LUMENT

SURVEY REPORT

CHALLENGES AND STRATEGIES FOR MULTIFAMILY INVESTORS

FALL 2023

SURVEY REPORT
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CHALLENGES AND STRATEGIES FOR MULTIFAMILY INVESTORS

EXECUTIVE SUMMARY

As the recovery from the Great Recession stretched on through the 2010s, it became all too easy to assume that the stability and historic low-interest rates of the decade would continue long into the future. And perhaps they would have, but the abrupt changes generated by the pandemic and its aftermath have swept these assumptions aside.

The last year and a half have been challenging for the multifamily industry as it assessed and adjusted to these new conditions and began to chart a path forward under very different circumstances. Lument launched this survey —*Challenges and Strategies for Multifamily Investors*—to gauge industry sentiment about how the next 12 months will unfold and to learn more about the steps companies are contemplating to navigate the next year successfully. This report reflects our findings.

Lument recently completed a survey of 300 senior multifamily executives, conducting 25-minute telephone conversations on topics that ranged from their views on the economy to steps they are taking to address insurance costs. The key findings of this survey show survey participants and their companies have been closely monitoring the macroeconomic environment and have emerged with a guardedly optimistic view of the future.

KEY FINDING 1

The Economy Will Avoid a Recession.

The longer growth remains in positive territory, the more confident multifamily executives are that the United States will avoid a recession. **Seventy-three percent forecast slow growth or better for the next 12 months—and have clearly taken a hard landing off the table.**

They have also looked closely at interest rates and don't see them falling to prepandemic levels, although **they believe the ten-year Treasury rate will fall suggesting that the recent moderation of interest rates will hold for an extended period.**

KEY FINDING 2

Both Tailwinds and Headwinds Exert Pressure.

The survey participants asserted that there are powerful underlying trends supporting the market over the next 12 months, such as the slowdown in the single-family home market (41% of respondents) and the growth in household formation (38%). At the same time, **the cost of borrowing remains an impediment for 35% of the respondents**, as do a host of issues including insurance costs (28%), real estate assessments and tax increases (26%), as well as wages and materials inflation (26%).

KEY FINDING 3

Multifamily Market Dynamics Will Shift to Favor Borrowers.

A particularly notable finding of the survey is that **nearly all the respondents (90%) said their companies would most likely be net sellers over the next 12 months**.

This result supports the view that the current bid-ask gap is beginning to narrow, which could cause transaction volumes to increase. **Forty-two percent of respondents selected a closing bid-ask gap as one of their top two tailwinds for the year ahead**.

KEY FINDING 4

Conventional and Affordable Executives Differ on the Best Solutions to Increase Affordable Units.

Affordable housing developers are focusing on solutions that make more projects possible: real estate tax relief (32%), expanding the tax credit program (25%) and zoning changes and waivers (24%).

Their conventional counterparts also chose real estate tax relief (29%) but place more value on lower interest rates (27%) because they would help move projects forward.

Some of the changes the multifamily industry is facing, such as the shift to remote work, are immediate results of the pandemic. Others, like dramatic increases in insurance costs and emerging shifts in investor preferences for different geographic areas, are the result of external factors like extreme weather. Our survey sheds light on these changes and highlights actionable insights that companies might consider when adjusting to these developments.

ACTIONABLE INSIGHT 1

Develop an Individual Insurance Strategy While Exploring an Industry Solution.

A full 98% of the multifamily executives in the Lument survey said that insurance costs were an issue for their companies. **Sixty percent are putting the development of new properties on hold while they find ways to adjust to these circumstances**.

Right now, there is no consensus about how to mitigate these increases, although the survey revealed that the strategies companies adopt are correlated with their size.

ACTIONABLE INSIGHT 2

The West May Be Replacing the Southeast as the Most Desirable Location.

When asked where they intend to focus their investments in the next 12 months, executive responses were evenly grouped—but significantly **the Southeast—the favored location for multifamily investment for at least a decade—came in last among respondents**.

By contrast, 57% of multifamily professionals said they would be investing in the West, although only 24% of our respondents' companies are headquartered there.

ACTIONABLE INSIGHT 3

The Talent Crunch Is Over but Companies Need to Emphasize Professional Development and Competitive Salaries.

Only 7% of survey participants said that they had trouble retaining talent and almost three out of five (59%) said they had no trouble at all. Interestingly, **just 12% say that in-office requirements are causing employees to look elsewhere**.

Rather, the perennial reasons for employees to leave an organization, like offers from competitors (29%), the desire for higher wages (25%), and the search for career opportunities (22%), are at the top of the list. These findings suggest that, with a secure talent pool, there is room for employers to focus on other areas, like creating paths to career growth and professional development.

ACTIONABLE INSIGHT 4

Find a Lender with Comprehensive Products, Services, and Strengths.

Regardless of where they sourced their debt, borrowers were not happy. **One of the most startling findings of our survey is that only 1% of the respondents feel that their current lender meets all their needs**.

They had three major issues: certainty of execution (51%), communication (49%), and technology tools (48%). **The survey participants wanted their lenders to offer a more comprehensive array of services**.

The results of this survey shed light on how the industry is responding to the tectonic shifts in economic and market conditions. In addition to enumerating the methods multifamily investors are employing to meet these immediate challenges, they underscore the opportunities for those that successfully make the transition to the new environment.

These opportunities persist because of the strong underlying fundamentals for multifamily—a long-term shortage of housing and steady population growth. The multifamily industry has weathered a series of cycles over the last fifty years, and the survey results support the contention that it will once again achieve a new equilibrium.

KEY FINDINGS

After a decade of steady growth, stability, and unprecedented low interest rates, the economy post the height of the pandemic has proven challenging for the multifamily industry. A number of factors, including a sudden shift in demand from goods to services, supply chain disruptions, and increases in global commodity prices, led to a sudden spike in inflation and, ultimately, a sharp response from the Federal Reserve.

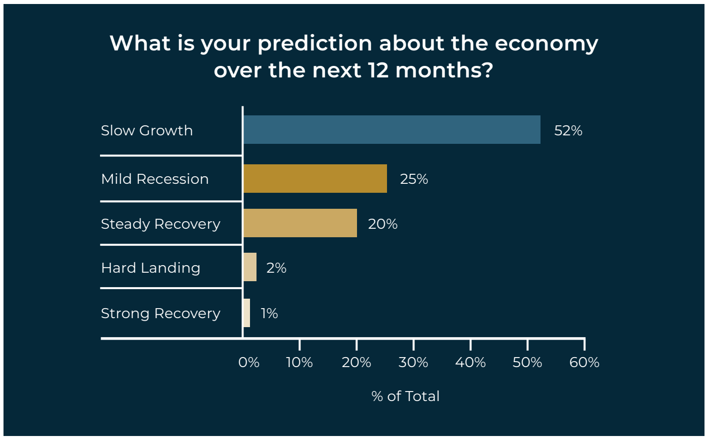
So far, the Fed has been successful in helping to stabilize the economy without oversteering into a recession, but the process has taken longer than anticipated. Multifamily companies find themselves facing interest rates that not only rose sharply but also have remained stubbornly high.

