The Investor's Guide to Today's Multifamily Conditions

ARA Research

Recent increased supply and slowing rent growth in the multifamily sector has raised questions about the prospects for for-rent residential investments.

But we believe a closer look at the causes of market distress and the demand drivers in place suggest that today's conditions could be clearing the way for attractive opportunities in the future.

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Today's Supply

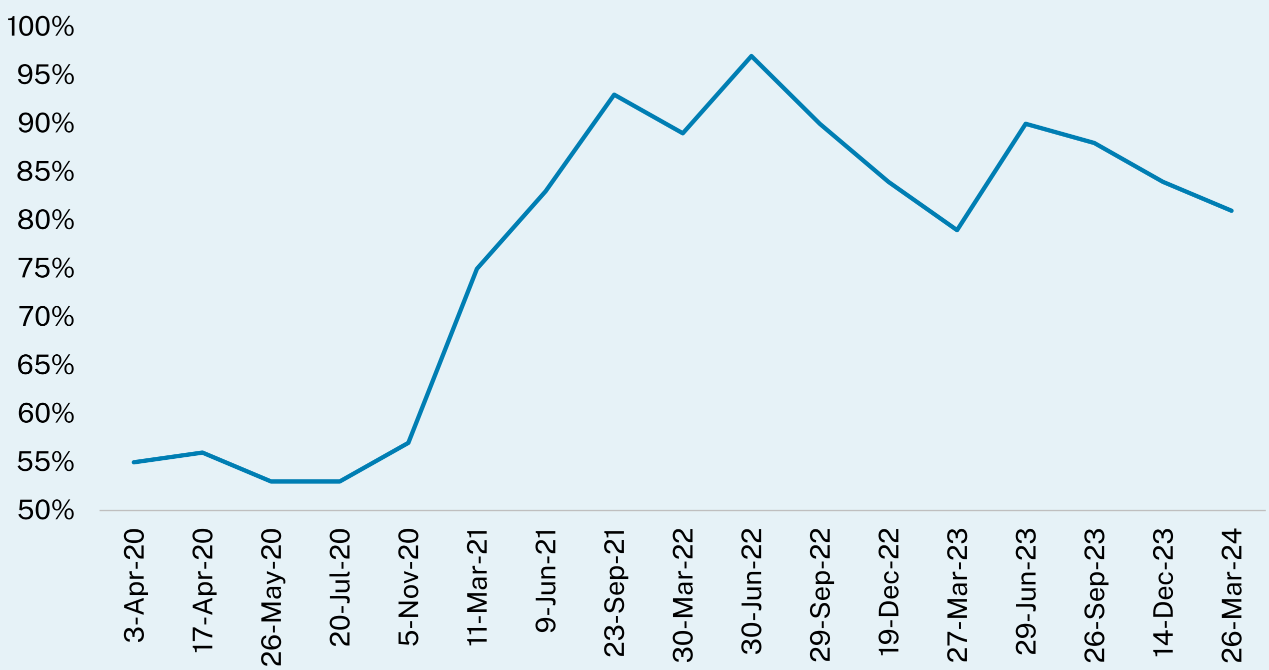
The saying goes "history may not repeat itself, but it often rhymes." For real estate, that has tended to show itself in a logical set of phases (Figure 1). Today, most would probably agree we are in the trough. Whether we are at the beginning or end is more hotly debated and depends on how much further you think values need to fall before reaching a bottom and how long it will take before they start their climb back up.

Many of today's apartment challenges can be attributed to timing. Pandemic-era conditions, including work-from-home orders, supply chain delays, and permitting office backlogs, created material delays in multifamily development. At the peak in 2022, 97% of respondents to the National Multifamily Housing Council's survey of apartment construction and development activity reported experiencing construction delays (Figure 1).

The result of these delays set off a chain reaction: first, it allowed for abnormally strong rent growth in 2020 and 2021 (as rebounding demand was met with constrained new supply), which spurred further late-cycle construction starts from those looking to take advantage of the red-hot market. This has led to all-time high deliveries hitting the market just as demand started moderating from its breakneck pace.

FIGURE 1

Percent of Multifamily Developers Experiencing Delays



Source: American Realty Advisors based on data from National Multifamily Housing Council (NMHC) COVID Construction Surveys and Quarterly Survey of Apartment Construction and Development Activity from April 2020 through March 26, 2024.

Today's Demand

Supply is only a concern when it is handily outpacing demand, so it is important to determine whether construction delays and overzealous investors created a short-term supply surge, or whether demand fundamentals have meaningfully shifted.

