MULTIFAMILY COMPS

Underwriting Multifamily with Inflation and Rising Interest Rates

Article 1: Revenue and Expense Growth

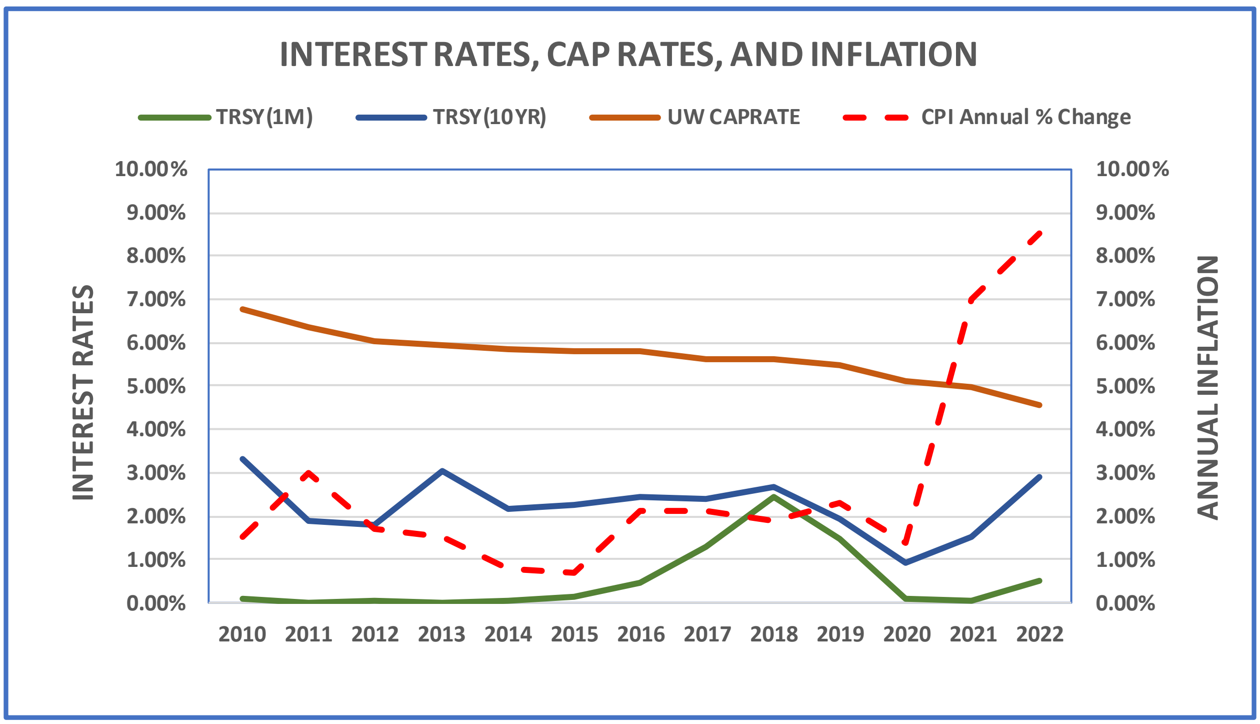
May 1, 2022

Research Series: The 2021 Multifamily Market experienced record transaction volume, high loan origination, low interest rates, high rent growth, and sustained CAP Rate compression. Now 4 months into 2022, inflation is at 40-year highs and interest rates are 150 basis points higher than Dec 2021 lows with expectations of multiple Fed Rate hikes over the next 9 months. This introduces high uncertainty into the three determinants of value: Revenue, Expenses, and CAP Rates. This research series will explore relationships amongst these variables with an emphasis on understating how Revenue and Expense Growth vary across property attributes, location, demographics, and affordability. We will also breakdown contributions to Expense Growth by Operating Statement Line-item. Our objective is to provide better insight into factors affecting forward growth assumptions when underwriting Multifamily assets.

Low Cap Rates with Rising Interest Rates and Inflation

Chart 1 below shows the striking rise in short-term (1 month) and long-term (10 year) US Treasury Rates and Inflation (Annual % Change in CPI) alongside the steady decline in CAP Rates. The CAP Rate used in Chart 1 is the Median value of Underwritten NOI divided by Appraised Values on Loan Originations in the Multifamily Comps LLC (MFC) Database.

