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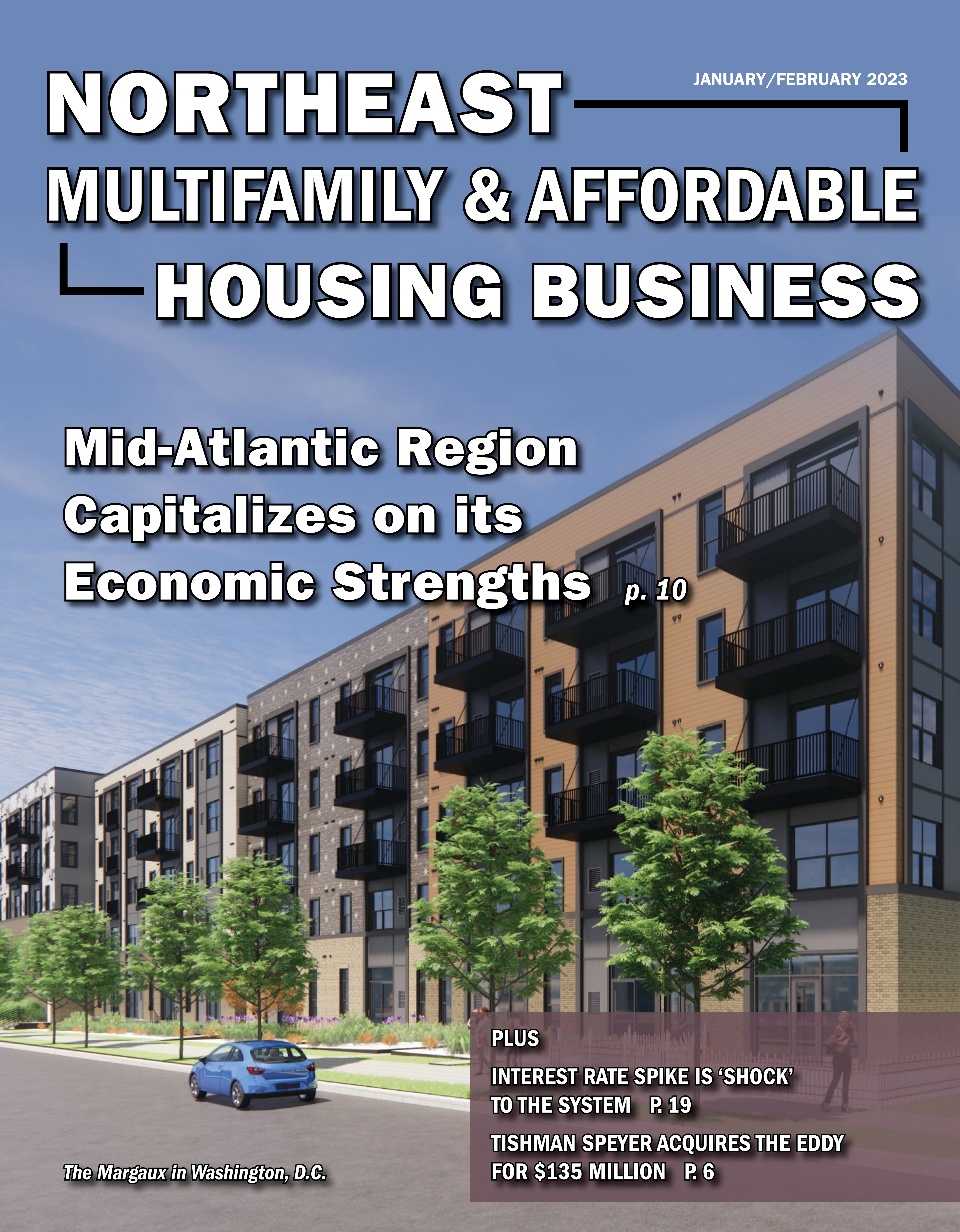
NORTHEAST MULTIFAMILY & AFFORDABLE HOUSING BUSINESS



Mid-Atlantic Region Capitalizes on its Economic Strengths

p. 10

PLUS

INTEREST RATE SPIKE IS 'SHOCK' TO THE SYSTEM P. 19

TISHMAN SPEYER ACQUIRES THE EDDY FOR $135 MILLION P. 6

The Margaux in Washington, D.C.