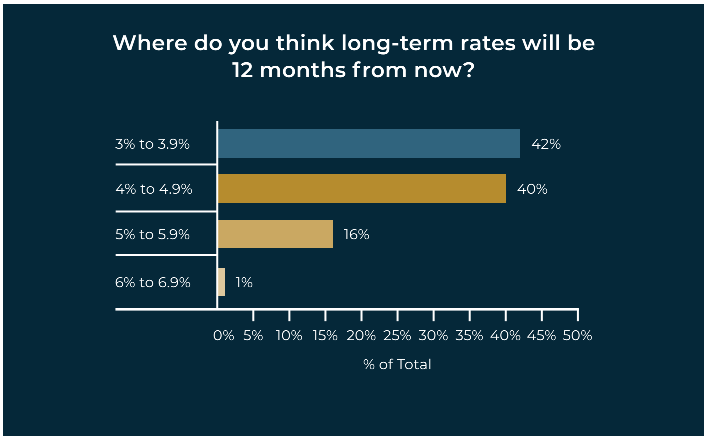
The key findings from Lument's multifamily survey paint a picture of the sector's growing confidence in the Fed's ability to sidestep a recession and at the same time highlight a recognition that, barring an external shock, interest rates will not come down substantially in the foreseeable future. The respondents also expressed the view that as companies come to grips with this new normal, we will see an increase in multifamily market activity over the next 12 months.

THE ECONOMY WILL AVOID A RECESSION

Barring external events, the respondents see the economy avoiding a recession, with **73% forecasting slow growth or better for the next 12 months.** While 25% predict a mild recession (compared to 20% who see steady recovery), **respondents have clearly taken a hard landing off the table.** Just 2% expected a deep recession in their future.

Regardless, no one foresees a return to pre-pandemic interest rates anytime soon. The respondents were closely split between those who see the 10-year Treasury rate falling into the 4% to 4.9% range over the next 12 months (40%) and those seeing interest rates dropping into the 3% to 3.9% range (42%).

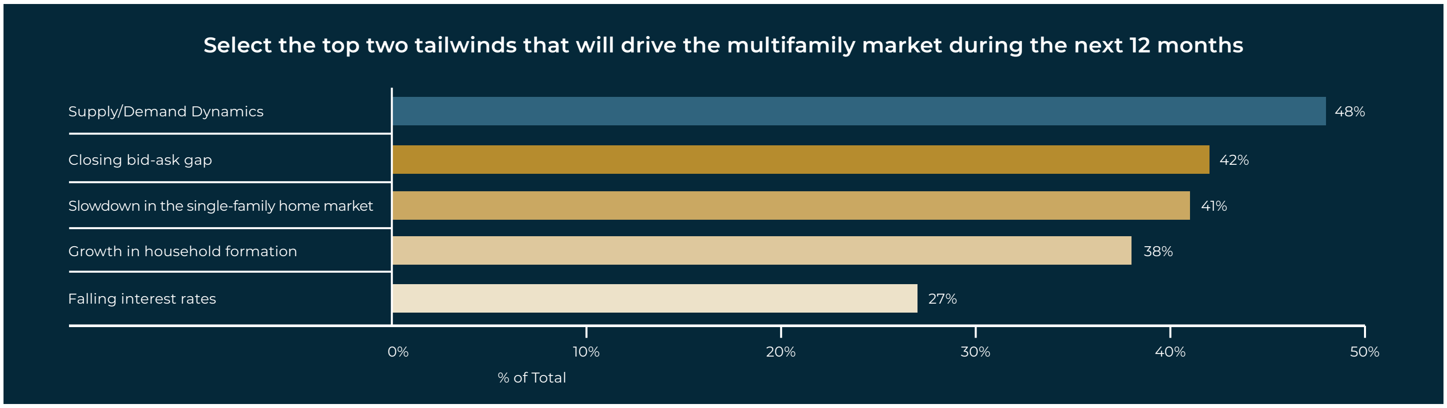




These predictions are in line with the revisions market observers have been making to their predictions over the last six months. Their changes reflect an emerging higher-for-longer consensus view on interest rates, which in turn reflects the continuing strength of the economy.

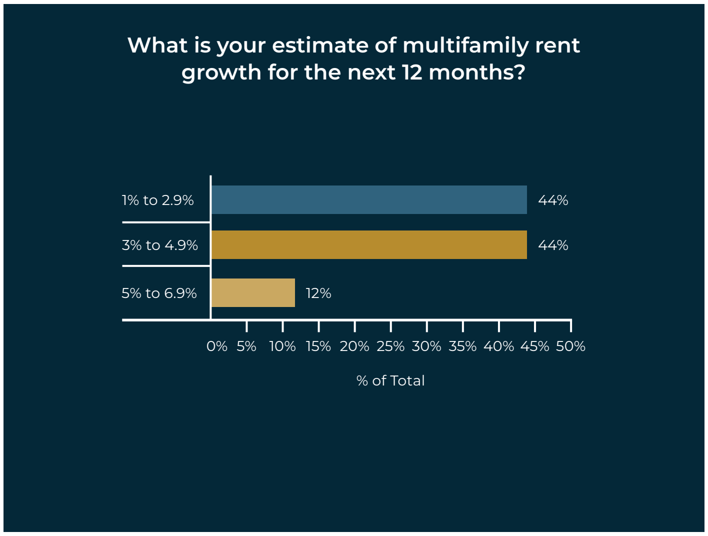
BOTH TAILWINDS AND HEADWINDS EXERT PRESSURE

