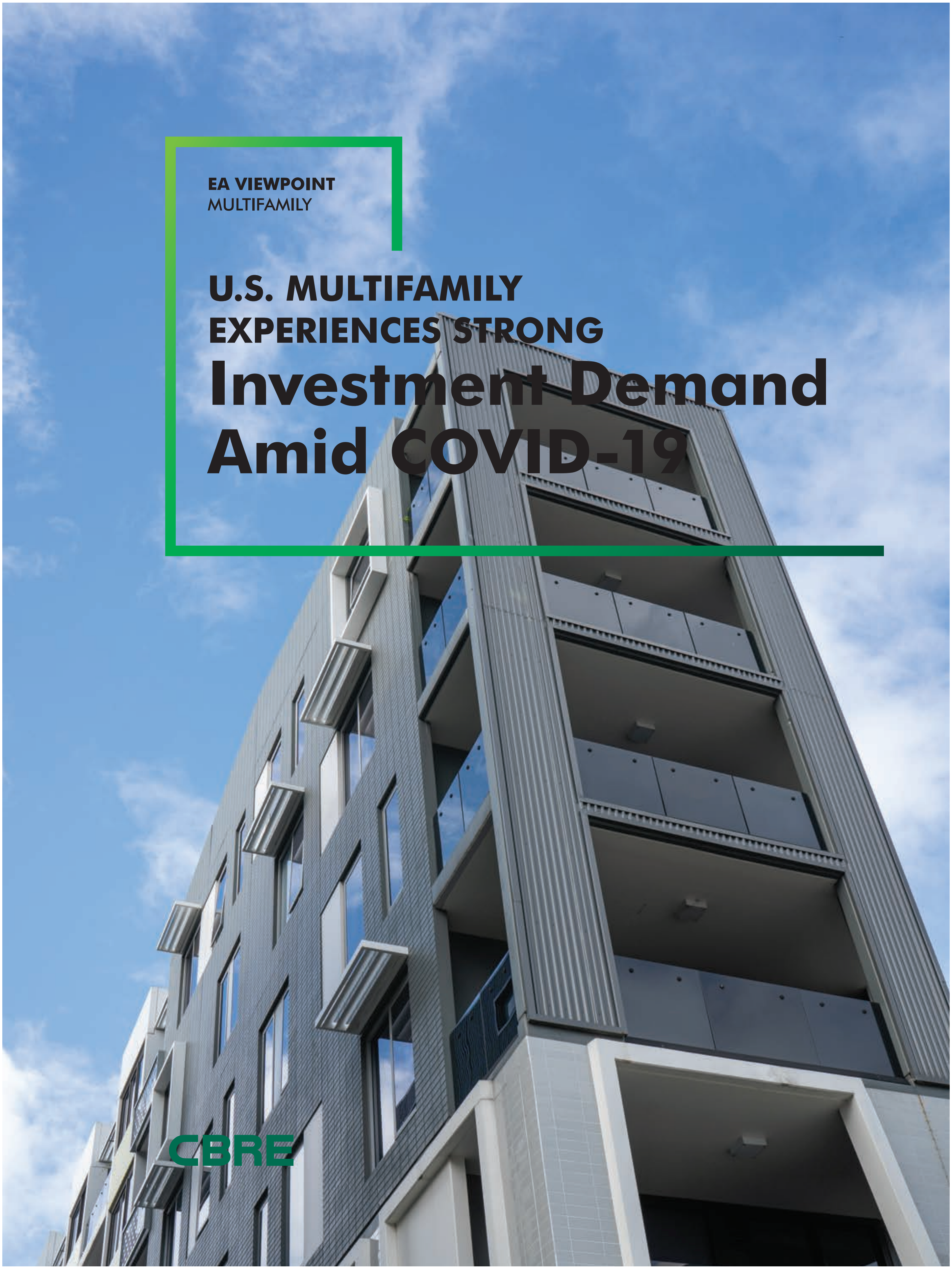
EA VIEWPOINT
MULTIFAMILY

U.S. MULTIFAMILY EXPERIENCES STRONG Investment Demand Amid COVID-19



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EXECUTIVE SUMMARY:

