Episode 71

Multifamily: A rental health check-in

With uncertainty swirling around the CRE space, we take a deep dive into the outlook for the rental market.

Rob Hoffman:
Welcome back to FireSide, a podcast from FS Investments. My name is Robert Hoffman, and today we're going to focus on a part of the market where many of us have some personal experience, multifamily apartments. From my perspective, having previously lived in New York City for the better part of 15 years, I certainly have my own personal experience with renting, both positive and negative, especially considering New York. It's got some unique challenges, but joining me to provide some market expertise is our director in charge of real estate inequities. Andrew Korz. Hey Andrew, how's it going?

Andrew Korz:
Hey, I'm good. How are you?

Rob Hoffman:
Good, good. So, you recently published a new research note on the multifamily sector titled "Multifamily: A rental health check-in," and I think it's a fascinating sector to focus on today. On one hand, mortgage rates are sky high. For many of us that weren't looking to buy a home in the early eighties, it seems crazy to lock in seven-plus percent on a 30-year mortgage, but that's where the market is. That alone would seem to be a huge factor benefiting the multifamily sector. But on the other hand, multi prices have actually seen some of the largest price declines coming off the post COVID boom and commercial real estate prices. So let's try and make some sense of all of that. Let's do it if we can, maybe before diving into multifamily, provide a bit of a broader backdrop on the CRE market. How is the market overall right now, deal volumes, pricing before getting sector specific? Is the market healthy?

Andrew Korz:
Yeah, so I'm going to start this off with a nice sports analogy here. So, we're sitting here late August, we're getting towards the end of the baseball season, and the Phillies just finished up a series against the LA Angels. We all got to see Shohei Ohtani play. I'm sure you know who that is. He's pretty clearly the best player in baseball, first player since the 1960s to play as a true two-way player, both the pitcher and a hitter, and the first one really to do it well, since probably Babe Ruth, unfortunately, as I'm sure a lot of you have heard, he recently tore the ulnar collateral ligament in his pitching elbow. Now he can still play, he can still hit, but number one, he can't pitch until he gets pretty significant Tommy John surgery. And secondly, there's almost no way that this isn't affecting his ability to hit as well and specifically to hit for power.

Andrew Korz:
And that's sort of how I see the CRE market right now. The market is clearly not operating at full potential here. Deal volumes are down around 33% compared to pre-Covid 2019 levels. If you look at the office sector, which obviously has some unique challenges, it's down about 65% versus 2019. Property values, which you mentioned are down anywhere from five to 15 or 20% depending on the sector. And financing, both on the equity and on the debt side has gotten harder to come by. And I think just like with bot's elbow, I think there's a very clear culprit here that has the market of a lot of its strength and its momentum. And that's the interest rate backdrop, which we've talked about a lot on this podcast. And in our research pieces, you've

kind of gone from the lowest financing costs in history really to the highest in over 15 years in a one-and-a-half year span.

Andrew Korz:
And that's really introduced a lot of friction to the market. Investors have had to really adapt to that new environment. I think the most important thing here though is that Mr. Otani, the market is not on the injured list right now. You've still got resilient fundamentals in most sectors when you look at the consumer helping to drive strength in retail and hotel. Obviously, we know about industrial multi we're going to talk about here and office is kind of in its own category. You still got capital out there that wants to be deployed into opportunities. It's just going to take some time; I think for the proverbial elbow to heal here for the market.

Rob Hoffman:
Yeah, wow. All right. I'll have to figure out if I can work some more sports analogies in throughout this episode.

Andrew Korz:
I figured we started off light.

Rob Hoffman:
Well, let's see. So, in terms of size, just how big is the opportunity for real estate overall? And obviously we're going to spend some time talking about Multi. It would strike me that Multi is maybe the largest sector within commercial real estate. Is that the case?

Andrew Korz:
Yeah, it kind of depends on how you look at it. It is the largest sector over the past, call it three to five years. It's pretty consistently accounted for about 40% of the transaction volumes, which are obviously easy to track because it's money changing hands. We can track those things. It's a little bit more challenging to track in terms of just the stock of value. Different people have different sort of measures for how large the commercial real estate sector is. I've seen anywhere from $15 to $20 trillion thrown around. It's probably somewhere between 15 to 25 or 30% of the overall market. So, if you take all the different sectors, the major sectors plus sort of the alternative sectors that we talk about, it is pretty far and away the biggest sector in terms of either overall value and probably more importantly for what we're talking about transaction volumes. And I think it's also unique in CRE terms because it's sort of like Maslow's hierarchy of needs. It's sort of at the bottom of that pyramid. It's along with food and sleep, shelter is sort of a core necessity for people. And because of that, consumers are really going to prioritize rent payments over a lot of other, call it discretionary goods and services. And this has traditionally made multifamily among probably the most defensive and resilient property sector when we have times of economic uncertainty.