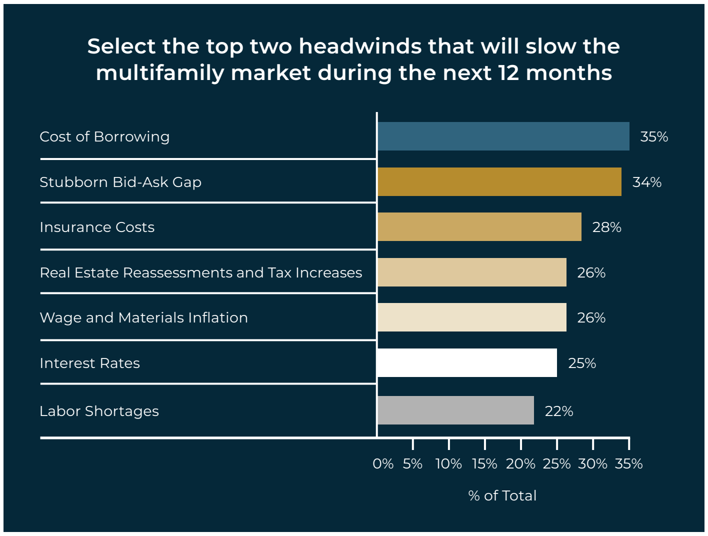
Looking ahead, multifamily professionals see market gridlock beginning to break up. Over the next 12 months, they see this year's record deliveries being absorbed and supply/demand dynamics serving as an active driver of the market (48%). They also see the slowdown in the single-family home market (41%) and the growth in household formation (38%) as positive trends supporting the market.



As a result, rent growth remained in line with inflation. Almost 90% saw rent growth falling to between 1% and 4.9%, and using the weighted midpoints of the ranges provided reveals a consensus rate of 3.3%. This number, however, could vary considerably, with markets with a higher share of new supply showing weaker rent performance.

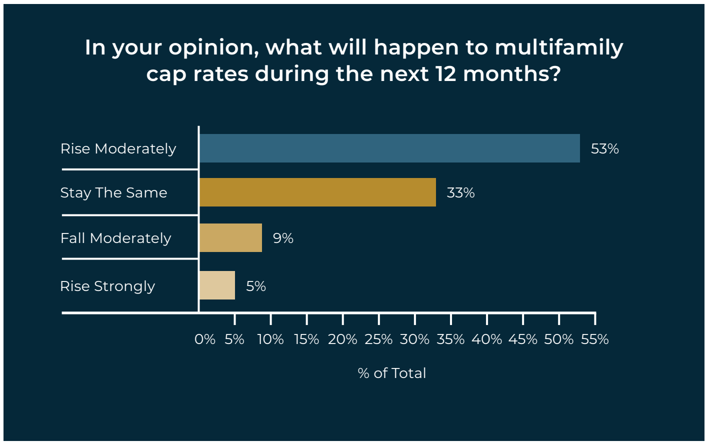
There are other headwinds to be addressed. **The cost of borrowing remains an impediment for 35% of the respondents**, as do a host of issues that were closely grouped by the survey takers when asked about headwinds for the year ahead. These were insurance costs (28%), real estate assessments and tax increases (26%), and wages and materials inflation (26%).

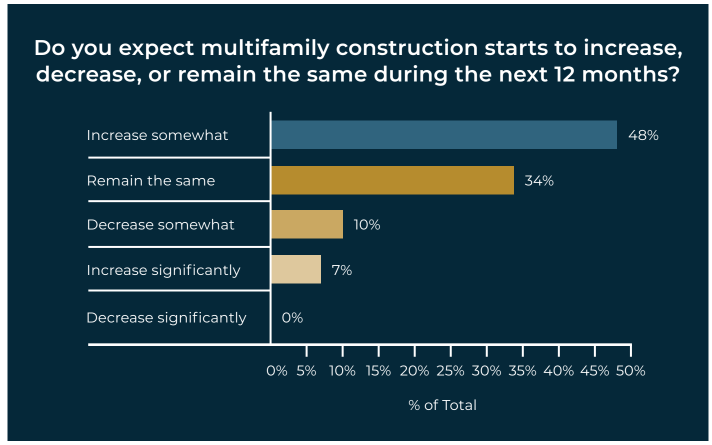




Respondents were closely split about the prospects of the bid-ask gap closing. Forty-two percent of the respondents felt it was narrowing while 34% felt that it remained significant enough to be considered a headwind. The net effect is that cap rates are expected to stay the same (33%) or rise slightly (53%) over the next 12 months.

Looking ahead, respondents see a revival of construction starts in 2024. Only 10% predicted a decrease, while a third thought starts would remain the same (34%) and almost half believed they would increase somewhat (48%). The persistent shortage of housing nationwide supports this positive outlook, though developers must contend with higher costs and more stringent construction lending requirements.

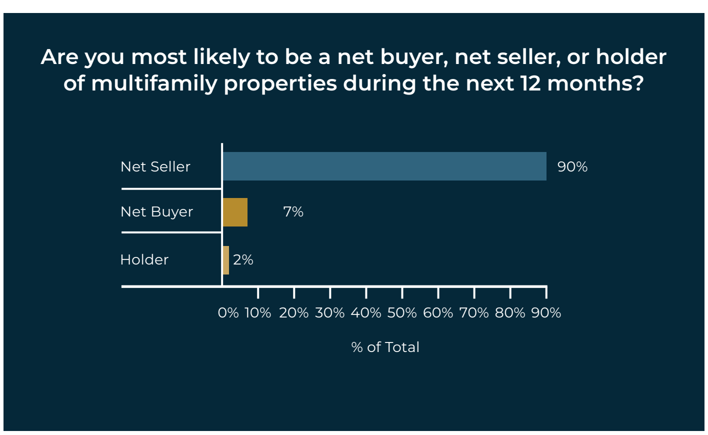


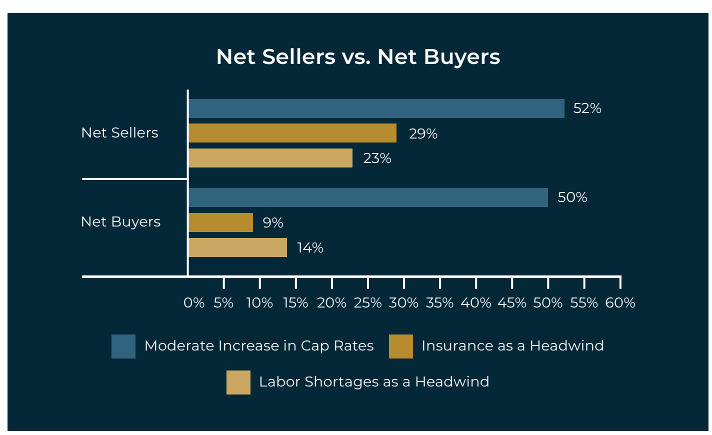


MULTIFAMILY MARKET DYNAMICS WILL SHIFT TO FAVOR BORROWERS

A notable finding of the survey is that **nearly all of the respondents (90%) said their companies were most likely to be net sellers over the next 12 months.** This represents a shift from the hold positions many owners have taken during the past year, and it also supports the view that the bid-ask gap is beginning to close. **Forty-two percent of respondents selected a closing bid-ask gap as one of their top two tailwinds for the year ahead.** If these net sellers are able to transact in the year ahead, perhaps buoyed by a closing bid-ask gap, transaction volumes could significantly increase.