Chart 1



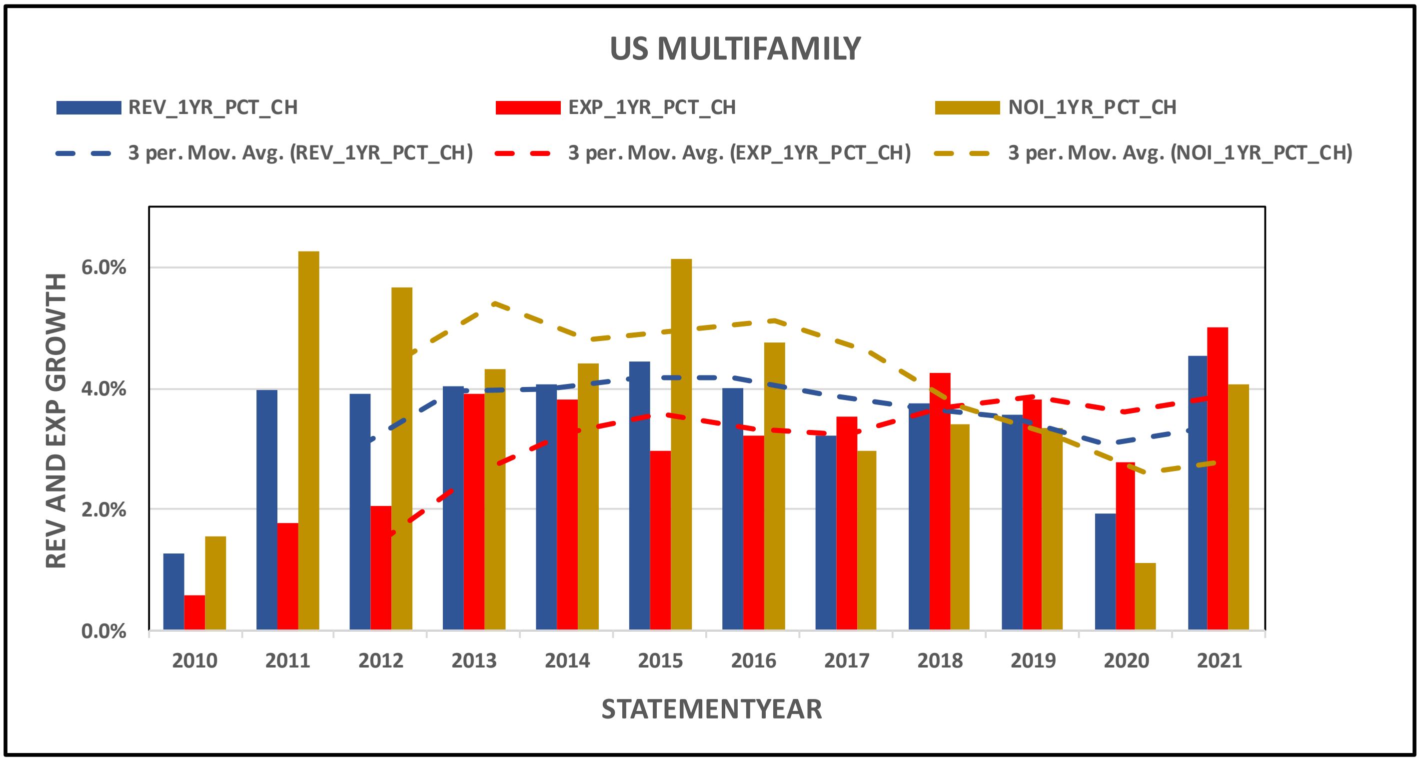
Sources: Fed, BLS, Multifamily Comps

It's natural to ask if the historically low CAP Rate is sustainable in the higher interest rate and inflationary environment. Based on current investment activity, it appears that investors are willing to accept low absolute and levered income returns based on the expectation of continued high Revenue Growth.

Accelerating Multifamily Expense Growth

Chart 2 below shows Median Annual Revenue, Expense, and NOI Growth and 3-year moving averages calculated across all properties in the MFC Database. The dataset for these calculations is properties in the Freddie Mac CMBS lending programs. This includes both institutional sized properties and smaller properties and the full range of property attributes, demographics, geographies, and affordability categories.

CHART 2: US Multifamily Revenue, Expense, NOI Annual Growth and 3-year Moving Averages



Source: Freddie Mac CMBS, Multifamily Comps LLC

It is notable that starting in 2017 Expense Growth outpaced Revenue Growth for the Agency financed dataset. Higher Expense Growth places a higher bar for Revenue Growth to achieve the higher expected NOI Growth baked into today's low CAP Rates. And it is natural to expect higher Expense Growth to continue and potentially accelerate in an inflationary environment. Our primary takeaway from these observations is that forward Expense assumptions merit close attention when underwriting multifamily property. Plugging in 3% is not the answer.

Article 2 of this research series will analyze differences in Expense Growth across major CMSA's alongside the Bureau of Labor Statistics (BLS) Regional All-Urban CPI indices.

Multifamily Comps LLC (MFC): The MFC Database is comprised of 45,000+ Lender Underwritten Financials and Appraised Values, and 150,000+ serialized Operating Statements extracted from Multifamily CMBS Offering Circulars and Trustee Reports. The primary database concentration is Garden style apartments serving middle income households. The database also includes significant groupings of Mid-Rise, High-Rise, Senior, Healthcare, Student, and Manufactured Housing. The Multifamily Comps (MFC) Statistical Valuation (STATVAL™) Application provides an automated and cost-effective method to perform a Benchmark Underwriting using the Income Capitalization Method in a manner that statistically matches underwriting assumptions on recent Loan Originations. Once a Subject Property has been entered into STATVAL™, a Benchmark Underwriting may be executed in as little as 5-10 minutes and cost as little as $200-$300 per Property for Clients who take advantage of volume pricing discounts. For further information, demos, and/or to set up a STATVAL™ User Account please contact our sales representatives:

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