Rob Hoffman:
And maybe just for a point of comparison, not the focus of our conversation today, but how does multifamily compare to the size of office, which clearly there's a lot of negative headlines around the office space.

Andrew Korz:
I think it's challenging to put a size on the total value of all U.S. office buildings, but from a transaction standpoint, again, office now only comprises about 12% to 15% of transaction volume vs. 40% for multi and ballpark, you could probably say the overall value of apartments in the U.S. is probably anywhere between one and a half and two times the value of office buildings.

Rob Hoffman:
Okay. Alright. No, it's good to think of it that way. So, look, as much as we don't need to talk about history in terms of what is the current state and what's going on in multifamily, but it is probably worthwhile to take a moment and walk us through how the pandemic impacted the

situation we find ourselves in today in regards to the multifamily sector. So what were some of the lasting impacts from the boom bust cycle that was created by the pandemic?

Andrew Korz:
Yeah, it's pretty crucial to first discuss what happened coming out of Covid to understand where the market is today. And I think to put it simply, you probably had the two best years in the modern history of the apartment industry coming out of the Covid lockdowns. Just some stats to put a finer point on that rents were up about 25% from the fall of 2020 to fall of 2022. That 24% is equal to the rent growth of the seven years leading up to the Covid pandemic. So just tremendous rent growth. Property prices were in mid-2022 at their peaks, 41% above where they were at the end of 2019. The peak of the market in terms of activity was probably in Q four of 2021 where you had 165 billion worth of apartments changing hands. If that were an entire year, it would be the third most active year in the history of the multifamily sector.

Andrew Korz:
And that was one quarter. So you had this incredible confluence of factors coming together to sort of create this perfect storm in the market. And I think if we consider what drove that from a fundamental standpoint, so if we think about demand for apartments, a lot of that comes from what economists call household formation, which is sort of this very strange way of talking about people either starting a family or moving out on their own and starting in early 2021 where you did have vaccination that was creating this quick rebounding activity and people wanted to get out there and do stuff and move into the city and get out of their parents' basement, you had this robust household formation where people wanted to go break out on their own and get their own apartment. And that really created this surge in apartment demand. You had over 3 million new households formed in 2021 and 2022.

Andrew Korz:
And alongside that sort of simultaneous trend was three rebound and employment and income. In mid-2020 you had an unemployment rate of 15%. By mid-2021 it was 5%. So, you had this real, not only sizable but quick rebound in employment and incomes. And of course, that is really the key metric for apartment demand in terms of the housing market. We all think of that period as a boom in terms of demand in the housing market. But you have to remember, a lot of people put off their decision to buy a house in 2020 and they came back in 21 and a lot of those people were not able to buy a house because I'm sure you remember all the crazy bidding wars that were happening, 10-20 bids on a single house, and a lot of those people just gave up and just said, all right, I guess I'm just renting for a couple more years now.

Andrew Korz:
So even though you did have a lot of new home buyers during that period, I think if people had their druthers, there would've been a lot more during that period. On the supply side, new construction fell behind in 2020. No developers really wanted to break ground on a new apartment project because nobody knew where the economy was going to be in 6, 12, 18 months. And then as demand came back so quickly, you just didn't have the new construction coming online to match that demand. And then finally, I think domestic migration created these massive imbalances in certain metros. So, you had two 300% increases in people moving into metros, especially in Texas and Florida. If you look at some rent growth over that two year period, Miami rents were up almost 40%. Albuquerque rents were up 32%. Knoxville, Tennessee was up 42%. Naples, Florida was up 59%. You had this reallocation of demand that just created incredible rent growth in parts of the country where people who could work remotely wanted to move. And then from an investment perspective, you combine that, all of that fundamental tailwind with rock bottom interest rates, and you just had incredible expected returns in the apartment sector. And that's kind of why we saw this activity.

Rob Hoffman:
So, demand is really strong. Supply is constrained. People had money to spend on rent, they're employed, as you said, it does sound like the perfect storm. And then that doesn't even factor into presumably residential housing affordability as mortgage rates skyrocketed, the lack of affordability for buying a single family home, pushing more people into multifamily. But yet

there are some cracks that have started to occur over the course on a perhaps tail end of 2022 into 2023. Where did that come from? What happened?