The reasons for this change in owner sentiment likely include pending debt or investment fund maturities, desire to create liquidity for future investments, and concern over rising costs. For instance, the firsthand experience that net sellers have had with operating expenses has certainly affected their thinking. They are much more likely than net buyers to see rising insurance costs (29% for net sellers vs. 9% for net buyers) as a significant headwind on the market and they are also much more concerned about labor shortages (23% vs. 14%).

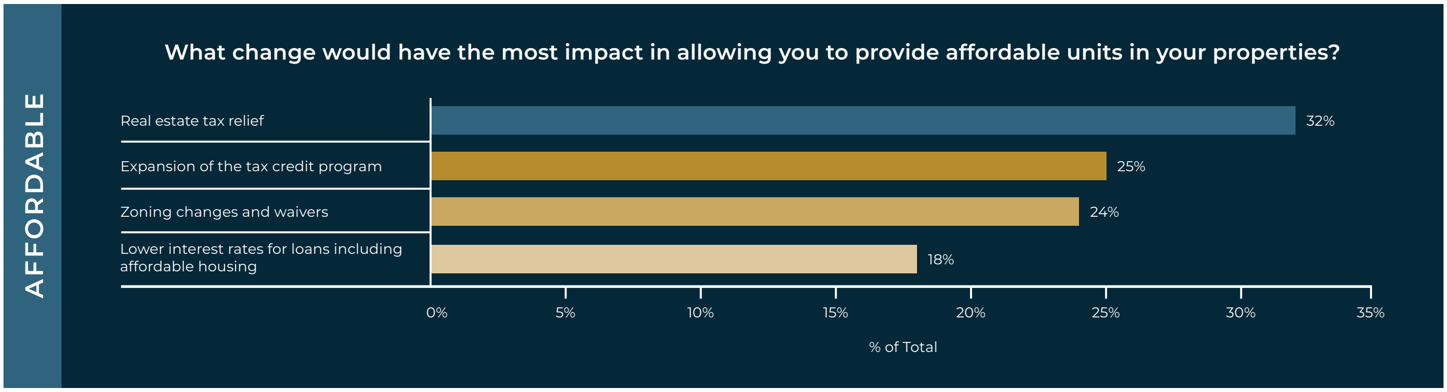


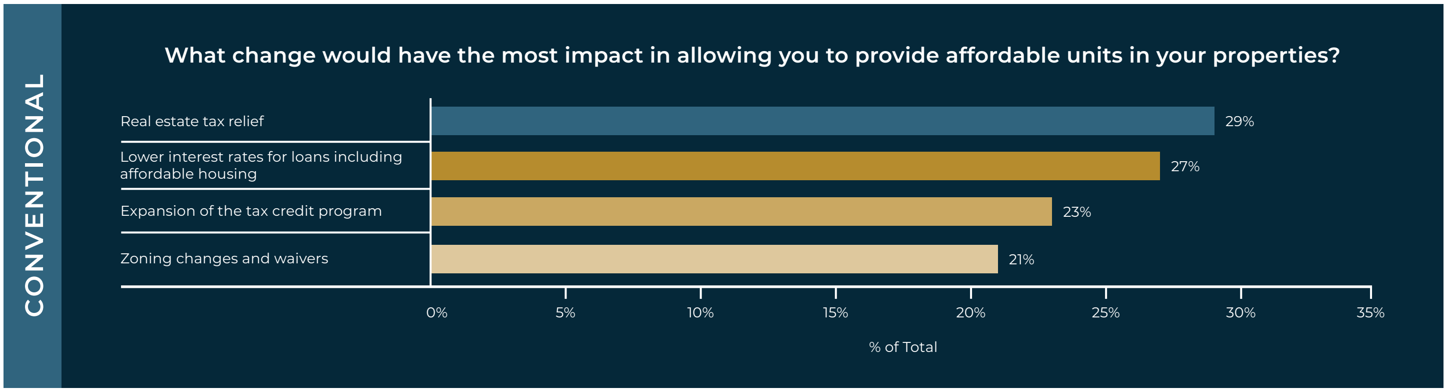


CONVENTIONAL AND AFFORDABLE EXECUTIVES DIFFER ON THE BEST SOLUTIONS TO INCREASE AFFORDABLE UNITS

The shortage of affordable housing seems impervious to changes in the economic climate—and the results of this survey touch on this critical issue. There is, however, a difference in perspective between those building exclusively affordable properties and those seeking to include affordable units in a conventional project.

Affordable housing executives focus on solutions that make more projects possible: real estate tax relief (32%), expanding the tax credit program (25%), and zoning changes and waivers (24%). **Their conventional counterparts also chose real estate tax relief (29%) but place more value on lower interest rates (27%) because they would help move projects forward.**





