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Multifamily Trends 2022

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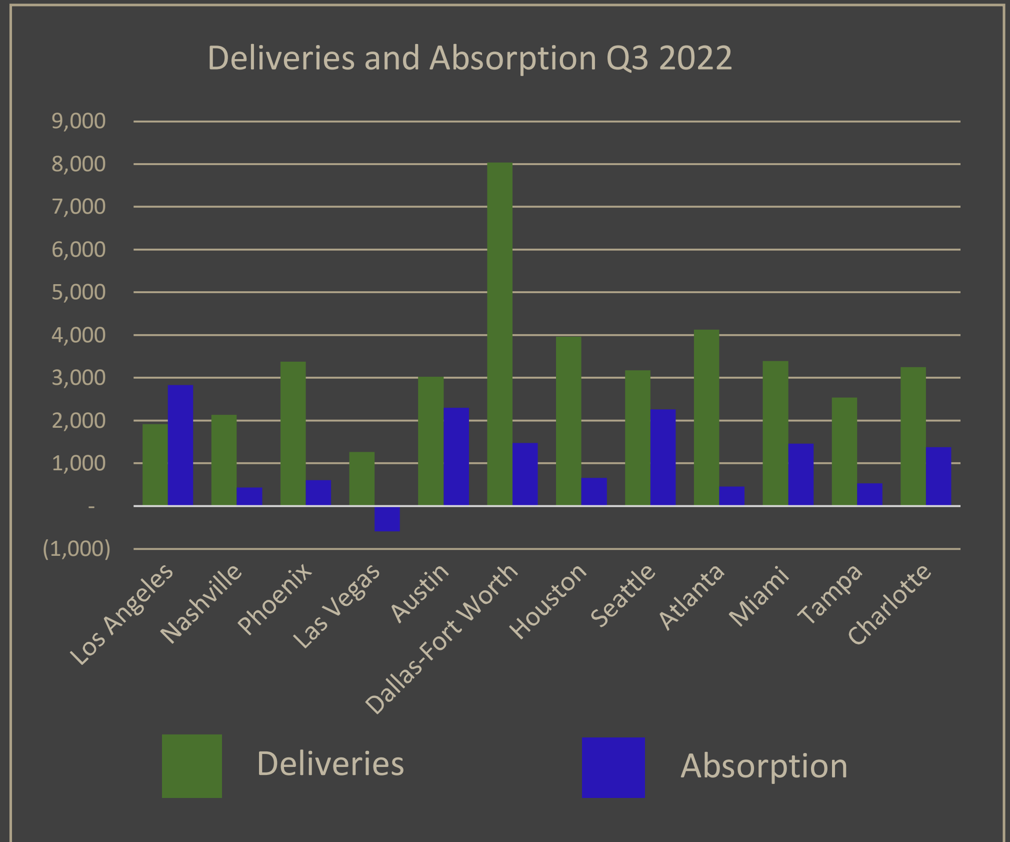
Costar data from Q3 2022 reveals an emerging trend in multifamily. Deliveries outpaced absorption by a wide margin in markets across the country, and a reversal of this pattern is unlikely. Multifamily construction starts in November 2021 were at their highest level since 1974, and demand is not matching this massive influx of supply. The market is already beginning to react as national monthly asking rent decreased by about $6.00 in the 3rd quarter, and national vacancy has gone from 4.7% to 5.5% in the past year. This phenomenon is most pronounced in secondary markets, especially in the Sun Belt. In contrast, primary markets like Los Angeles have continued to perform well.



Causes

The increasing oversupply in certain markets is due to a variety of factors, but there are a few that stand out. Not least of these is the rising cost of construction, which grew 5.3% on average from 2016 through 2018 and grew 23% from 2019-2021. This motivated developers to build in metro areas, where higher rents can compensate for higher costs. The cost of larger projects also increased more slowly than that of smaller projects, and this turned the attention of developers toward mid- and high-rise buildings, which now make up the majority of new developments. From 2020-2022 the construction cost for 8-24 story buildings increased 8%, and the cost for 1-3 story buildings increased by 18%.

Additionally, investors moved away from retail and office, which suffered most in the pandemic, redirecting capital into multifamily, which performed well. Absorption dramatically outpaced deliveries in 2021 by a factor of 1.7 nationwide, and rent was increasing rapidly while vacancy dropped. Looking to capitalize on these trends, developers rushed to build, and construction starts in many markets like Dallas, Nashville, and Phoenix reached all-time highs.

Investors also became increasingly focused on secondary markets, especially in the Sun Belt, where there is a lower barrier to entry. With a lower cost of land, these markets were also able to provide stronger yields, and with rent growth rising quickly, potential upside lured investors en masse. For example, rents in Phoenix had increased 21% year-over-year in Q3 2021, and sale price per unit increased by 28% during the same time. Simultaneously, Tampa saw rents increase by 23% and sale price per unit increase by 47%. This growth was impressive and attractive at the time, but as population growth slows and supply peaks, a market correction seems inevitable.

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Opportunities

As markets are flooded with supply over the next several quarters, vacancy will increase significantly, and rents will likely drop to compensate. Newly constructed class A properties will see the greatest difficulty, as 69% of properties under construction are 4- and 5-stars, which is disproportionate to the number of renters capable of paying rents at that tier. The difference in rent between 4- & 5-star units and 3-star units is striking at about $600, and rent concessions will not be sufficient to attract renters of 3-star units to 4-star units in large numbers. The net income of class A properties in secondary markets will most likely see significant losses, and many business plans formulated in 2020-2021 will no longer be viable. Pressure from interest rate hikes will also result in increasing cap rates. This combination of income loss and cap rate expansion will mean an enormous drop in value for many multifamily assets.

The table below illustrates the effects of income loss and cap rate expansion, with percent change of property value shown in grey.

Income Loss

Cap Rate	0%	2.5%	5%	7.5%	10%	12.5%	15%	17.5%	20%
4.4%	0%	-4%	-8%	-13%	-17%	-21%	-25%	-29%	-33%
4.5%	-2%	-6%	-10%	-14%	-19%	-23%	-27%	-31%	-35%
4.6%	-4%	-8%	-12%	-16%	-20%	-24%	-28%	-32%	-36%
4.7%	-6%	-10%	-14%	-18%	-22%	-26%	-30%	-34%	-38%
4.8%	-8%	-12%	-16%	-20%	-24%	-27%	-31%	-35%	-39%
4.9%	-10%	-14%	-18%	-21%	-25%	-29%	-33%	-36%	-40%
5.0%	-12%	-16%	-19%	-23%	-27%	-30%	-34%	-38%	-41%
5.1%	-14%	-17%	-21%	-25%	-28%	-32%	-35%	-39%	-42%
5.2%	-15%	-19%	-22%	-26%	-29%	-33%	-37%	-40%	-44%
5.3%	-17%	-20%	-24%	-27%	-31%	-34%	-38%	-41%	-45%
5.4%	-19%	-22%	-25%	-29%	-32%	-35%	-39%	-42%	-46%

As property values decrease, opportunities to purchase multifamily assets at attractive bases will emerge at a rapid rate. Especially susceptible markets like Las Vegas may see class A properties come onto market for below replacement cost. This market has already seen negative absorption for the past 4 quarters, and 2023 is projected to see the highest number of deliveries since 2009. Over the long-term, construction will slow, and the imbalance of supply and demand will moderate, allowing for properties purchased in distressed sales to be sold for outstanding profits.

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