Interest Rate Spike Is 'Shock' to the System

The bid-ask gap between buyers and sellers has widened, but brokers expect local, private investment and strong real estate fundamentals to reignite transaction activity later this year.

Compiled by Kari Lloyd

The brisk pace of apartment sales during the first half of 2022 led many brokers across the Northeast to anticipate a record year in deal volume. But to combat inflation, the Federal Reserve in March 2022 issued the first of eight consecutive interest rate hikes, the latest of which was a quarter-point increase in early February of this year. The target range for the federal funds rate is now 4.5 to 4.75 percent. That's significant because the fed funds rate directly influences what consumers are charged on credit cards, personal loans and even mortgages.

At a news conference in early February, Fed Chairman Jerome Powell said that although inflation is easing — the Consumer Price Index fell from an annual rate of 9.1 percent in June 2022 to 6.5 percent in December — further rate hikes were likely necessary in the short term.

Against that backdrop, *Northeast Multifamily & Affordable Housing Business* sent questionnaires to Northeast-based brokers to gain their perspective on the major takeaways from 2022 and to share their predictions for 2023. The participants included Nigel Crayton, director at Greysteel; Lev Mavashev, principal at Alpha Realty; Nat Gambuzza, senior managing director at Berkadia; Simon Shkury, president and founder of Ariel Property Advisors; and Jeff Algatt, senior vice president of capital markets at Colliers. Their edited responses follow.

NMAHB: From your perspective, what has been the biggest story on the investment sales and development front over the past 12 months?

Gambuzza: The biggest story is clearly what is happening with interest rates and how they are affecting loan proceeds. As interest rates started to rise in the second quarter of 2022, the conversation came up regularly, but it was not an immediate concern. Most investors were willing to accept a modest bump in rates. As we entered the third and fourth quarters of the year, rates had moved up multiple times, and it was an unavoidable topic that needed to be discussed by everyone in the transaction.

The fundamentals for apartments are still strong. There is a shortage of housing, rents are still growing, and with interest rates rising less people will be purchasing homes and defaulting to rentals. Cap rates are still adjusting to the quick rise we had in 2022, but I also think there is a sense of stability now as the Fed indicated it will decrease the pace and intensity of rate hikes. This should lead to investors re-entering the market this year.

Mavashev: It's no secret that last year was a rough year due to rising interest rates. After almost 15 years of low rates, 2022 was a shock to both buyers and sellers in the market. Rates doubled within nine to 10 months. Buyers didn't know how to underwrite deals anymore as their cost of capital was constantly changing, and banks were re-trading. Most investors moved to the sidelines to watch the rates play out, while desperate sellers couldn't catch a bid. Cap rates rose quickly to catch up with the rising rates.

NIGEL CRAYTON
Greysteel

Crayton: The biggest storyline over the past 12 months has and will continue to be inflation. Inflation has had a direct impact on everything in commercial real estate. Initially thought to be transient due to the economy 'reopening' post-pandemic, we quickly realized that inflation was entrenched in almost every sector of the economy. From interest rate hikes to development slowdowns due to increased costs and labor, inflation has had chilling effects on the investment sales market over the past calendar year.

Shkury: In 2022, the demand for investing in New York City multifamily was at one of its highest levels in the past 20 years. The New York City investment sales market, in general, was very strong — $39 billion in volume and more than 2,700 transactions. It was one of the best years in the past five, according to our firm's research. Of those total trades, $16 billion were multifamily transactions, or 42 percent of all properties sold, which is the highest percentage ever recorded in the city.

The property at 1 West Dickerson Ave. is a 214-unit building located in Dover, N.J. Resident amenities include a gym, basketball court, lounge and garage parking.