- U.S. Multifamily remained the preferred investment sector in 2020, with its share of overall transaction activity reaching 36% - its largest share since 2001.
- Rents overall declined by 4.2% in 2020. However, despite the ongoing pandemic, out of the 69 multifamily markets tracked by CBRE Econometric Advisors (EA), 45 recorded positive rent growth in 2020.
- Fundamentals weakened the most in major metros, urban cores, and Class A units.
- Major markets (San Francisco, New York) saw the largest rent declines, while the leading mid-tier markets (Riverside, Sacramento, Albuquerque, Tucson) saw rent growth exceeding 5%, surpassing pre-COVID levels.
- The vacancy rate in urban core submarkets reached 6.1% in Q4 2020, its highest level since Q2 2010. Suburban submarket vacancy was relatively stable over this same period.
- Similarly, vacancy rates for Class A jumped to 5.9% in Q4 2020, while Class B and C vacancy rates remained flat.
- EA expects national multifamily fundamentals to begin to recover in mid-2022, with secondary markets leading the recovery, followed by major metros.

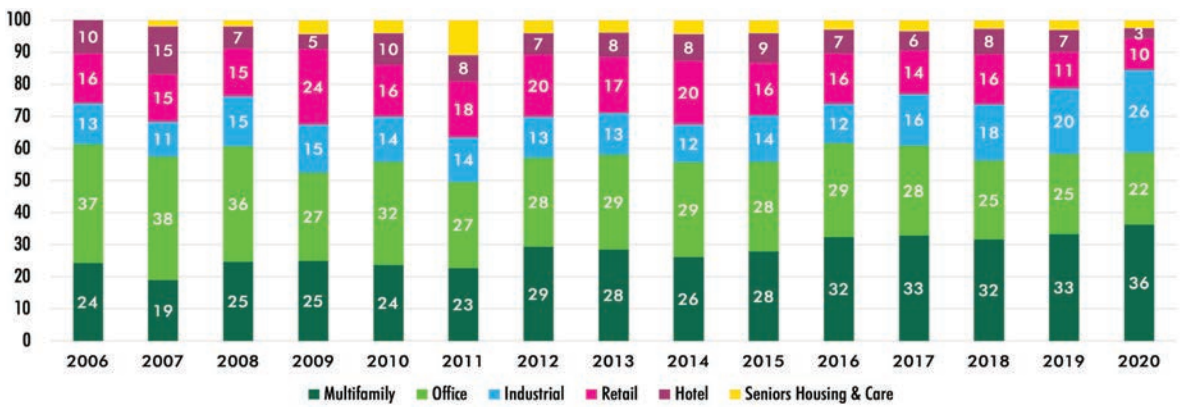
INTRODUCTION

This ViewPoint analyzes the U.S. multifamily sector before and during the COVID-19 crisis. We explore investor rationales, new trends brought on by the pandemic and older trends that have been accelerated by it, and why EA believes multifamily will continue to provide stable and consistent returns in the future.

EXPANDED INVESTMENT ACTIVITY IN THE U.S. MULTIFAMILY SECTOR

The multifamily sector's share of overall transaction activity has grown steadily over the past 15 years. Starting from a quarter of all transactions in the mid-2000s, multifamily expanded to a third of all transactions by 2016, overtaking the office sector, and giving multifamily the largest share of any property type by investment volume. It remains the preferred sector in 2020 with its share reaching a 20-year high of 36%, underscoring investors' confidence in the sector.

Figure 1: Transaction Volume Share by Property Type



Source : Real Capital Analytics, Q4 2020

A combination of robust historical performance, resiliency during the pandemic, and expectations of stable future rent growth are fueling investors' confidence in the multifamily sector. Supported by demographic trends and a growing preference for urban living, multifamily provided high and stable cash flow yields compared to other CRE sectors over the past decade. While pandemic-related shutdowns in urban areas caused demand to slip from pre-COVID levels, multifamily did not experience the pull-back seen in retail, office or hotel. In the post-pandemic future, investors see multifamily as a safe, stable asset with less volatility and uncertainty than other sectors.