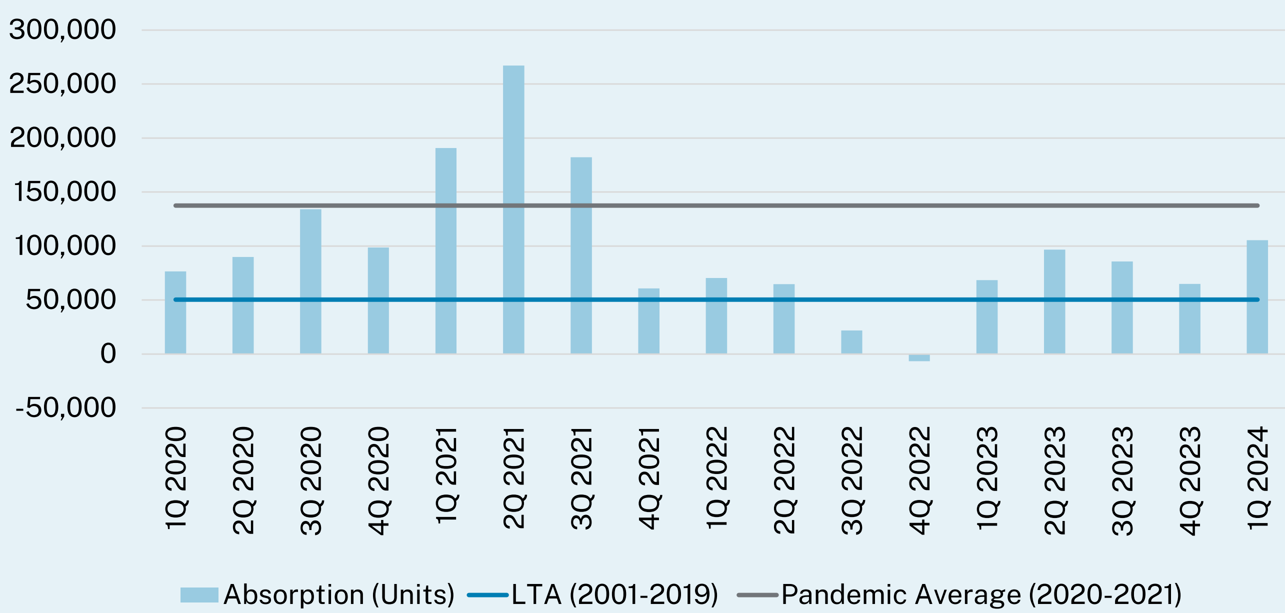
Quarterly demand over the last 18 months has averaged roughly 70,000 units nationwide, firmly above the pre-pandemic long-term average of ~50,000 units. From a historic perspective, this recent period has been a very robust one in terms of absorption.

However, it is likely that the current supply wave is in direct response to the staggering 137,500 units per quarter that were being absorbed in 2020-2021, which was nearly 3x the long-term average (Figure 2).

The explanation for the recent moderation is relatively straightforward: young adults were uncoupling from parents and roommates at a faster rate in the early days of the pandemic, and that rate has since normalized, though is still strong relative to longer-term norms.

FIGURE 2

Quarterly National Apartment Absorption



Source: American Realty Advisors based on data from CoStar as of April 2024.

Capital Market Conditions

Declining occupancies and more subdued rent growth are adding strain to owners' refinancing prospects – already stressed due to the higher interest rate environment. Loans maturing over the coming few years (to the tune of $645 billion between 2024 and 2026) face considerably higher rates than when they were originated; whereas in isolation this would simply mean setting aside more of a property's income to cover the increase in the debt servicing costs, the timing of this particular bout of cyclical weakness means not only will new loan costs be elevated, but the operating revenues available to support the higher costs are diminished.

In some cases, this may lead to an unserviceable debt load; it is this scenario where potential distress (and a resulting swath of opportunities to capitalize on fire sales) stands poised to materialize in a very real way.

Incorporating Market Shifts into Strategy

Today's conditions prove that the multifamily sector is not bulletproof, and that the importance of basics like supply and demand cannot be overstated. However, despite the immediate challenges posed by cyclical weaknesses and the looming potential distress in assets acquired during the past few years, the sharp drop in multifamily starts (down 43.7% in March of 2024 compared to the same period one year prior[1]) and multifamily permitting (down an average of 28% year-over-year over the last consecutive four quarters[2]) signals a pivotal moment for forward-thinking investors. This forthcoming pullback in new inventory, coupled with sustained, albeit more normalized, demand should help move fundamentals nearer to equilibrium.

For those looking beyond the immediate horizon to 2025 and beyond, the current market conditions offer a unique window to acquire assets at potentially lower valuations. Now is not necessarily a moment for caution, but rather for discerning, proactive engagement. An ability to anticipate fundamental improvement (and translate that through an informed submarket and asset strategy) should further drive conviction in taking advantage of today's distressed buying opportunities.

1 Source: FRED St. Louis as of April 2024.
2 Source: The Census Bureau and the Department of Housing and Urban Development's Monthly New Residential Construction reported dated April 16, 2024.

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