R O U N D T A B L E

SPONSORS
ALLIANZ REAL ESTATE • BARINGS
SUPPORTERS
CADWALADER • CARROLL • THE PRAEDIUM GROUP

The last safe harbor

The multifamily sector has consistently been a stable performer, and lenders and investors think this will not change anytime soon. By Rob Murray

The US multifamily space was a strong performer throughout the covid-19 pandemic and continues to be seen as an attractive and well-positioned property type – against a backdrop of high wage growth, low unemployment and a severe supply-demand imbalance, particularly in affordable housing.

But the sector is not without its challenges, according to panelists on *Real Estate Capital USA*'s inaugural multifamily roundtable discussion.

The event featured a panel comprising several leading industry figures active in the multifamily sector: Nasir Alamgir, managing director and head of real estate debt portfolio management at Barings Real Estate; Russ Appel, founding principal at The Praedium Group; Michael Cale, co-head of debt investments at Allianz Real Estate; Patrick Carroll, founder of CARROLL; and Michael Ruder, special counsel at law firm Cadwalader, who focuses on CMBS securitizations and other structured finance investments.

The panel began by considering the current state of the pricing landscape for multifamily – against a backdrop of declining valuations in some other real estate sectors.

Carroll says conditions are currently difficult – both for investors buying apartment properties and those lending on them.

"It's challenging to get financing right now, and it feels like 90 percent of the lenders that have been active over the last few years are on the sidelines," Carroll says. "Freddie Mac and Fannie Mae have been the most attractive options here recently, whereas they were almost irrelevant for the past few years."

Carroll acknowledges that it is still possible to get deals financed – adding that his own firm had closed two in August. "But it's definitely a thin lending market, and there are a lot fewer lenders out there today," he says.

Ruder echoes that sentiment, acknowledging that there have been challenges in bringing CMBS securitizations to market this year due to interest rate volatility.

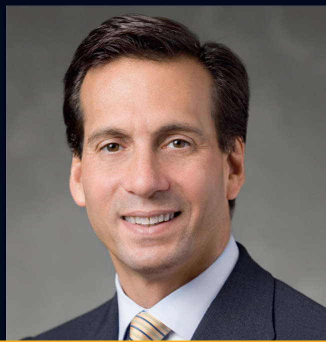
The agencies are "one of the big differentiators" for the multifamily housing sector, says Appel. "When the private markets become less active and less liquid, you have this extra source of liquidity – which is really highly protective to this sector, relative to the other property types."

Ruder agrees, pointing to the early days of the covid-19 pandemic in 2020 and Russia's invasion of Ukraine this year as prime examples of the agencies providing a liquidity backstop for the multifamily market. But this financing can be selective.

"It's very difficult to convince borrowers to do long-term fixed-rate financing right now, because of the increase in interest rates," Cale says. "People still want flexibility, and there's a school of thought out there that rates are going to come back down over the next nine months. But then other

Patrick Carroll
Founder and chief executive officer, CARROLL

Carroll is the founder and chief executive of CARROLL. As CEO, Carroll helps define and implement strategic plans to expand the firm's portfolio. As an investor, Carroll has led to $12.1 billion in acquisitions and $8.2 billion in dispositions of multifamily real estate, producing an average gross IRR of 29 percent.



Russell Appel
Founding principal, The Praedium Group

Appel has been building Praedium since 1991 and overseen all aspects of its activities, including strategy and investment policy. He has also filled senior roles at the real estate groups of Goldman Sachs and Credit Suisse First Boston, where he oversaw the execution of commercial and multifamily asset securitization and sale advisory assignments of more than $13 billion.

Nasir Alamgir
Head of real estate debt portfolio management, Barings

Alamgir is a member of Barings Real Estate, a global real estate platform with extensive capabilities across both debt and equity. Alamgir oversees the firm's real estate debt investment portfolios, with responsibilities, including team leadership, portfolio management, investment strategy and development of new investment funds and accounts.