NMAHB: At its December meeting, the Federal Reserve raised the benchmark federal funds rate by half a percentage point, officially raising the target range to between 4.25 and 4.5 percent, the Fed's seventh rate hike in 2022. (The Fed raised the target range for the federal funds rate 25 basis points to between 4.5 and 4.75 percent in February 2023.) What impact did the rise in interest rates have on buying and selling in your territory in 2022?

Shkury: Although the New York City investment sales market was very strong in 2022, the year would have been significantly stronger absent the rising interest rate environment. Mortgage rates rose rapidly by 100 percent — from 3 percent at the beginning of the year to close to 6 percent at the end of the year. As a result, our firm's research shows that the investment sales market slowed in the second half of the year with dollar volume declining by 29 percent and transaction volume declining by 21 percent compared with the first half.

Crayton: Rising rates have led to lowering pricing in the market. At its core, commercial real estate is a mathematical equation. The higher your cost of debt, the less you are willing to pay for an asset. With property values lowering from their COVID peaks, it has caused a pause in the market as owners are grappling with yesterday's prices and buyers are inputting today's debt. The higher interest rates and the widening bid-ask disparity between buyers and sellers are the two major culprits behind the market slowdown.

Mavashev: The NYC multifamily market definitely saw a slowdown in transaction activity, especially in the third and fourth quarters of 2022. Rates were hiked intensely, and it seemed like it was never going to stop. This uncertainty made it more difficult for buyers to size up a deal. They couldn't anticipate the interest rate at closing or underwrite to a future potential refinance rate. The economics of the deal kept changing. Many investors decided to stay on the sidelines as there was so much uncertainty in the market, and this resulted in a slowdown of transaction activity.

Algatt: Class A assets did not trade in Northeastern Pennsylvania. Class B workforce, garden-style properties were the most active, especially smaller-sized transactions under $5 million where higher down payments were deployed by private buyers with abundant cash reserves. Nationally, investment sales volume declined in the latter months after strong numbers were posted earlier in 2022.

NMAHB: In the wake of the series of interest rate hikes by the Fed, have cap rates on property sales in your region increased? If not, do you anticipate cap rates will increase in the near term?

Crayton: Yes, cap rates on property sales have increased. For example, if you were previously buying deals at a 5 cap when debt cost 3 percent, there was a spread between your projected returns and your cost of capital. As the cost of debt rises, buyers are still looking for that same (or even greater) spread as there is more inherent risk when the cost of debt rises. To avoid a negative leverage scenario, the rise in the cost of debt has had a positive correlation with the rise in cap rates for buyers.

Shkury: Yes, cap rates have moved up a bit. The free market residential market was somewhat unchanged as interest rate growth coincided with robust rent growth. However, rent-stabilized multifamily has seen cap rate expansion and is much more sensitive to rising interest rates. This is because annual rent increases are capped, and the Housing Stability and Tenant Protection Act (HSTPA) does not allow adequate rent increases to offset the cost of renovating vacant units.

Mavashev: For rent-stabilized multifamily buildings I think cap rates will continue to rise as they continue to lose their investor appeal — mainly due to a cap on allowable rental increases while operating costs are rising.

Free-market multifamily buildings, on the other hand, are showing signs of increased demand and I think cap rates will actually decrease in 2023 due to lack of supply. As more investors enter the market in 2023, their preference will be for free-market buildings, as rents can be raised to offset rising expenses such as cost of debt. Despite the rising interest-rate environment, investors are excited for such products as they can capitalize on the upside potential in the free-market rents.

NMAHB: Which category of buyers in your territory has been the most active over the past year? Do you anticipate any changes on that front in 2023?

Mavashev: The local private investors will be the most active buyers throughout 2023. They have more patient capital and can underwrite deals more competitively as they typically don't syndicate their deals with outside capital. For the past two years, the most active buyers have been syndicators and private equity-backed operators. But as they are searching for better returns in this economic climate, the local family offices and private investors will be the more competitive buyers in 2023.