DEGREE OF RESILIENCE OF MULTIFAMILY SECTOR VARIED BY CLASS, TYPE & REGION

From Q4 2019 to Q4 2020, the U.S. Sum of Markets multifamily vacancy rate increased by 40 basis points (bps), while rents fell by 4.2%. This is a milder response than that experienced during the Global Financial Crisis (GFC), when, within a year, vacancy rose by 180 bps, and rents fell by almost 7%.

But there is more resiliency in the multifamily sector than those national numbers suggest. The Sum of Markets statistics are dominated by large, dense, expensive metros which have been harder hit by COVID-19. These large metros saw many of the urban amenities that attract renters to higher priced markets shuttered in the interest of public health, while simultaneously, the prevalence of remote work made it possible to migrate to cheaper, less dense markets. These smaller metros were only lightly affected by these demand issues, and most are well on their way to recovery, posting year-over-year vacancy decreases in Q4 2020 and positive rent growth.

Performance by type, class, and geography varied along similar lines. Suburban, Class B/C and mid-size Midwest, West and Southeast multifamily markets have all fared better during the pandemic than Class A apartments in urban cores on the East and West coasts.

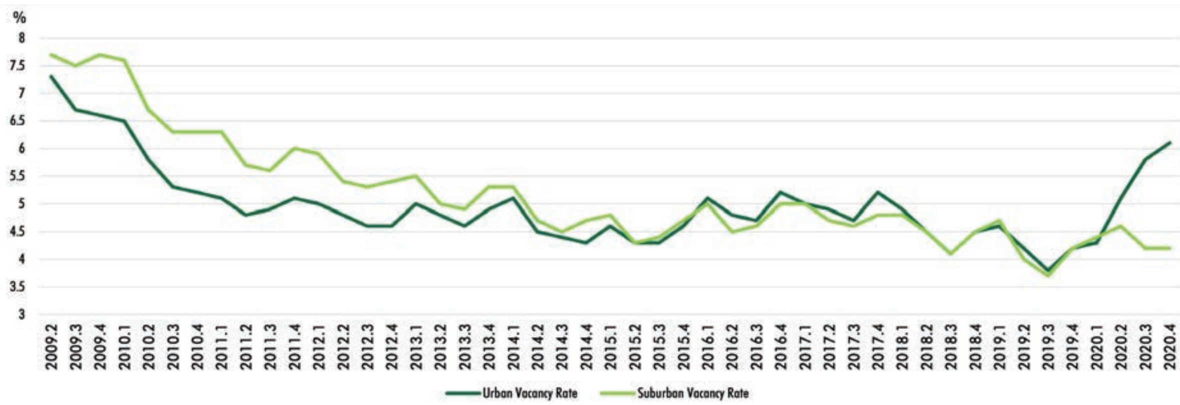
PERFORMANCE DIFFERENCES IN URBAN AND SUBURBAN MARKETS

The pandemic dramatically reshaped urban life in 2020. Urban core submarkets, like large, expensive markets, lost attractions such as walkable restaurants, bars and entertainment venues due to pandemic-related shelter-in-place orders. Meanwhile, unemployment from hospitality and service industries put more pressure on urban cores already stretched thin for affordable housing. Consequently, the worst-hit submarkets this year have been the urban cores in San Francisco and New York City, where effective rents fell by more than 20% year-over-year, as tenants either condensed households or moved to outlying areas.

This disparate impact of the pandemic on urban core and suburban submarkets is most starkly illustrated in their recent divergence in vacancy rates. Urban core and suburban vacancy converged in 2015 and have been essentially the same for the past five years. The flight from the shuttered, expensive urban cores is evidenced by a 200-bp jump in vacancy after Q1 2020, reaching 6.1% in Q4 2020, its highest level since Q2 2010. While, in suburban markets, vacancy has remained on its pre-COVID trajectory.

