Full Tilt—The Outlook For Multifamily Lending

— by JAMIE WOODWELL —

Multifamily lending is booming. Last year's breakneck pace of lending is expected to carry into 2015. But where's it all headed?

Multifamily lending has been running at full tilt—with 2014 setting new records in terms of lending and the amount of multifamily mortgage debt outstanding. ¶ The market has carried that momentum into 2015, and what lies ahead will depend largely on interest rates and how investors' expectations about interest rates affect cap rates and cap-rate spreads.

The lending market

The multifamily lending market is large and diverse. Borrowers range from individuals taking out loans in order to maintain five-unit investment properties to real estate investment trusts (REITs) fine-tuning their leverage on a nationwide portfolio.

Loan sizes range from tens of thousands of dollars to hundreds of millions of dollars. And lenders range from small community banks to the commercial mortgage-backed securities (CMBS) market.

In 2013 (the latest year for which there is complete information), 2,898 lenders made 44,696 loans totaling $173 billion. The Mortgage Bankers Association (MBA) estimates that when the final numbers come in for 2014, lenders will have made $190 billion in multifamily loans—a 12 percent increase.

MBA's preliminary estimate is that bank portfolios accounted for $75 billion of the 2014 total, Fannie Mae and Freddie Mac for $61 billion, life insurance companies $18 billion, the Federal Housing Administration (FHA) $10 billion and the CMBS market $9 billion.

Growth in lending has led to record levels of multifamily mortgage debt outstanding. At the end of the fourth quarter of 2014, there was $964 billion in multifamily mortgage debt outstanding—7 percent more than at the end of 2013.

As with originations, growth was driven by bank portfolios, which grew by $35 billion or 13 percent during the year; and by Fannie Mae, Freddie Mac and FHA, which grew by $22 billion or 6 percent (see Figure 1).

The change during 2014 in bank holdings of multifamily loans was the largest increase in both absolute dollars and in percentage terms since the series began in 1993.

It was a strong year for multifamily lending.

Market growth

At its heart, the rise in multifamily lending can be tied to changes in apartment fundamentals and in investor demand for multifamily properties. Both have seen remarkable growth.

Fundamentals

Growth in multifamily lending has tracked improvements in apartment fundamentals. Vacancies are down, rents are up and net operating incomes (NOIs) are up. According to data from the Census Bureau, multifamily rental vacancy rates fell to 7.7 percent in the fourth quarter of 2014, the lowest level since the mid-1980s.

Data from Reis Inc., New York, shows that the tight market conditions led to effective rent increases of 3.6 percent over the course of the year. And in the fourth quarter of 2014, NOIs tracked by the National Council of Real Estate Investment Fiduciaries (NCREIF), Chicago, increased by 3.6 percent on a year-over-year basis (see Figure 2).

Robust demand remains for apartment properties, and there are some indications that the share of U.S. households renting rather than owning could continue to rise. But it is also true that the remarkable tightening the market has seen is unlikely to continue. While demand remains strong, construction activity—which had been on hiatus following the Great Recession—has grown to meet the current lack of availability. Just as vacancy rates are back to levels last seen in the mid-1980s, so is the number of units under construction.

As that new supply comes online, vacancy rates are forecast to increase and rent growth is forecast to slow. This is not to say that property incomes will fall. Rather, the pace of income growth—which had reached levels as high as 9 percent per year in 2012—is likely to work back to rates closer to the 2.5 percent to 3.5 percent range that marked the average and median annual increases, respectively, over the 2001–2014 period.

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Those moderating incomes will be a moderating force on property prices as well.

Apartment values

Property values are a function of property incomes and investors' required yields (aka capitalization or cap rates). The cap rate is calculated as a property's earnings divided by its value, or the net operating income divided by the property sales price. Mathematically, given a constant NOI, a higher capitalization rate will result in a lower property value. And given a constant cap rate, a higher NOI will result in an increase in property values. For example, a 3 percent rise in NOIs would result in a 3 percent rise in values. It is easy to see that NOI growth of 9 percent in 2012 and of 5 percent in 2013 contributed significantly to recent increases in multifamily property values.

But NOIs weren't alone in pumping up values. At the same time NOIs were increasing, cap rates were falling. According to Real Capital Analytics Inc. (RCA), New York, at the end of 2010 the apartment cap rate was 6.5 percent. That fell to 6.3 percent at the end of 2011 and 6.1 percent at the end of 2012, rose to 6.2 percent at the end of 2013 and ended 2014 at 6.0 percent (see Figure 3).

The overall drop in the cap rate from 6.5 percent to 6.0 percent equates to—absent any change in NOIs—a rise in apartment property values of 7.7 percent.