Andrew Korz:
I think anytime you have a perfect storm, eventually the storm kind of ends. And I think that's kind of where we've been for the past, call it six to 10 months or so. And I think simply put a lot of these factors either reversed or mean. Reverted, right? You think about that household formation, people moving out on their own, the rebounded employment and income. I think with the onset of inflation beginning in mid-21, but really eating away at folks' paychecks beginning in late 2021 and then into 2022, people were just much more reticent to branch out on their own. And this is not necessarily some exogenous shock from other parts of the economy. Rents were a massive part of the inflation issue. So, it wasn't like it was just other goods and services that were weighing on people's cashflow. And then they said, oh, you know what? Because of that, I can't afford rent. It was really the increase in rents that made people more reticent to move out on their own and say, you know what? Maybe I should stay with my roommates for a couple more years. I think that disincentivized people to go out and create new households, and obviously that hits demand. And then on the new construction side, anytime you get rent growth of that magnitude, developers are going to see that it becomes a really attractive time to develop a new apartment building when values are rising, when rents are rising that quickly. And that's exactly what happened, right? The developers saw great opportunity starting in early 21, we saw a lot of new projects get underway, as we know it took longer because of some supply chain issues because of some of the secular changes we've seen in the construction industry.

Andrew Korz:
It's taken a while for those new units to come online. But starting in mid-2022, we did start to see those new units come online. So you started to see this supply demand imbalance that had been firmly on the side of demand start to swing towards supply. And this is all combined to mean that the power has sort of switched firmly from the side of landlords who could set their price because there was such little selection for tenants looking to move to now there's a little bit higher vacancy, there's nice new apartments coming online, and tenants can shop around a bit, which has shifted the power towards those tenants.

Rob Hoffman:
Although, I mean, look, there's still places, as I mentioned, New York City's recording the highest average monthly rents in the history of the city. So it's not all bad. I mean, I guess like many sectors in commercial real estate, it becomes very specific demographically where you are type of building, all that type of stuff.

Andrew Korz:
Again, all of these things are on the margins. We're certainly not seeing rents fall pretty much anywhere. There are some metros where like the Phoenixes and the Las Vegases where rents just got so over their skis, and because of that there was a lot of development there. You have seen rents come down modestly, but by and large, I mean rents don't tend to fall ever because people's income generally rises. And generally you can charge a percentage of people's income. And that's been how apartments are priced historically.

Rob Hoffman:
Yeah. So where do you think it goes? What's your outlook from where we sit today? Will it stabilize and start to grow from I guess a pricing perspective on multifamily? Are there still positive fundamentals that underlie the space? What's your view? Yeah,

Andrew Korz:
I view this current moment as a pretty healthy rebalancing for a sector that just got way too hot. And again, I think it's important to impress upon listeners that this was a major driver of the inflation issue we've seen over the past two and a half years. So I think to the extent we have higher interest rates, that we have higher inflation, a lot of that is due to some of the issues that we've just talked about. I think for the economy as a whole, this has been a pretty healthy

rebalancing. I think on the construction front, there is a lot of concern here. You see a lot of stories about a record high number of apartments under construction right now. For me it's sort of a short term versus medium term thing. We do have a backlog of apartments under construction, there's no doubt about it.

Andrew Korz:
And those are going to be delivered. I think people are comparing this to the seventies where there was a similar number of units under construction. We have almost doubled the number of housing units in the US right now compared to what we did then. So the actual expansion of the supply is half the rate basically. And also back then, apartment units would be delivered in between 10 and 12 months on average, right? Today it takes 18 months generally to deliver a new apartment building. So you can take the roughly 900,950,000 units that are under construction, and they're going to be delivered over the next probably 18 months versus the next 10 or 12. So it'll be a more gradual increase in supply. And then I think sort of interestingly, if you look at a leading indicator of construction, that would be permits for new buildings and those are way down, those are down like 40% compared to their 2021 highs.

Andrew Korz:
And I think this is sort of a perverse impact of the fed's tightening, where you have a demand supply imbalance to remedy that you should want to increase supply, but higher interest rates to incentivize new construction. And that's exactly what we're seeing. So I think over the medium term, of course, you have to deliver all these apartments that are under construction, but as we sort of get to that next wave, the permits would tell you that this is going to be a pretty brief building boom. And in a year from now, we could very well be back to a point where we don't have enough supply coming online. Secondly, I think, and just to sort of briefly finish this off, incomes to your point, are still really strong right now. The end consumer for apartments are workers. And when workers are healthy, the industry tends to be pretty healthy.

Andrew Korz:
And I think finally, to your point on apartments versus the housing market, shelter tends to be a relative value decision. And I think overall, we still have a housing shortage. Despite the little housing construction move we've had in both multi and single family housing, we've still had more new households form than we've had new housing units built over the past three years. So if we have a three or 4 million unit housing shortage, we haven't put a dent in that. And then obviously to your point, buying a house is just much more expensive than renting an apartment right now. So I think there are a lot of reasons to believe that this is more of a healthy short-term rebalancing than it is something more structural.