As for multifamily rents, urban core submarkets' year-over-year rents declined by 12.1% from Q4 2019 to Q4 2020, worse than the 10.6% peak-to-trough contraction during the GFC. Suburban submarkets have been much more resilient, with rent slipping by only 0.4%, compared to 6.7% during the GFC.

Figure 2. Downtown and Suburban Multifamily Vacancy Rates



Source: CBRE Econometric Advisors, Q4 2020

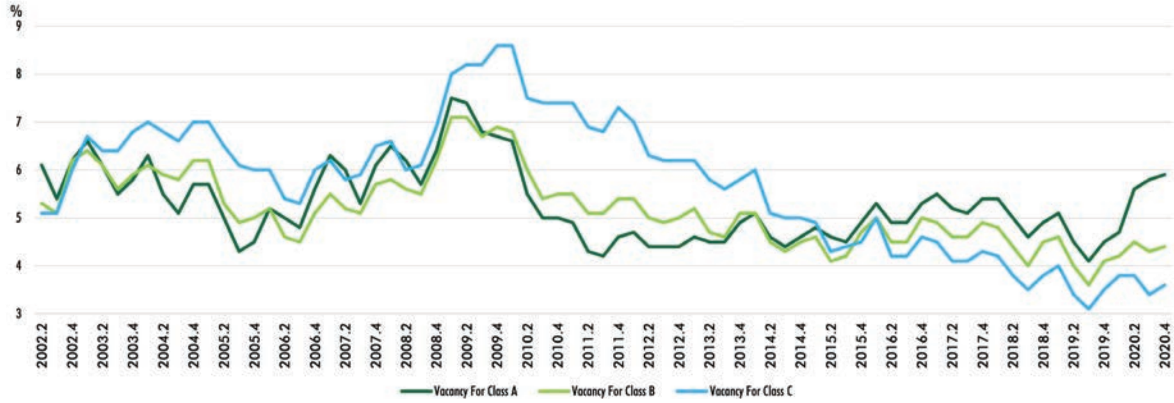
Although current trends can still change or even reverse after the pandemic ends, with social distancing restrictions fading away and commercial activity in downtowns restarting, there is support for the argument that suburban multifamily markets were affected less by the crisis even compared to the past recession.

PERFORMANCE BY BUILDING CLASS

Social distancing measures also disproportionally affected employment in the services and hospitality businesses, which tend to pay lower wages. In theory, disproportional impact on low-income categories of workers should negatively affect demand for Class B and C multifamily housing, but as Figure 3 illustrates, this wasn't the case.

Higher unemployment rates in the low-wage service industry did not translate into higher vacancy rates in Class B and C. Due to supply constraints, Class B and C have been outperforming Class A since 2015. Rather than seeing this gap shrink with the onset of the pandemic, we saw them diverge further, as vacancy rates for Class A units jumped to 5.9% in Q4 2020, a 140-bps increase from the year before, while Class B and C vacancy rates stayed relatively stable. In addition, Class C year-over-year rent growth remained positive in 2020, while growth rates for Class A and B turned negative.