Michael Ruder
Special counsel, Cadwalader

Ruder concentrates his capital markets practice on commercial mortgage-backed securities transactions and other securitizations, frequently representing issuers and underwriters in connection with agency and private label CMBS securitizations. He also advises securitization clients on sustainable finance and other ESG matters, including serving as issuer's counsel on the $3 billion green CMBS securitization of New York's One Vanderbilt.

Michael Cale
Co-head of debt investments, Allianz Real Estate, US

Cale is the co-head of debt Investments for Allianz Real Estate, US. Based in Atlanta, he is focused on origination. Cale joined the firm in July 2019 and is a member of the senior management team. He has 20 years of experience in real estate. Prior to joining Allianz, Cale was senior vice-president and head of capital markets at Voya Investment Management. He has held previous leadership positions within Voya and was a former director at HFF.

people feel differently. So, it has been difficult. I think we're in a little bit of a discovery mode – and have been for most of the summer."

Appel put out a question to the lenders on the panel, asking why spreads appear to have gone up, considering that they would typically compress when risk-free rates rise.

Cale says that on the balance-sheet side of the world, lenders peg themselves to corporate bonds. "It is a relative value play more than anything. Corporate bonds have widened by an average of 70 basis points, in the same time frame that the interest rates have gone up."

Fixed-rate spreads have not risen by a commensurate amount; in fact they have generally come down, Cale adds. "But [fixed-rate spreads] just haven't come down to the level that people are used to seeing," he adds.

"On the floating-rate side, it's all about financial engineering. If a debt fund's [credit line pricing] goes up, they're going to pass that down to the asset level, and so on and so forth. So it depends what kind of financing you're looking at."

Barings' Alamgir says that, from his perspective, there is a common theme in the markets. "What you're hearing is about the uncertainty in the markets, and it's about fewer data points," he adds.

"If you look at transaction volume – on the debt side or even the equity side, actual equity sales taking place – all of that is down significantly."

Transaction volumes were still relatively good during the first quarter of this year, but this was largely due to pent-up deals hanging over from the end of 2021, Alamgir explains.

Volumes are down in Q2 and Q3, "so we have fewer data points to really gauge where values are, or where relative value is," he adds.

"When you think about trying to price a loan or buy a property today, it's hard to figure out what those correct numbers are."

> *"As a lender, we wonder about where values are going to go"*
>
> **NASIR ALAMGIR**
> **Barings Real Estate**

Are current rents sustainable?

The dynamics of asset fundamentals have been skewed by the pandemic, too, says Alamgir. Recent rental increases are unsustainable, Alamgir adds, citing year-on-year rent rises of over 40 percent in some submarkets of Miami.

"As a lender and a buyer, we use historical data to make assessments," Alamgir says. "When something goes up by those types of numbers, it's very hard for us to figure out what the right gauge should be; it's certainly not going to go up 40 percent every year for the foreseeable future."

As a positive, Alamgir is seeing a great deal of discipline among borrowers and lenders this time around – more than in all the prior cycles he has experienced during his 25-year career in the real estate lending market.

The panel went on to consider ways in which the economics of lending are changing in the multifamily space, with lenders taking new approaches to structuring and de-risking loans at a time of reduced leverage.

"At the end of the day, it's just math; a lot of these deals don't work, because of where interest rates are and where spreads are," Cale says. "Debt yield is one thing; coverage is another. With cap rates where they were and interest rates going up, what might have been a 65 percent loan request six to nine months ago just doesn't work anymore based on the economics. You have to push back and require somebody to put more equity in – and that's a situation that makes people uncomfortable, based on what's happened in the past."

Lenders are finding ways to work around the issue, using structures such as master leases, says Cale – adding that such approaches can work well in markets where rental growth has been high and is likely to be more resilient going forward.

"If you look at the market dynamics with supply and demand, certainly you would still have a bullish outlook on where multifamily is, specifically in some of the Sun Belt markets," he says.

Panelists pointed out that the current environment of negative leverage – when the cost of leverage is higher than the cap rate at which a property is bought – is a potential indicator of a recession when looking at historical trends over the last few downturns.