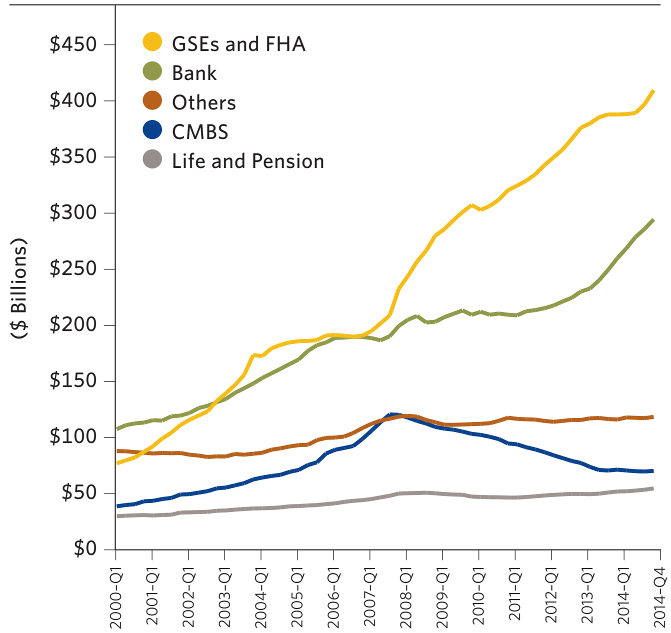
As a measure of investment return, cap rates are tied to broader market yields, with the 10-year Treasury yield serving as a benchmark for the return on a risk-free investment. Ten-year Treasuries have been providing extraordinarily low yields (below 2 percent for much of the first four months of 2015), and the competition to place investment dollars has brought cap rates down to record-low levels.

Looking forward, the good news is that cap rates have not fallen as far as Treasuries have, and the spread between cap rates and Treasuries is at a relatively wide level.

During the fourth quarter of 2014, the average apartment cap rate as measured by Real Capital Analytics was 6.0 percent—3.7 percentage points above the 2.3 percent average of the 10-year Treasury yield during the period. By comparison, that spread was as high as 4.6 percentage points in the throes

FIGURE 1

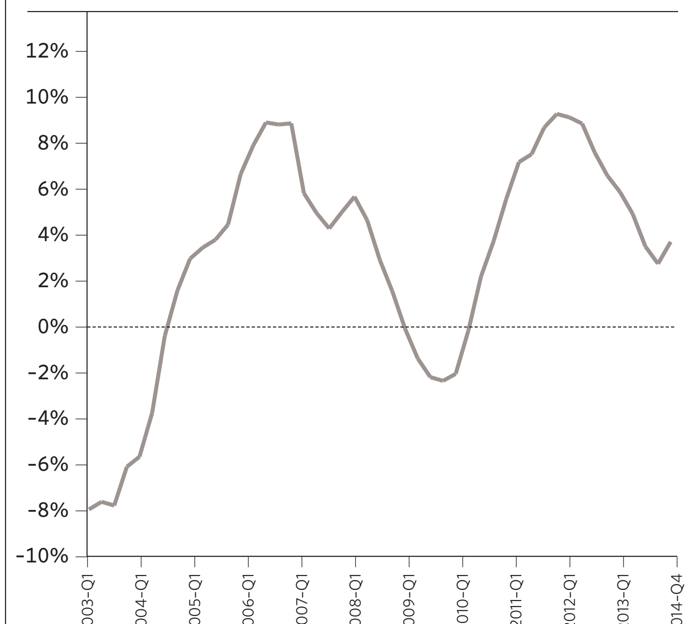
MULTIFAMILY MORTGAGE DEBT OUTSTANDING



SOURCE: Mortgage Bankers Association (MBA)

FIGURE 2

YEAR-OVER-YEAR APARTMENT NET OPERATING INCOME (NOI) GROWTH AMONG NCREIF SAME-STORE PROPERTIES



SOURCE: National Council of Real Estate Investment Fiduciaries (NCREIF) of the last recession and as low as 1.3 percentage points in 2006 as the market was last peaking.

The implication is that when/if interest rates rise, cap rates may not rise as quickly as Treasuries.

Why is this important?

MBA's April interest-rate forecast anticipates 10-year Treasury rates will average 2.2 percent in 2015 and 3.0 percent in 2016—a rise of 80 basis points. Adding that increase to the recent 6.0 percent cap rate equates to—absent any change in NOIs—a decline in property values of 13 percent.

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Forecast

It turns out that one's forecast for multifamily mortgage originations should be closely tied to one's outlook for interest rates and cap-rate spreads.

We speak of originations being tied to loan maturities, new construction activity and a range of other factors, and all of those factors affect the overall level, but when one lines up the various data series (which are available over an admittedly short period), property sales jump out as the clear driver of multifamily mortgage originations (see Figure 4).

And when one looks at what drives property sales, property values and changes in those values are dominant. As outlined earlier, interest rates and cap-rate spreads drive values.