Figure 3. Multifamily Vacancy Rate by Class

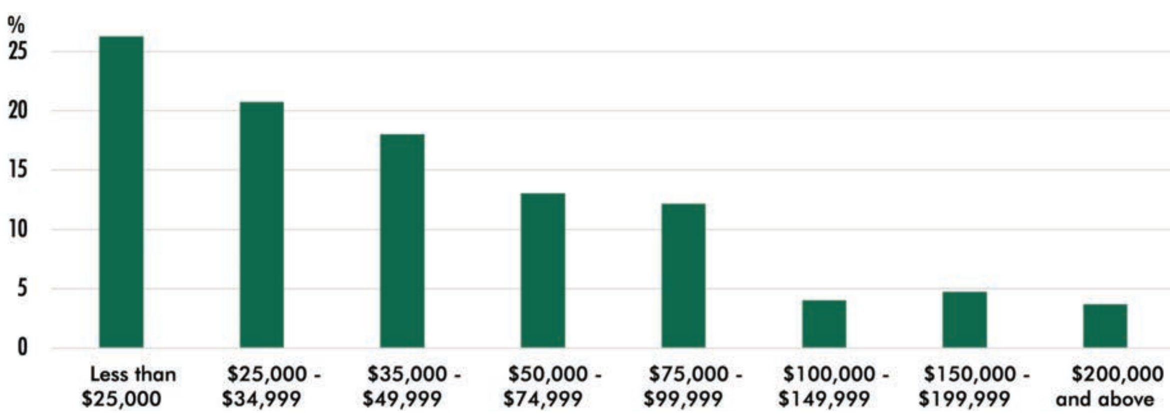


Source: CBRE Econometric Advisors, Q4 2020

One possible explanation for the relative underperformance of Class A in light of these labor dynamics is that high-income renters are more able to work from home, and therefore have more flexibility in choosing where to live and whether to buy or rent housing. With their offices closed, they opted out of expensive, office-adjacent apartments. Class C residents typically can't move as freely as their higher-paid counterparts, and experienced tighter competition for already scarce affordable units.

Recently enacted government policies, such as eviction moratoriums, also contributed to Class C overperformance. According to a recent U.S. Census Bureau Household Pulse Survey, about 18% of all renter-occupied households were behind on their rent payments. For households with an income of less than $50,000 a year, 22.5% were falling behind on rent payments.

Figure 4. Percent Of Renter Households Behind On Rent Payments, By Income



Source: U.S. Census Bureau; Household Pulse Survey, February 2021

The issues currently faced by the multifamily industry, especially for landlords serving the most vulnerable and financially fragile groups of renters, won't be resolved by the market mechanism alone, and will require financial aid and public policy support from all levels of the government until the labor market fully recovers.