Rob Hoffman:
Well, and something that you've written about in your quarterly outlooks for real estate in general, and in talking about multifamily, I mean, correct if I'm wrong to this last point that you just made, it's a little bit of a healthy correction, but for many investors in multifamily apartments, certainly looking back over the past five, 10 years coming out of the financial crisis, returns have been outstanding, right? People that own those buildings over that entire period of time are sitting on an asset that has significantly more value, even despite recent cool off considered for the marketplace, right?

Andrew Korz:
Yeah, absolutely. And that I think is critically important because those owners still have equity in the buildings. Again, they're not underwater. They're not going to hand over the keys to the lenders. They're going to continue to operate the property to look to refinance, to get through this period, to slog through if they can. And the hope is that in a year or two values will have recovered and they can still make a nice gain on their investment.

Rob Hoffman:
So how does this evolving scenario shift the focus for investors that are looking to capitalize on the opportunities available to them in commercial real estate and specifically as it relates to the multifamily sector?

Andrew Korz:
Yeah, I think this is so interesting because it's, you almost have the mirror image of in terms of investing in the sector, you almost have the mirror image today compared to the 2010s where the 2010s you had lackluster income growth. Actually it was fine, it was stable, it was steady at, call it two and a half to 3% rent growth over that period. But you had these exceptionally low interest rates that allowed you to ride the wave of capital appreciation over that period. And right now, I think it's the opposite where you've had this incredibly strong income growth, but now you've got the cost of financing. That's really become an issue for borrowers. And I think the bottom line is multifamily tends to be, it's among the most resilient industries out there, I think economically. And that's because of its defensive nature, because of things like demographics and some of the issues we're seeing in the housing market right now with affordability.

Andrew Korz:
I think despite that, owning a multifamily property is tough right now, I think, right? So again, the cost of financing is the biggest reason for that, and we've talked a ton about that, but it's not the only one, right? Labor costs are up, whether you're talking about construction, whether you're talking about hiring maintenance workers, anything like that, labor costs are up, property taxes are higher. Given the surge in values we've seen since the start of covid, the biggest one you hear about is insurance costs are skyrocketing in certain markets. And certain markets in Florida, you see two to three times what insurance costs were maybe five years ago. Because not only are replacement costs higher, but the risk of natural disasters in those places has risen significantly. So it's not easy to own and operate and finance a multifamily asset right now. So I think you've got to take that backdrop all together.

Andrew Korz:
It's a tremendously stable income stream, but one where financing and operating the assets has become challenging. And I think that fact kind of chops off your upside, right? It chops off that price appreciation upside. Our view is that you're better off on the debt side on multifamily where not only are you the beneficiary of higher financing costs where you can get two to 300 basis points better yield than you could just two, two and a half years ago, but you get first dibs on that stable income stream by being the highest in the capital structure. So I think we've talked about this from a market-wide standpoint, this switch from low interest rates subsidizing property borrowers to now lenders being in the driver's seat. And I think there's no sector that it's clearer than in multifamily.

Rob Hoffman:
I mean, it's almost as if you'd call it a term, it a shifting of the cash flows. But when you think about all the money that comes out of a multifamily apartment, it sounds like the thesis right now is it's not necessarily an awful time to be an owner. We think the sector is generally healthy and will recover, but a greater percentage of those cash flows right now are going to the lenders and away from the equity holders.

Andrew Korz:
Yeah, no, that's exactly right. And I think whereas the returns for a lot of the last 10 or 15 years for borrowers were grow my incomes at a stable rate and I can just expect the exit cap rate to fall and the values to rise now, I think borrowers are going to have to roll up their sleeves, try to keep expenses under control, try to drive higher rents, and that's just a much different world. And from an income standpoint, we are, most properties can still cover their debt service, which as a debt holder, that's all we care about, right? But yes, from a borrower standpoint, I think the return drivers over the next call at three to five years are going to be much different.

Rob Hoffman:
Great. Well, thank you very much. Always a fascinating topic to talk about real estate and some of your views and appreciate the opportunity to have you here. I'm sure we'll do it again. I don't know, I guess we're only a few weeks away from maybe our next research roundup, so get an opportunity to talk about the space more broadly. Yeah,

Andrew Korz:
We'll have the Q4 outlook coming up pretty soon likely. So look out for that.

Rob Hoffman:
Awesome. Well thank you very much. Take care. Awesome.

This episode is recorded at the FS Investments headquarters in Philadelphia's historic Navy art. It was produced by the investment research team. It was edited and engineered by Erin Sherman. Special thanks to show coordinator Ellie Zang. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcast. Thanks for listening.