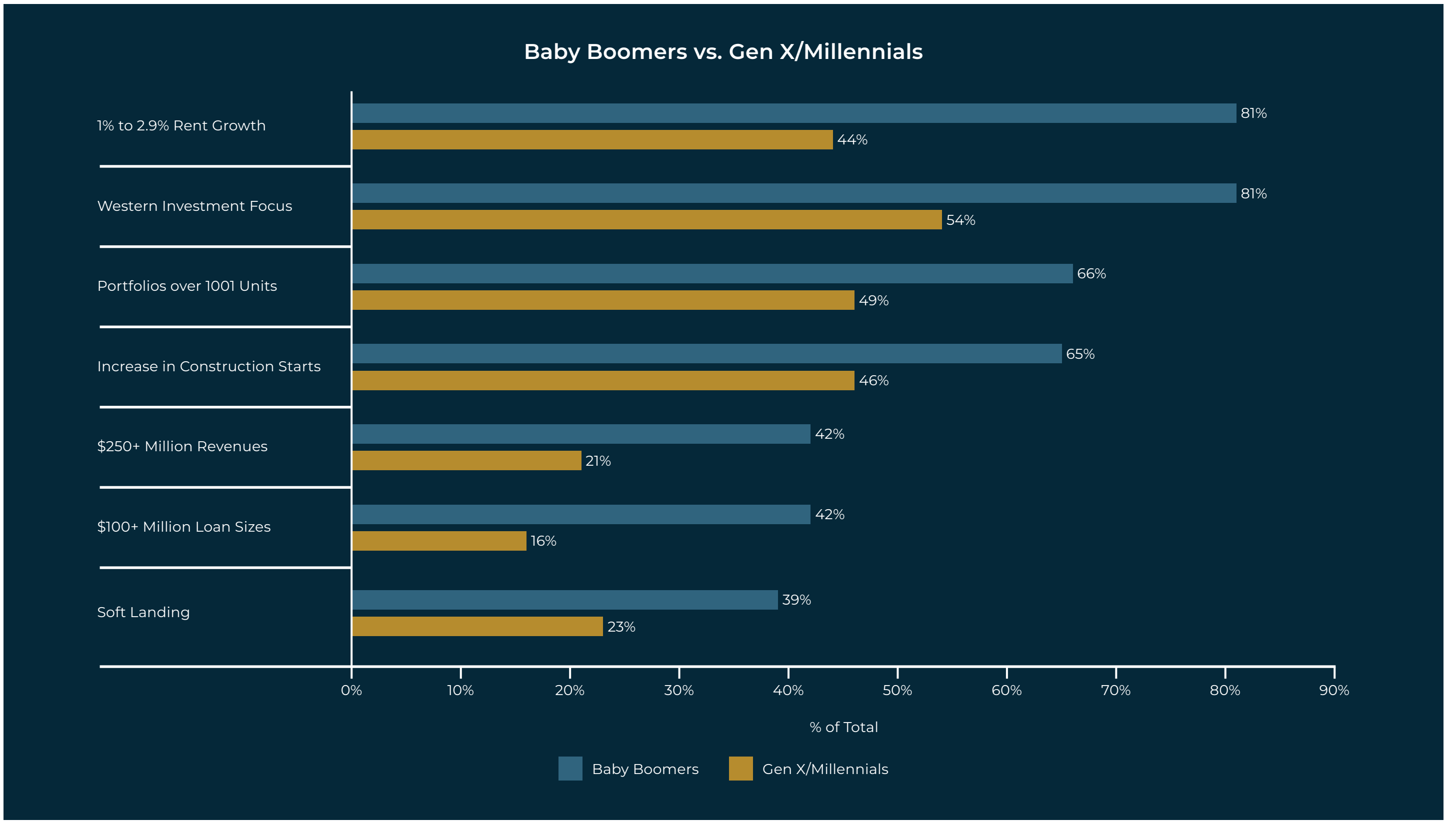
THE GENERATIONAL DIVIDE

The Lument survey revealed significant differences between Generation X (ages 43 to 58) and millennial (ages 42 and younger) respondents and their baby boomer counterparts (ages 59 and older). The divide is sharp enough to indicate that different strategies and expectations should be adopted when interacting with the two groups.

As a whole, boomers were more pessimistic about the economy and the immediate outlook for multifamily. For instance, far more boomers (39%) thought we are heading into a mild recession in 2024, compared to 27% and 16% for their Gen X and millennial colleagues, respectively. At 81%, they were virtually united in predicting that rent growth would fall into the 1% to 2.9% range, compared to 44% for Gen X and millennials combined. And 81% said they would be shifting their investment focus to the West, versus 54% for the two younger cohorts.

On the other hand, boomers were significantly more likely than younger colleagues to believe that construction starts would increase over the next 12 months (65% of boomers vs. 46% of Gen X and millennials), signaling longer-term optimism about the market.

Some of these differences can be attributed to more years of experience. Baby boomers have been through several economic cycles over the last 40 years. They also may reflect the size of their businesses. Boomers (42%) are twice as likely to report that their companies have annual revenues over $250 million than the other groups combined (21%). They are also more likely to work for companies with portfolios over 1,001 units (66% to 49%) and with typical loan sizes in the $100 million plus range (42% to 16%).



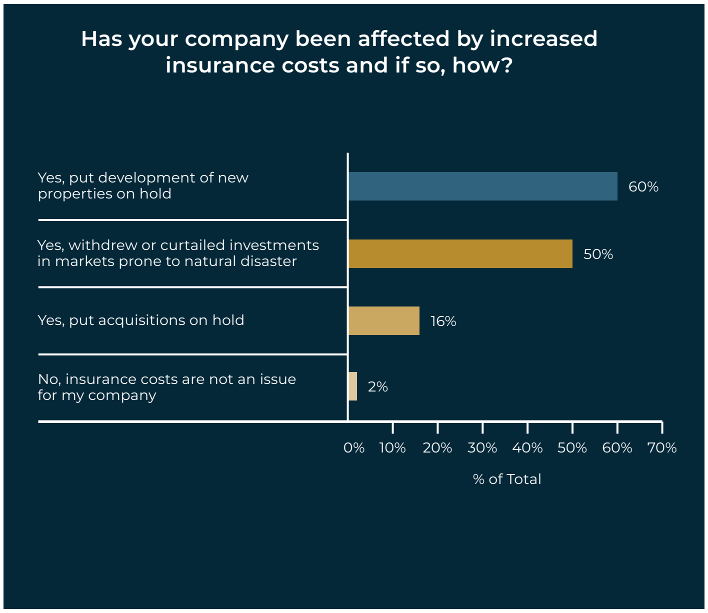
ACTIONABLE INSIGHTS

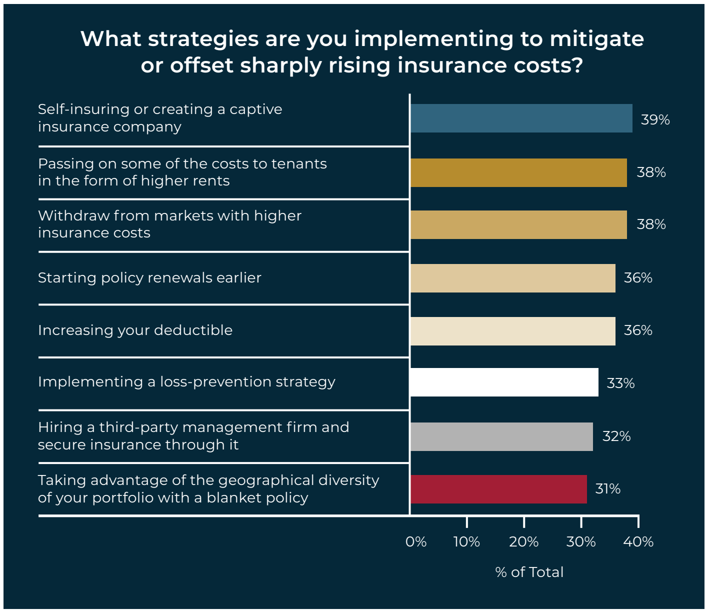
After undergoing a period of relative stability, the multifamily business has entered a cycle of more rapid change. Some of these changes, like the tight labor market and the shift to remote work, are immediate results of the pandemic. Others, like dramatic increases in insurance costs and emerging shifts in geographic preferences, are the result of external factors. Lument's survey spotlights these changes and highlights actionable insights that multifamily companies might consider when adjusting to these developments.