Interest rates

Interest rates have stayed lower longer than most predicted. At the end of 2008, when the 10-year Treasury was 3.8 percent, a survey of economists by the Federal Reserve Bank of Philadelphia predicted rates would rise to 4.0 percent by the end of 2009. Instead they fell to 3.4 percent.

At the end of 2009, when rates were at 3.4 percent, the survey predicted rates would rise to 4.0 percent. Instead they fell to 2.5 percent. For 2011, the prediction was for rates to end the year rising to 3.3 percent; instead they fell to 2.2 percent. And so on.

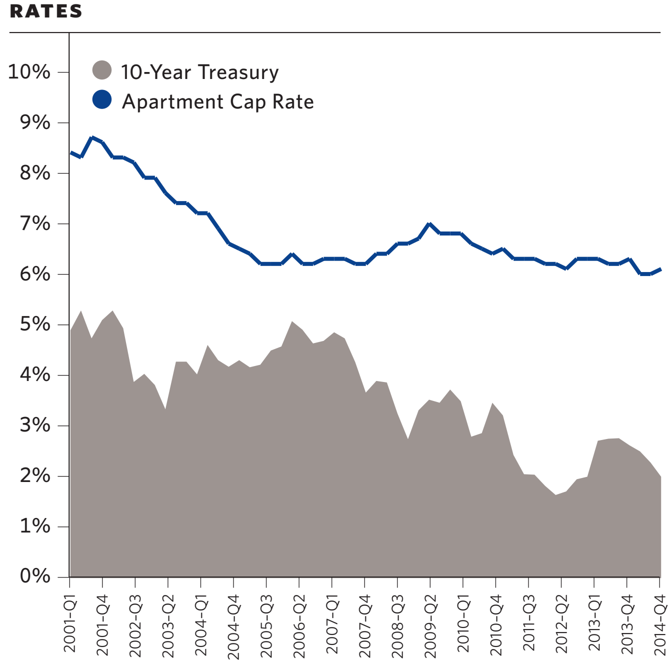
It would be easy to learn from this the lesson that rates are not destined to climb; that the flood of foreign capital is breaking down the traditional relationship between domestic economic growth and interest rates; and that negative interest rates in other countries are evidence that U.S. rates are not likely to rise anytime soon. And it would be hard to look at the evidence from recent years and not accept that there is some truth to this.

At the same time, the U.S. economy, as a whole, is performing quite well. Gross domestic product (GDP) growth is strong—well in excess of inflation and long-term interest rates—and job growth has brought us to the first stages of wage growth.

A strong arbitrage exists between today's low interest rates and the return coming from economic growth. To give up on the connection between GDP growth and a rise in interest rates

FIGURE 3

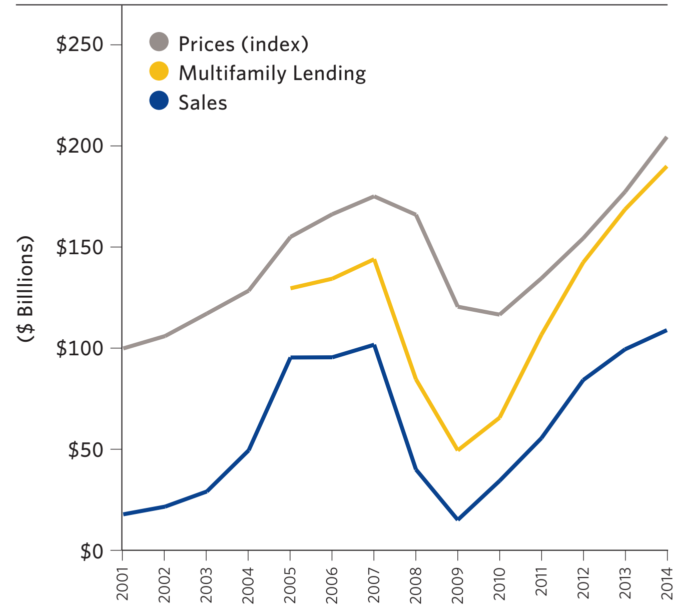
INTEREST RATES AND MULTIFAMILY CAPITALIZATION RATES



SOURCES: Real Capital Analytics Inc. (RCA), Federal Reserve Board

FIGURE 4

MULTIFAMILY PROPERTY PRICES, SALES AND LENDING



SOURCES: MBA, RCA, Moody's/RCA Commercial Property Price Indexes would be to turn one's back on a long and studied history.

Cap-rate spreads

Cap-rate spreads can be seen as a gauge of investors' bullishness about multifamily properties relative to the risk-free security of Treasury bonds. Tight spreads (such as in 2006 and 2007) signal a strong willingness among investors to put their capital to work in properties. Wider spreads indicate reluctance.