Responding to a rhetorical question

Supply-demand balance

Panelists address concerns about multifamily oversupply for the market coming online

"I've heard recently that a wave of supply [of multifamily properties] is going to hit in 2023 – but it seems like every year I hear that," Carroll says. "Day to day, we're not seeing massive over-building; we're still seeing high occupancies, we're still seeing good demand, good traffic, and people moving to the southern half of the country. So supply is not something that necessarily keeps me awake at night." Markets that routinely get a supply hit, such as Dallas and Houston, are likely to see some overbuilding, he predicts, "but I don't think there's some looming oversupply issue in multifamily."

Appel points out that interest rates going up for potential homebuyers is likely to be acting as a "protective factor," for multifamily, with the decline in affordability leading to more demand for rental housing as residents decide to rent for longer. "There is supply coming into some of these markets, but demand still seems to be pretty strong," he adds.

Appel asks Carroll whether a boost in domestic migration was benefiting his firm.

"Yes, I've always heard the statistic that 10,000 people move to Florida every day – so if that's even kind of close, that's a lot of apartment units," Carroll says. "It takes a while to build apartments and you can only build about 300 at a time. What seems like a lot of units, if it's offset by people moving there – quality people with quality jobs – then that definitely softens the blow."

Appel agrees, pointing out that a lot of people are migrating from higher income markets and bringing that higher income with them. "I think that's definitely helping, and you also have some good wage inflation going on in the marketplace, which is supporting rental rates. I think people are underestimating the wage pressure that is supporting affordability — particularly in the Sun Belt markets where there's more growth," Appel says.

"It's very difficult to convince borrowers to do long-term fixed-rate financing right now, because of the increase in interest rates"

MICHAEL CALE
Allianz Real Estate

posed by Appel about the performance of assets this year, Alamgir acknowledged that "the assets have actually held up. So I think multifamily continues to be one of the safest asset classes, maybe outside industrial. And most lenders this year – and during the pandemic – have been lending predominantly in those two asset classes, and most equity investors have been investing in those two asset classes."

Alamgir adds: "I think what we are seeing today is the consequence of Russia and Ukraine; recessionary rates; the lingering effects of the pandemic; continuing supply-chain disruptions – all of these things.

"This uncertainty that is taking place has now been exacerbated by the Fed basically saying that they are not going to come to the rescue anymore. If you look at what is happened since the global financial crisis, the Fed has come to the rescue pretty much every time we have gotten into trouble – and markets pretty much priced that in. Real estate markets were no different, we were pricing in this rescue capital… that is no longer the case."

Sounding a note of caution, Alamgir says he is not sure this rescue capital exists. "And a lot of people aren't sure it's there, so every time they feel like they know what the Fed is going to do, equity markets rally. You're seeing that uncertainty today, and it's weighing on the system."

Appel points out that he cannot remember any other time when general market demand was declining but the Federal Reserve was raising rates. "It's definitely different," he adds.

"And that's against the uncertainty – and markets don't like uncertainty, so it makes it very difficult to price assets today," agrees Alamgir. "As a lender, we wonder about where values are going to go."

Office exodus

Ruder questioned how long the 'flight-to-suburbs' trend will last, as well as the related pandemic-driven trend toward home working that has taken people out of city centers.

Appel says: "What's amazing to me is that despite the fact that people are working from home, if you look at New York City, for example, how low the actual physical occupancy rates in office buildings are, and that you still see people wanting to live in these cities. They want to take advantage of the services, restaurants, entertainment and so on, even though they're not going to the office – it's surprising me, actually."

As society readjusts post-covid, the panel considered whether the next year or so might see more and more employers impose back-to-work orders, with staff required to resume working from the office at least most of the week.

"Key fob swipes in New York City were somewhere around 40 percent pre-Labor Day, so certainly nowhere near full occupancy," Alamgir says, adding that anecdotal reports indicate this number has risen after the holiday.

"But multifamily performance in New York City is at historical highs. People who left New York came back, and came back quickly."

There is a generational divide here too, says Alamgir. "If you're making distinctions in terms of desire to work in the office, and you explore millennials and the younger cohort versus the older cohort, I think there's still a philosophical gap between how often is often enough."