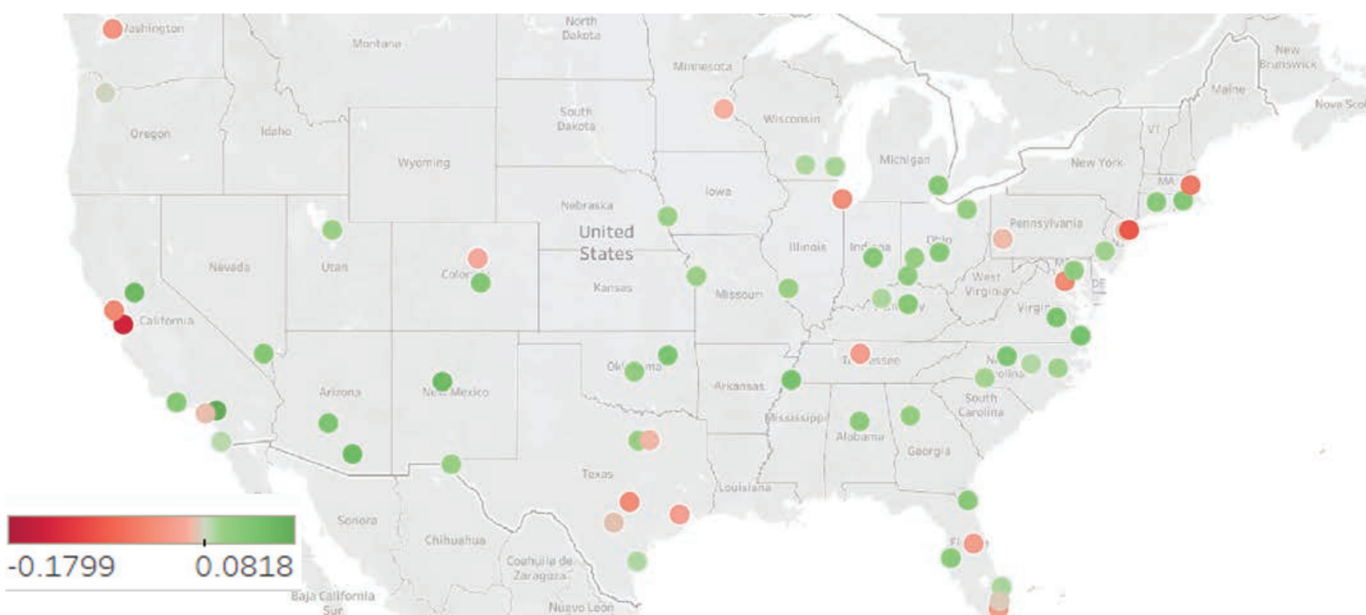
PERFORMANCE BY MARKET

Despite the ongoing pandemic, out of the 69 multifamily markets tracked by EA, 45 recorded positive rent growth in 2020. As mentioned earlier, remote work policies and unconstrained choice of housing allowed employees to choose more freely where to live. While some renters chose the suburbs over downtowns within the same metro area, others went further and moved away from gateway cities to secondary and tertiary markets, often to be closer to family.

Consequently, markets with the highest annual rent growth in Q4 2020 were mid-tier markets: Riverside, Sacramento, Albuquerque, Tucson, Memphis, and Norfolk, where rent grew over 5% year-over-year. With downtown commercial activity severely affected by the pandemic, rents fell furthest in major U.S. metropolitan areas, such as San Francisco, San Jose, Oakland, New York, Boston, and Los Angeles, where rents fell by at least 5% in 2020.

We expect this trend will reverse starting in the second half of 2021 and throughout 2022, with demand shifting back to major metros, as mass vaccination distribution allows shuttered urban core engines to restart.

Figure 5. Map of U.S. Multifamily Rent Growth in 2020



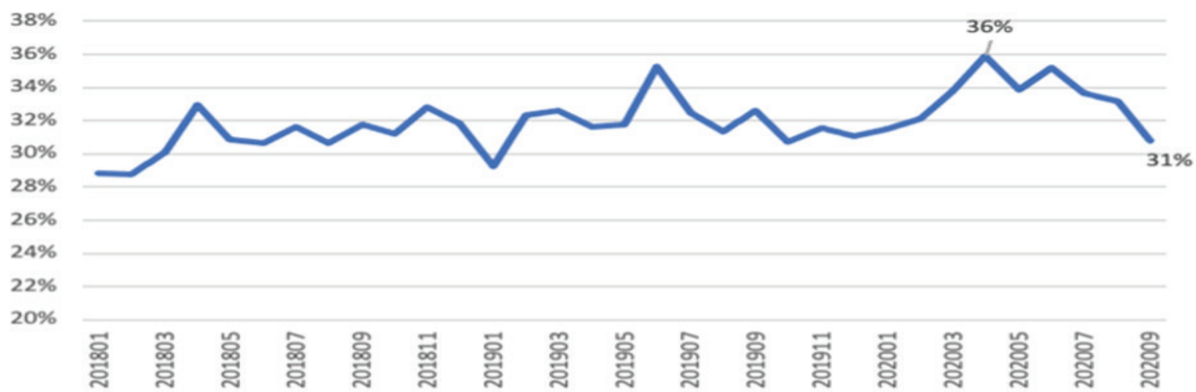
Source: CBRE Econometric Advisors, Q4 2020

SINGLE-FAMILY HOMES

Median home prices jumped 15% year-over-year in 2020, according to Redfin. Does this reflect an exodus of renters from the multifamily market to single family homeownership? EA doesn't think so.

Consider first-time homebuyers, who usually come from a pool of former renters. If demand is shifting from renting to buying, it is reasonable to expect an increase in the share of first-time homebuyers. But, according to the National Association of REALTORS® (NAR), the share of first-time homebuyers slipped to 31% in December 2020 - one of the lowest readings in the past three years. This underscores the dearth of affordable single-family starter housing, and that many potential first-time homebuyers are unable to take advantage of historically low mortgage rates and will likely stay in multifamily rentals in the near term.