DEVELOP AN INDIVIDUAL INSURANCE STRATEGY WHILE EXPLORING AN INDUSTRY SOLUTION

A full 98% of the multifamily executives in the Lument survey said that insurance costs were an issue for their companies. Clearly, they are affecting business decisions: **60% have put the development of new properties on hold while they find ways to adjust to these circumstances** and/or find ways to reduce their insurance costs. Not surprisingly, virtually all net buyers (95%) said that insurance costs would prevent them from making acquisitions.

There appears to be no single best way to react to the insurance crisis. The eight strategies that participants said their firms were implementing were tightly grouped, with just eight percentage points separating the highest-ranked choice (self-insurance or creating a captive insurance company) from the lowest (using a blanket policy to take advantage of a portfolio's geographic diversity).





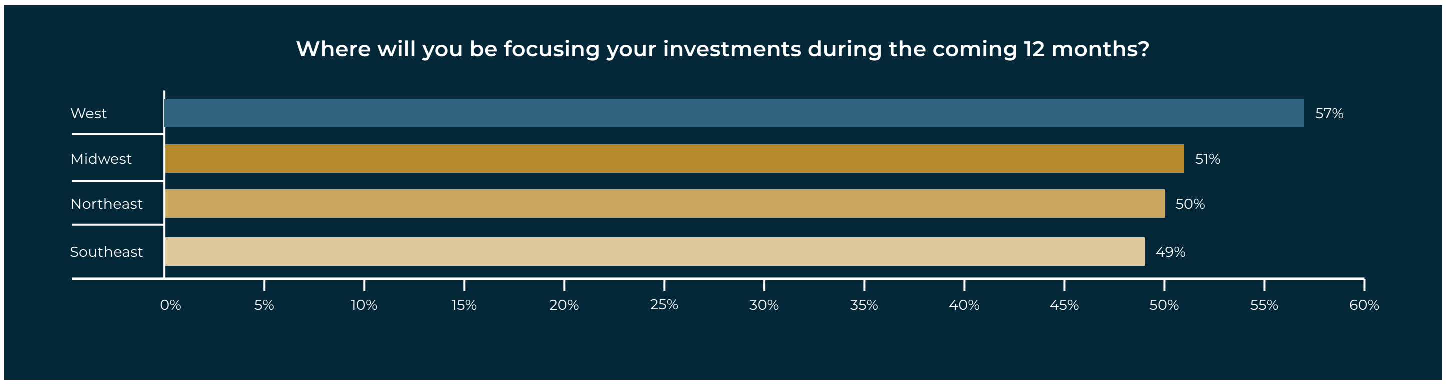
There was some difference among those with portfolios of different sizes. Companies with 1,000 units or less are less likely to consider passing costs on to tenants in the form of higher rents (35%), while companies with 1,001 or more units were more likely to self-insure (41%). Another approach is to increase income from other sources. The survey respondents were willing to consider a variety of revenue-producing programs, from storage services (49%) to turnkey Internet (41%).

Regardless of these strategies, now may be the time for executives to join together with industry associations and legislators to forge a comprehensive strategy for addressing rising insurance. And for multifamily companies to take the reins and consider what potential sources of relief best suit their individual needs.

THE WEST MAY BE REPLACING THE SOUTHEAST AS THE MOST DESIRABLE LOCATION

While real estate professionals still value the Southeast, it may be time to cast a wider net. When asked where their companies intend to focus their investments in the next 12 months, the results were fairly evenly grouped—but significantly **the Southeast—the favored location for multifamily investment for at least a decade—came in last among respondents.**

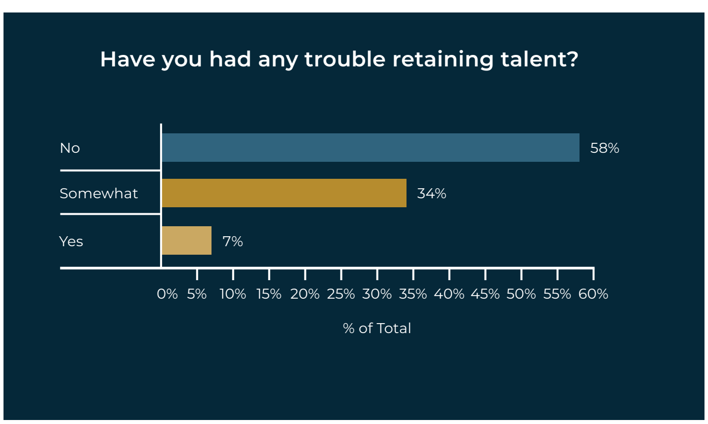
Attention is beginning to shift to the West. Fifty-seven percent of multifamily professionals said they would be investing in that region although only 24% of our respondents' companies are headquartered there. Rising insurance costs are likely generating some of this shift. Executives from companies headquartered in the Southeast (31%) were slightly more likely to see insurance costs as a headwind as were executives (34%) from companies with over $250 million in revenue.