A tipping point for ESG

The panel went on to consider how green lending and ESG initiatives have been adopted by both the equity and debt sides of the multifamily market.

Ruder recognizes that green lending practices were more prevalent in

Growth in affordable housing

Many established multifamily players have been expanding into the affordable housing market

Alamgir points out that there can be tax benefits to lending in the affordable space, adding that Barings also does fixed forwards, "taking out those construction loans and pairing up with those construction lenders."

He adds: "There are certainly attractive, risk-adjusted returns in that space from our vantage point – but it's also mission-driven in terms of having a positive social impact on our communities."

Historically, affordable housing investments tended to be made by private investors, says Appel, but the last five to 10 years have seen a significant increase in institutional adoption of affordable strategies. "I think that as housing has become more institutionalized to the big institutions, it has spread to affordable as well," he adds.

Ruder agrees, noting that Freddie Mac and Fannie Mae appear more focused than ever on "mission-driven" loans to help ease the housing shortage. "If you are a borrower that meets their definition of being mission-driven, then you are in the proverbial right place and time," he adds.

Europe for several years. "I think a bit of a tipping point was reached over the last year or two in adopting these practices into real estate in the US," he says. "There's a lot of opportunity. Just in the last few weeks, we've seen rating agencies on CMBS securitizations starting to ask questions about ESG matters from a credit perspective, such as whether major properties are subject to any municipal or state energy efficiency laws, or whether a C-PACE lien is in place on the property or allowed under the loan documents."

Ruder predicts that questions about efficiency, retrofits, building emissions and other environmental concerns are likely to be adopted into lending applications soon, for all types of commercial loans including multifamily.

Institutional commitment to ESG is growing, says Appel. "It has been around for a long time with European institutions; I think the Canadian institutions are right behind them, and US institutions are definitely growing in their broader commitment, although there's some pushback there in certain cases."

Firms are growing in their sophistication when it comes to using ESG as a way to reduce risk and enhance returns, Appel observes – but he points out that this is still a fairly nascent development. "At the moment, I think a lot of people are doing it almost as its own strategy, as opposed to really utilizing it to enhance what they already do," he says.

"There's a lot of opportunity to be creative," says Ruder.

He points to lenders adopting green value-add multifamily strategies that can be deployed to retrofit assets such as older urban buildings.

"The US has been slow to absorb ESG initiatives when compared with our counterparts in Europe," says Cale. "I think the main reason on the debt side is that in Europe, most of the debt that's on property-level assets is through the banking market, so it's a little bit easier to regulate – more of a one-size-fits-all."

> *"I think people are underestimating the wage pressure that is supporting affordability – particularly in the Sun Belt markets"*
>
> **RUSS APPEL**
> **The Praedium Group**

By contrast, the US market involves so many different sources of funds and capital that "there's not a lot of consistency from a regulation standpoint on ESG in the US, which I think is what hampers some of the growth here," Cale adds.

"One of the concerns for us, though, is that as a lender we can encourage ESG characteristics but legally enforcing them could create liability," explains Alamgir. And he adds that building standards represent a moving target: "We look to support LEED Gold and LEED Platinum projects but 10 years from now, these standards could evolve based on changes in regulation and public perception. So that creates uncertainty too."

Praedium's Appel drew attention to what he saw as a democratization of pricing cap rates among properties

"I think a tipping point was reached over the last year or two in adopting [ESG] into real estate in the US"

MICHAEL RUDER
Cadwalader

that are nearing obsolescence. "In 2021 in particular, it seemed like the range of variation between cap rates was not that wide for almost an entire asset class," he says, "and what we saw was everything trading within a relatively narrow range, where historically you have much bigger ranges. Everything went to what I would call a broadly similar cap rate."

Now that liquidity is leaving the market, we are likely to see more differentiation once again, Appel says – particularly for obsolete properties or those affected by factors relating to age and ongoing capital costs. "We believe that, and we found it very hard to buy certain types of assets over the past few years, where historically there had been a wide spread to core assets but that spread had really narrowed," he adds.

"The cost of that capital wasn't as differentiated, either," Alamgir observes. "As a lender, you were charging borrowers nearly the same rate for a Class-A newly built property as you were for a class B value-add deal."