Crayton: Local, private investors have by far been the most active in our market over the past year. Local investors typically have more surety as they have better intelligence on the market. Also, national banks have pulled back on lending. With national banks slowing down, we have seen a rise in preferred equity and regional and community lending as debt sources. Local investors typically have these local relationships, allowing them to be more aggressive in the marketplace.

I would anticipate more of the same in 2023, as I don't see national banks as a competitive lending source until rate volatility is reeled in.

Shkury: All of the above, depending on the sub-segment and product type. This is the amazing part about New York City: every property has its bucket of capital. REITs, foreign, local, national firms and private investors were all involved in purchases of free-market multifamily last year.

Demand for free-market residential buildings was robust in 2022, accounting for 75 percent of the $16 billion multifamily market. Post-HSTPA, the active investor profile for rent-stabilized rental buildings has shifted to private high-net-worth individuals and family office investors with patient capital. Rent-stabilized buildings accounted for 19 percent of all multifamily sales in New York City in 2022.

Algatt: Private local investors were the most active last year in Northeastern Pennsylvania. REITs and national buyers were absent perhaps because of a dearth of institutional-quality assets on market or available for off-market transactions.

NMAHB: Are you seeing any trendlines regarding the type of apartment properties that are most frequently changing hands? Do investor preferences vary when it comes to suburban product versus urban product?

Algatt: Workforce, garden-style housing transactions in suburban and rural locations dominated the landscape. Urban areas continued to see new supply through apartment conversions, but those projects remain closely held for the time being.

NAT GAMBUZZA
Berkadia

Gambuzza: All asset types within the multifamily sector are still in high demand. We saw demand surge for suburban apartments at the onset of the pandemic. Since then, we have seen a healthy balance of demand for suburban and urban rentals. Once renters moved to the suburbs, many got used to that lifestyle or continued to work from home. At the same time, urban market demand has risen from renters who crave urban amenities as well as the need to return to work.

Value-add remains the most desired with its inherent opportunity to hedge inflation and create value. Properties with assumable debt have increasingly become attractive. In many cases, the rates are substantially lower than what is available in the market but most importantly, it removes the uncertainty of how the debt will look.

Crayton: With the cost of construction at all-time highs, we have seen investors shift focus from self-building new apartment projects to looking to acquire recently delivered apartment buildings. With the cost to develop increasing, resulting in the replacement cost gap widening even further, investors can acquire newly built assets with typically higher returns and less risk than new construction. Urban product seems to be leading the way, as renters continue to return to major metropolitan cities.

Mavashev: I am seeing a trend of strong demand for deals with attractive assumable financing already in place. In today's high interest rate market, buyers are attracted to deals with assumable mortgages at a low interest rate.

Shkury: Institutional demand for free-market residential buildings in New York City was significant in 2022, and we expect this to continue. Demand drivers included New York City's rent growth compared to receding rents in the Sun Belt and inflationary pressures as free-market rental buildings could be considered an inflation hedge. Additionally, there is a perpetual low supply of housing in New York City due to a lack of government incentives to build rentals. Estimates show that 560,000 new housing units will be needed by 2030 simply to keep up with anticipated population growth.

NMAHB: What do you see as the biggest challenge affecting the multifamily market in your territory and why?

Crayton: Categorizing the increased cost of borrowing with rising interest rates. If the cost of borrowing goes up, it will result in pricing retracting. This means there will be less inventory as owners pivot to an extended hold or refinance in the interim until things begin to normalize. Everything starts and ends with the rising cost of debt. As the cost goes down, I would expect market fundamentals to begin to normalize.

Mavashev: Besides the macroeconomic issues such as rising interest rates and a possible looming recession, I think the key challenge for multifamily in New York City is its regulatory environment. New regulations are a burden to operators and always translate to higher taxes and higher operating costs. Approximately 45 percent of the housing stock is rent-regulated, and the other free-market units are under constant threat from local politicians to regulate those units as well. It's still the main reason many investors are shying away from NYC, especially if it's a rent-regulated building.