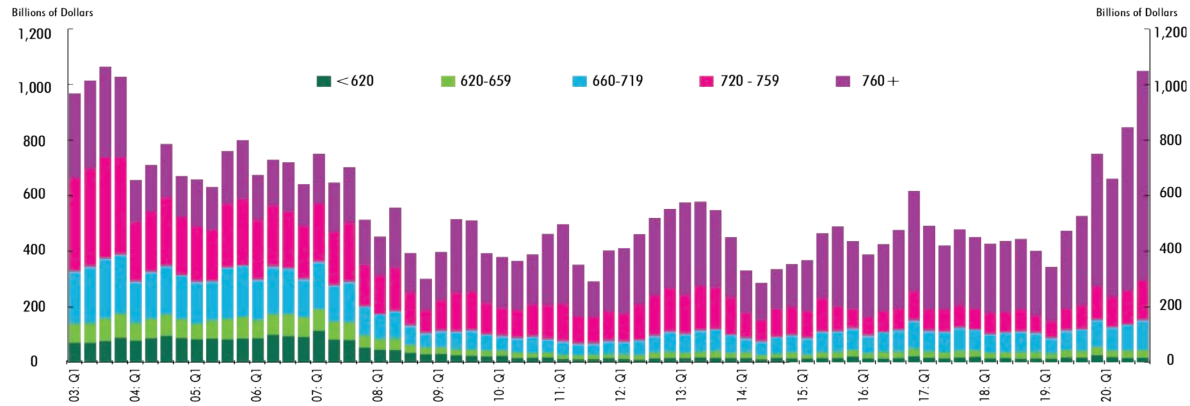
Figure 6. First-time Homebuyer Share



Source: National Association of REALTORS® Survey Q4 2020

At the same time, according to a recent New York Fed report, the credit score among mortgage originations increased greatly over the past 12 months, suggesting that the majority of current applicants are better qualified to receive a loan, and are either well positioned existing homeowners, or renters with high scores who decided to switch from renting to owning. The latter group was more likely to rent Class A properties before switching to homeownership, further contributing to demand headwinds for Class A units.

Figure 7. Mortgage Originations By Credit Score



Source: New York Federal Consumer Credit Panel; Equifax Q4 2020

ECONOMIC OUTLOOK AND MULTIFAMILY FORECAST

While many economic indicators are still in negative territory, the situation continues to improve. According to an advance estimate of the Bureau of Economic Analysis, the U.S. economy grew at 4.0% (annualized rate) in Q4 2020. The February 2021 unemployment rate slipped to 6.2%, a considerable decline from 14.7% recorded in April, but still above 3.5% recorded in March 2020.

With vaccines being distributed and a new $1.9 trillion economic stimulus approved, we expect the U.S. economic recovery to accelerate throughout 2021, with new household formation rising, and the reopening of major metros spurring recovery in the multifamily sector. The long-term outlook for multifamily remains strong, with both national rent and vacancy expected to recover to pre-COVID levels in the second half of 2022, with secondary markets leading the recovery, followed by major metros.
While the multifamily sector is seen by investors as the CRE leader in the stable cashflow yield, EA expects a quick turnaround in the multifamily sector, several key trends require further monitoring and analysis.

The pandemic has led to elevated unemployment levels and continues to disproportionally affect millions of low-income workers. Without comprehensive public policy and sufficient financial aid, it will be challenging to unwind the debt already accumulated by low-income renters during eviction moratorium periods.
The pandemic also accelerated single-family housing demand and the rise of homeownership. Due to the unique combination of remote work, accumulated personal savings and low mortgage rates, many millennials used 2020 to start looking for their first house. While the current scarcity of affordable single-family housing prevented many first-time homebuyers from buying a home, this is a trend that will inevitably

increase as the millennial cohort ages. Therefore, landlords and investors need to start thinking beyond millennials and looking at the preferences of Generation Z, which is not just a fully digital version of millennials, but also the most diverse and the best-educated generation yet.

Remote work arrangements likely contributed to the increased demand in suburban living and outflow of tenants from primary to secondary markets. While no future is certain, it is unlikely that those trends will continue after the pandemic ends. The mass roll-out of vaccines will soon make commuting and going back to the office safe again, and, although remote working is here to stay, it cannot fully replace person-to-person interaction. Even if workers only commute to the office in the city two days a week, the bright city lights and return of urban amenities will spur a return to major urban areas soon.

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