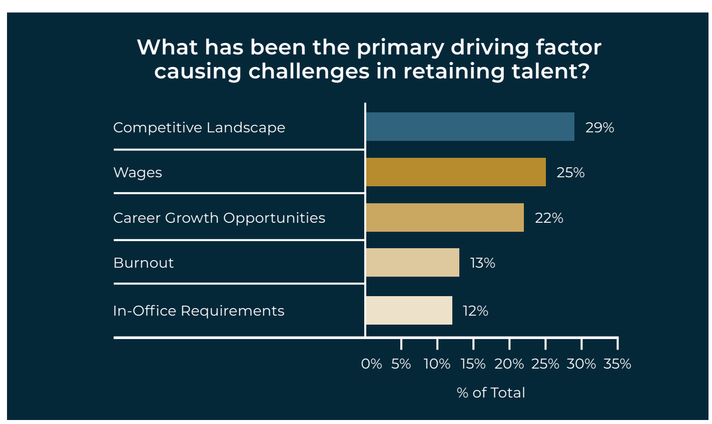


THE TALENT CRUNCH IS OVER BUT COMPANIES NEED TO EMPHASIZE PROFESSIONAL DEVELOPMENT AND COMPETITIVE SALARIES

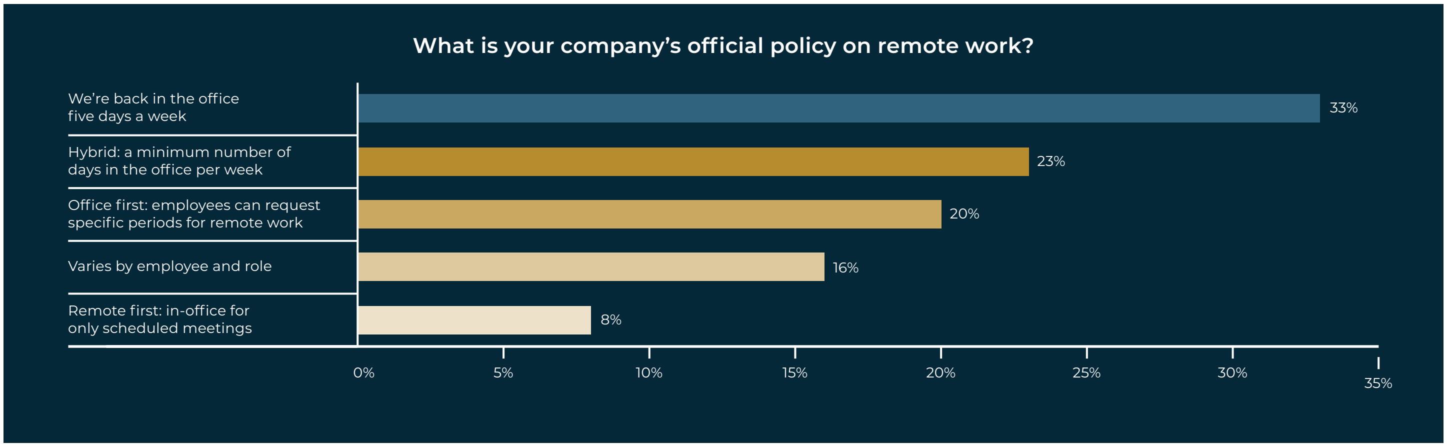
The days of prolonged job openings and extended talent searches seem to be over for most companies. **Only 41% of the participants in the survey said that they had trouble retaining talent** and almost three out of five (58%) said they had no trouble at all. Small companies with fewer than 50 units are lagging somewhat, with 17% reporting that they are still having difficulty keeping qualified employees.

Of those companies having retention issues, it is noteworthy that, despite the press coverage about the rise of remote work, **just 12% say that in-office requirements are causing employees to look elsewhere.** Rather, the perennial reasons for employees to leave an organization, such as offers from other employers (29%), the desire for higher wages (25%), and the search for career growth opportunities (22%), are at the top of the list.





In fact, remote work is far from universal. Forty percent of the survey participants said their firm had no remote work policy and of those who did, a third said that they were back in the office five days a week, while another 23% said that employees were required to be in the office a set number of days each week.

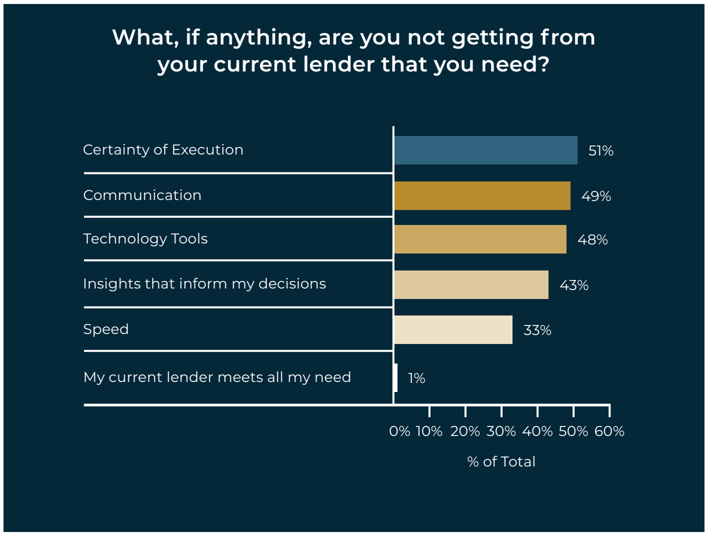


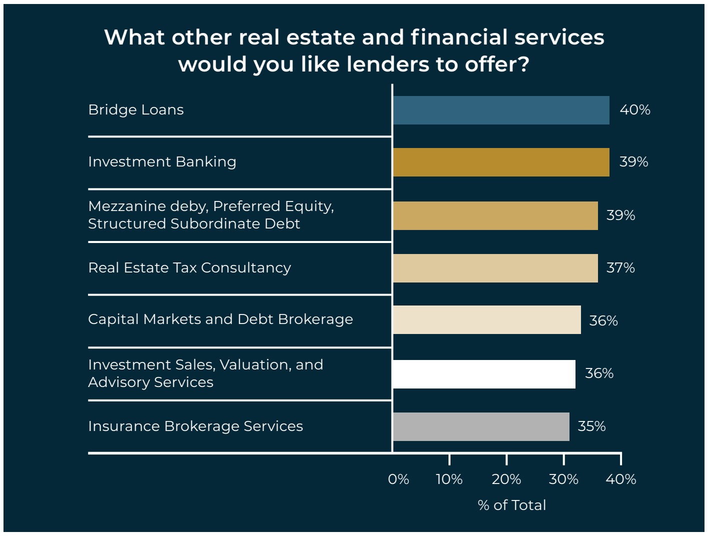
FIND A LENDER WITH COMPREHENSIVE PRODUCTS, SERVICES, AND STRENGTHS

When asked where they will be turning for financing during the next 12 months, the replies of multifamily executives were not surprising. Seventy-five percent of firms with revenue over $250 million who typically seek loans in the $100 million-plus range were likely to turn to national banks. By contrast, 58% of smaller companies with revenue between $20 million and $49.9 million looking to borrow less than $60 million were likely to seek out agency lenders.

But regardless of where they turn, borrowers said that lenders could do much more. **One of the most startling findings of our survey is that only 1% of the respondents feel that their current lender meets all their needs.** They had three major issues: certainty of execution (51%), communication (49%), and technology tools (48%). **The survey participants also wanted their lenders to offer a more comprehensive array of services.** The responses were a statistical dead heat, with just five percentage points separating bridge loans from insurance brokerage services.