Shkury: New York City owners of rent-stabilized apartment buildings are facing a perfect storm as mortgage maturities and resets are approaching for properties purchased before the passage of HSTPA in 2019.


SIMON SHKURY
Ariel Property Advisors

Sharply higher interest rates combined with the impact of the regulation have resulted in a decline in valuations. HSTPA regulations essentially pulled the rug out from under the owners of these buildings, who had counted on the ability to renovate and improve often long-neglected apartments and buildings and offset their investments with appropriate rent increases.

Renovating and upgrading a rent-stabilized apartment after a long-term resident moves out can cost as much as $100,000, but the low rents permitted under HSTPA barely cover basic operating costs. A major reason that over 40,000 rent-stabilized units remain vacant in New York City is that owners have no incentive to invest capital in them.

Briar Manor Apartments is a 60-unit community located in Berwick, Pa. Aparments come with in-unit dishwashers and private assigned parking spaces.

Gambuzza: Interest rates and the increased cost of borrowing will continue to be the biggest challenge in our markets. It is very difficult to navigate transactions when borrowing rates, costs and loan amounts are constantly changing. Connecting with a lender early and locking in rates is paramount right now.

NMAHB: CBRE's 2023 multifamily outlook indicates that pricing is adjusting to higher interest rates and that additional increases in cap rates are on the way. How does this align with your predictions for your territory in 2023?

Crayton: It's not a prediction anymore as we are already seeing it. Borrowers have to pay more, which leads to buyers expecting higher returns. With borrowers' underwriting assumptions shifting higher, we predict pricing retraction from 2021 numbers.

Gambuzza: Cap rates have already increased, but they have not matched the same level of increase as interest rates. There are several factors that are keeping cap rates at modest increases: one is that rents are still very strong with little vacancy being experienced in our markets; the second is there is such a limited supply of quality apartments that come to market for sale.

Algatt: Investors view multifamily as a safe harbor. Multifamily is one of the most sought-after asset classes, buttressed significantly by the liquidity and appetite of seasoned government-sponsored enterprise financing, and the strength of local banks. Any cap rate increases in Northeastern Pennsylvania multifamily transactions are unlikely to be significant or long-lasting.


JEFF ALGATT
Colliers

Shkury: We believe that long-term opportunities will continue to exist in the multifamily market in New York City, as evidenced by the interest of institutional investors in this sector, albeit mostly in free-market properties. The next 18 to 24 months will likely see a substantial financial restructuring in rent-stabilized buildings and an uptick in sales. Fortunately, the New York City real estate market is resilient and has a pocket of capital for every type of asset, and rent-stabilized buildings are no exception. While institutional investors are pivoting, long-term investors with patient capital, mostly private high-net-worth individuals and family office investors, will stay with rent-stabilized assets.


The Pointe of Stoneybrook is a 192-unit community located in Seaford, Del. Resident amenities include a 2,500-square-foot clubhouse with gathering room, fitness center and an outdoor pool.

Mavashev: Overall, I think cap rates for New York City will remain steady at their current level. But for certain free-market product, I actually think cap rates will decrease despite higher interest rates. Well-located, free-market buildings in prime locations of Brooklyn and Manhattan are in low supply and high demand. We'll actually see them trade below 'market' cap rates. It's just a simple story of supply and demand.


LEV MAVASHEV
Alpha Realty

NMAHB: Is there anything that you'd like to add or emphasize that you believe is important to note in the multifamily industry?

Crayton: The market isn't all doom and gloom. Yes, values are not at 2019-2021 peaks anymore, but if you bought correctly, you are still up and playing with house money.

Gambuzza: New Jersey and the greater region benefit from the tremendous amount of capital here. There is plenty of private capital coupled with an entrepreneurial spirit that will continue to navigate through transactions. Our region is well-banked, so there are many lender options available. Lastly, our market tends to hold up better during downturns than other markets, so we become a target for investment dollars. ●