Last year's 3.6 percentage point spread is 20 basis points wider than the 3.4 percentage point median quarterly spread for the period 2001 to 2014. It is 90 basis points wider than the 2.7 percentage point spread of 2004 and 150 basis points wider than the 2.1 percentage point spread of 2005.

All of which is to say that given a bullish perspective among investors, but a concern about a potential rise in base interest rates, the cap-rate spread for apartments has some room to tighten. How much it might tighten depends on how investors view both future multifamily income growth and future interest-rate movements.

The multifamily lending market will remain active, dynamic and the largest part of commercial real estate finance.

Scenarios

There are any number of potential paths for interest rates, cap rates, property fundamentals and other factors affecting multifamily lending volume. For purposes of discussion, here are four (see Figure 5).

- ***Flat interest rates, declining cap rates:*** Base Treasury rates remain flat, and investors buy into the notion that rates may stay lower longer than previously anticipated. Cap-rate spreads tighten and the average cap-rate drops. Property prices gain on both NOI growth and cap-rate compression, and property sales and originations both grow.
- ***Rising interest rates, flat cap rates:*** Base Treasury rates rise, as forecast, and the rise is largely absorbed by compression of cap-rate spreads. Under this scenario the average cap rate remains relatively flat, allowing prices to follow modest NOI growth, and property sales and originations remain relatively flat or grow slightly.
- ***Flat interest rates, flat cap rates:*** Base Treasury rates remain flat and investors—anticipating future interest-rate increases—hold cap-rate spreads flat. Under this scenario the average cap rate remains relatively flat, prices follow modest NOI growth, and property sales and originations remain relatively flat.
- ***Rising interest rates, rising cap rates:*** Base Treasury rates rise, as forecast, but the rise is only partially absorbed by a compression of cap-rate spreads. Under this scenario the average cap rate rises slightly, cancelling out NOI growth and leading to flat property prices. Property sales and originations fall slightly.

These are clearly not the only possible scenarios (e.g., interest rates could rise and investors could become concerned about multifamily fundamentals, leading to a more rapid increase in cap rates). The point is that thinking through the different scenarios can help mortgage market participants identify a range of potential market conditions and prepare for each. In a pop-psychology sort of way, scenarios can also help firms think through what their expectations about the size of the lending market may imply about interest rates and cap rates going forward.

As the earlier example of the Philadelphia Federal Reserve survey demonstrates—and Yogi Berra may have said—the accuracy of forecasts is very hard to predict. They are not a sure thing.

What forecasts can do is provide a framework for thinking through what the most likely outcomes are, and what those outcomes may imply for one's market and one's business.

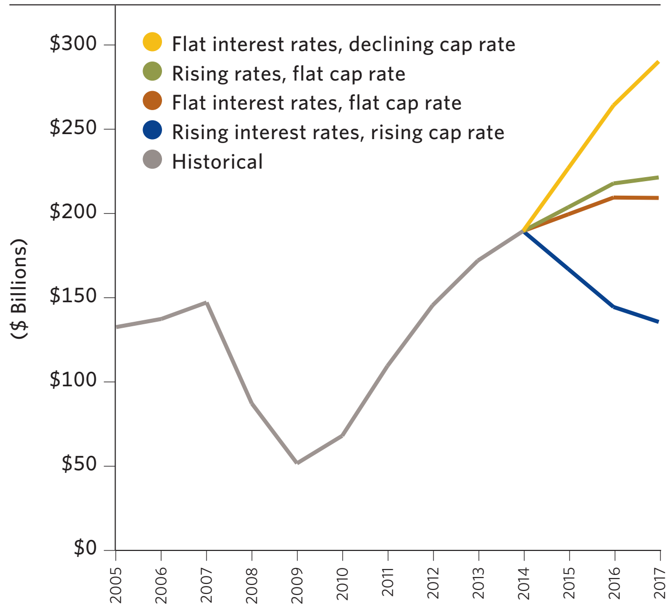
At the time of this writing, MBA's forecast is for interest rates to rise over the next two years, and for apartment cap rates to absorb a good portion of that rise. The result will be continued, but moderating, increases in multifamily property prices and sales, and multifamily lending volumes that continue at a high pace but do not increase dramatically. By the time this article appears, that forecast may have changed, but the underlying relationships between interest rates, cap rates and lending volumes are likely to remain.

Down to a sound bite

On the margins, future lending volumes will be determined by the direction of interest rates and cap rates, and through them property sales. Regardless of what happens on the margins, the multifamily lending market will remain active, dynamic and the largest part of commercial real estate finance. The question here is whether the next year sees lending volumes remain strong or whether they find a whole new gear. **MB**

FIGURE 5

POTENTIAL PATHS FOR MULTIFAMILY LENDING VOLUMES



SOURCE: MBA

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