Here again, answers varied by the size of their firm. Those with portfolios under 50 units and revenues in the $25 million to $49.9 million range expressed a strong preference for real estate tax consultancy (75%). Larger firms remained more evenly split among the alternatives, but the underlying message is clear: Borrowers want more from lenders than just a loan.





CONCLUSION

The multifamily industry has entered an era of rapid, order-of-magnitude change. The interest rates companies pay on their loans, most obviously, and operating costs, notably insurance, are suddenly significantly higher than they were two years ago. Firms must not only adjust to this tectonic shift but also develop strategies to flourish in this new landscape.

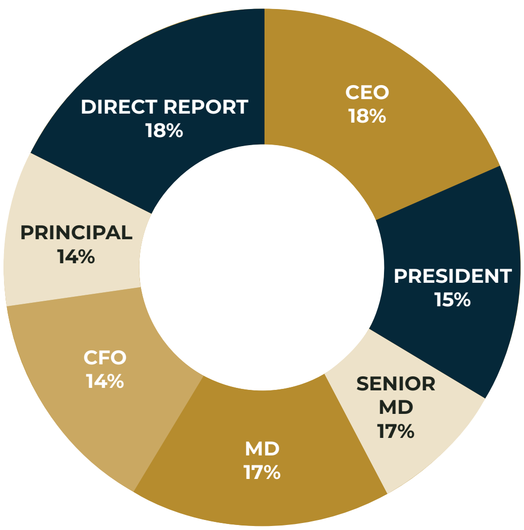
The results of this survey shed light on how the industry is responding. In addition to enumerating the methods multifamily investors are employing to meet these immediate challenges, they underscore the opportunities for those that successfully make the transition to the new environment.

These opportunities persist because of the strong underlying fundamentals for multifamily —long-term shortage of housing and steady real-term population growth. The multifamily industry has weathered a series of cycles over the last fifty years, and there is every reason to suppose that it will once again achieve a new equilibrium.

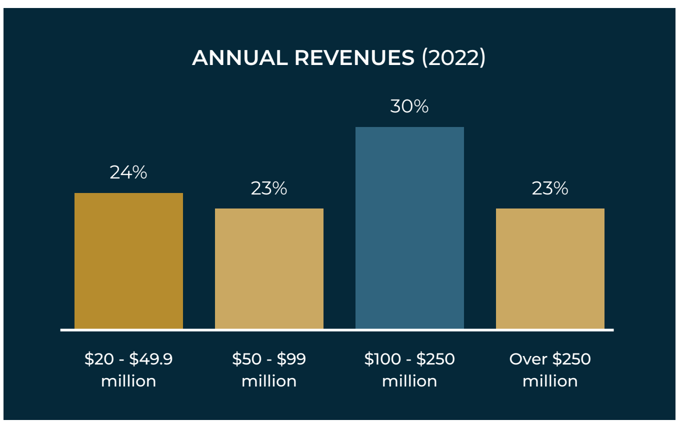
EXPLORE LUMENT'S MULTIFAMILY OFFERINGS

ABOUT THE RESEARCH

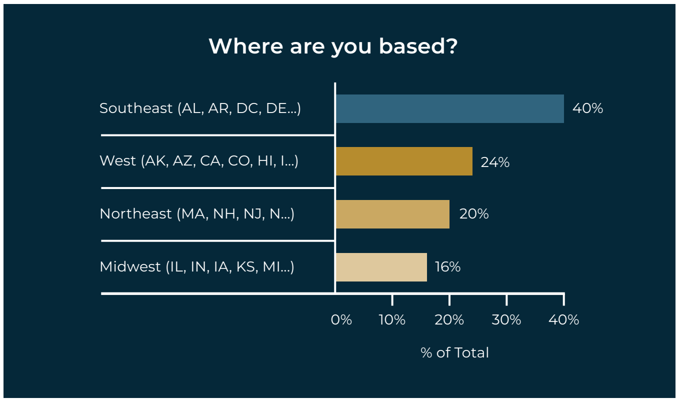
Lument engaged Beresford Research, a market research firm, to conduct a study of the challenges facing middle market multifamily investors. Between August 14, 2023, and September 12, 2023, Beresford completed 300 25-minute telephone surveys with CEOs, CFOs, presidents, senior managing directors, managing directors, principals, and their direct reports working for conventional multifamily and affordable multifamily developers and investors in the United States.

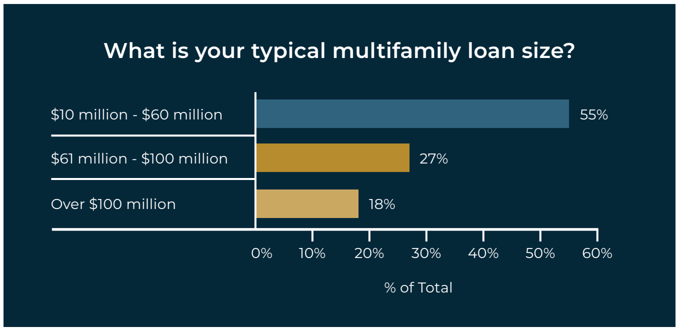


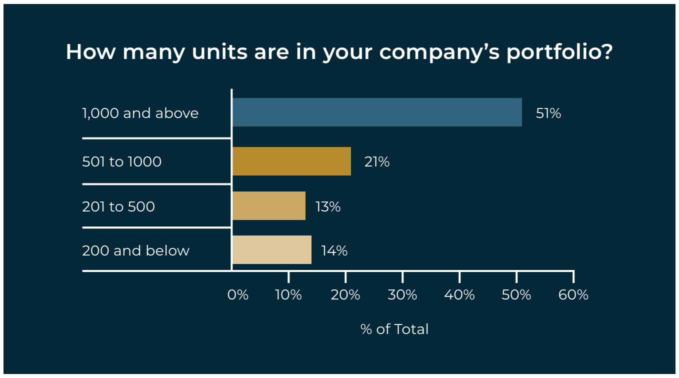
By design, all respondents had an average multifamily loan size of at least $10 million and annual revenues ranged from $20 million to over $250 million. The margin of error for the total results is ±5.66 points at the 95% confidence level.



The respondents were headquartered around the country, with the largest group based in the Southeast (40%). The majority had an average loan size of between $10 million and $60 million, and 72% had portfolios larger than 500 units and 51% had more than 1,000.







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