment sales continue to outpace other commercial property types in terms of growth of volume year over year. Multifamily sales in the first quarter were up 33% compared to a year earlier and were up 52% in 2011 compared to 2010.

In preliminary full first quarter numbers, CoStar Group is showing nearly $14 billion of apartment property sales in the first quarter vs. $10.5 million a year ago. The segment recorded $64.6 billion in sales last year vs. $42.5 billion in 2010.

The health of the market has caused some to question current market property enthusiasm and valuations. However, new analysis from Fitch Ratings, Moody's Investor Services and Freddie Mac dispel some investor concerns by reporting that market fundamentals appear to support current valuations.

According to new research from Freddie Mac, while multifamily property values are increasing, they remain an average of 26% lower than the market's peak in early 2007.

And multifamily cap rates in January 2012 were 40 basis points lower than the average between 2000 and the present, Freddie Mac economists estimated.

Multifamily property values fell 40% from peak to trough. Since reaching a low in the third quarter of 2009, values have recovered to 2004 levels but are still 25% lower than the peak in 2007, the firm said.

Strengths Signaling Some Underwriting Risk

However, Fitch Ratings said it is increasingly seeing risks forming in the sector's acquisition underwriting, in addition to its growing sensitivity to an increase in interest rates, future supply, changes to government sponsored entities (GSE) Fannie Mae and Freddie Mac, and most importantly, improvements in the single-family residential market.

Recent trends in underwriting suggest risks for the sector beyond the 12-month range. Some borrowers (predominantly unrated private owners and operators) and lenders have resumed pro forma underwriting that was wildly popular during the heyday of the bull market. This type of underwriting depends on low interest rates at the time of refinancing to maintain capital values. Rising interest rates or a failure to achieve underwriting assumptions due to pressures related to rental affordability could create the difficult refinancing conditions other property sectors encountered in 2008-2011, Fitch said.

Another long-term risk for the sector is potential changes to the GSEs. The political discussion around winding down Fannie Mae and Freddie Mac may increase after this November's election. Disruption in the liquidity they provide is unlikely to be completely absorbed by the traditional secured lenders, namely insurance companies, given their balance sheet constraints and concentration limits, Fitch said.

However, Fitch Ratings said it expects the positive operating performance of the multifamily sector to continue during the next 12 months, and further expects that it will continue to contribute to the performance of real estate investment trusts (REITs) that invest in those properties.

Fitch noted that the positive operating performance is expected to continue as the current supply/demand imbalance remains in place for the short term. While supply remains low on both an absolute and relative basis, with 2011 deliveries trailing Fitch's estimate of the annual obsolescence factor, long lead times created by the entitlement and construction and some continued (albeit moderating) hesitancy by lenders and principals to move further out on the risk spectrum into development should provide a clear window for 2012-2014 deliveries.

Demand Way Outpacing New Supply

Even if the supply pipeline was filling up faster, it would still be outweighed by demand. Low levels of new apartment construction, an improving employment picture, and the weak single-family housing market have been contributing to robust fundamentals in the multifamily housing sector in the U.S., Moody's Investors Service reported.

"For the multifamily REITs, the strong fundamentals have pushed occupancy and cash flow growth past recent highs, which in turn have led to meaningful improvements in credit metrics," said Chris Wimmer, a Moody's vice president, senior analyst.

Moody's noted that pipelines of new development have been expanding, however, given inexpensive capital and strong investor interest in the multifamily sector, "We do not foresee dangerous levels of new supply nationally for at least the next 12 months, though some specific submarkets could show some strain, and there may be enough new construction to moderate rents," Wimmer said.

Despite a reversal in the decline in multifamily completions in 2011, the supply of new multifamily units remains well below its historical averages.

At the same time, the demand for apartments has been growing despite the lackluster employment picture. Moody's noted that much of the new hiring has been among the younger members of the population, who are significantly more likely to be renters rather than owners.