Capital on the sidelines

Carroll highlights a lack of liquidity on the borrower/buyer side. "Whenever there's less competition, pricing lags and liquidity lags," he says. "Right now, I've heard of deals not getting any offers. And I've certainly heard of deals not clearing at their strike price. Whenever you hear something like that, it scares you a little bit when you're talking about an illiquid asset."

"But there's money on the sidelines," Appel counters, arguing that the issue is not really liquidity, but pricing expectations.

"And you also have borrowers that were a lot more disciplined this time around," Alamgir adds.

"They aren't forced sellers – if they don't get the bid, they'll just hold onto the asset."

Pricing, meanwhile, is very different now compared with a year ago, says Cale. "The last five to seven years, there's never really been an issue on the takeout scenarios – first, because rates were so low; secondly, there was rental growth; and, thirdly, there was a lot of available capital. But now, if you're buying a multifamily asset and you want to do a three-year floating-rate loan and turn it into a transitional asset, the concern now is what does the takeout look like. What does that look like in terms of the financial situation of the property, and what kind of capital is there?

A slower lending pipeline

"As a lender, our pipeline is a lot slower," says Alamgir. "We have plenty of dry powder to put to work, but it's about making sure that we're doing it at a level we feel comfortable at."

Barings' leverage levels have come down 10 percent since the start of the year, he notes. "But a lot of the current loan requests have come down too, so again it's back to the disconnect between where interest rates are going and where cap rates were – and trying to find the right debt coverage ratios or the right debt yield ratios."

Debt yield is consistent regardless of where cap rates are, making it a useful metric for analyzing credit as a lender, he adds. "But in an uncertain environment, the challenge is determining where those underwritten cashflows are going to be."

Alamgir continues: "Multifamily assets are good assets, in terms of being able to reset rents in an inflationary environment. We've talked about wage growth, which means renters can pay more, and there's the disconnect compared with the value of single-family homes. The cost to rent is a lot cheaper than the cost to buy in some markets – and those fundamentals really make you feel comfortable, regardless of what sort of recessionary environment we might go into."

Cale says: "There's debt out there, but until these assets get repriced you're seeing either fewer bids, or fewer bids at the pricing level. I don't know where we go from here, and I think people are waiting for rates to come down. They're waiting for spreads to come down a little bit, and on the lender side we're waiting for the assets to come down so they can get priced accordingly. So it's a strange time right now."

Why it's hard to see headwinds

Toward the end of the discussion, panelists considered what the next six to 12 months might hold for the multifamily real estate space, in terms of threats and opportunities.

The multifamily sector is reliant on the employment market, notes Cale, so a recession and subsequent slowdown in the employment market is likely to impact on rental properties. Other factors, such as the distinct supply and demand characteristics of different markets and the uncertain future of the work-from-home trend, are also affecting market participants' ability to peg cashflows, he adds.

"A 20 percent year-on-year increase in rents is obviously not sustainable," Cale says. "But what's the right number going forward in a market like Raleigh, for example? Is it 10 percent or is it 2 percent? And then there's also pressure on the expense side of the equation; if you're growing rents, that's great — but what does your expense side look like?"

On balance, the multifamily industry seems well positioned, argues Appel. Some of the current demand is likely to be protected by higher mortgage rates and fewer people moving into home ownership because of reduced affordability, he says.

"There are fewer headwinds for multifamily versus other property types," says Alamgir, again citing factors such as high wage growth and low unemployment, as well as low housing stock. "It's hard to see multifamily getting meaningfully hit, even in a recessionary environment."

Picking up on Cale's prediction of rental growth between 2 percent and 10 percent, Appel points out that "if you hit a recession and you've had two quarters of negative GDP, then to even think about positive rental rate growth is still pretty decent."

The cost of debt continues to be a stress point, he says, "and all those threats are real – but I think that operationally this property type is pretty well positioned." ■

"It's challenging to get financing right now, and it feels like 90 percent of the lenders that have been active over the last few years are on the side lines"

PATRICK CARROLL
CARROLL