# Multifamily Real Estate Market

CIM

**Compelling Opportunities Amid Market Disruption**

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**The convergence of multifamily cap rate correction, record quantities of maturing debt, and a constrained commercial real estate (CRE) financing market has created a compelling environment for multifamily investment.**

## Overview

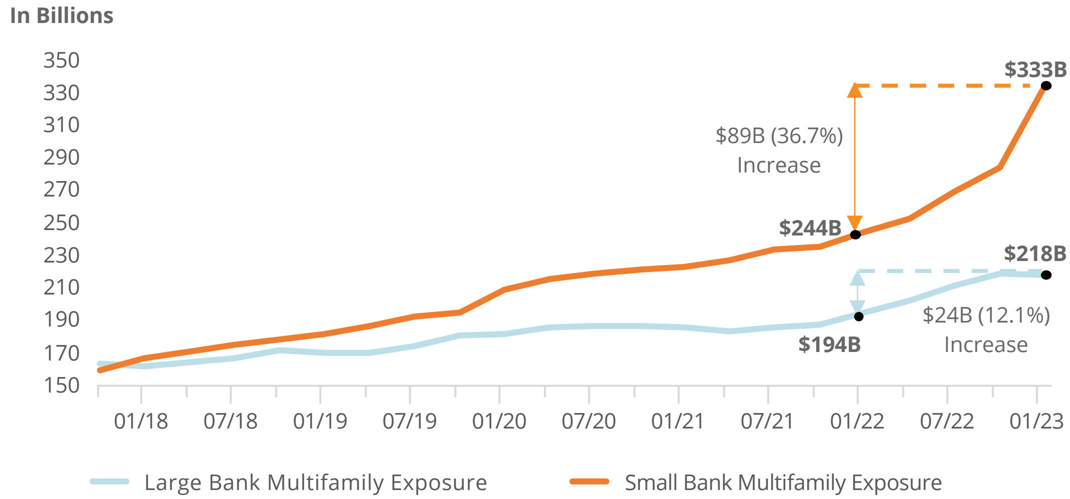
Over the past 12 months, the CRE market has wrestled against a rising federal funds target rate, the failures or near failures of several regional banks, and a potential looming recession. These factors have contributed to reduced liquidity and tightening lending standards in the CRE capital markets.[1]

The credit markets have seen a sharp increase in rates with commercial mortgage rates on 7/10-yr fixed product sitting at 6.8% in June of 2023, up 330bps from a near-term low in Q3 of 2021. Cap rates have also risen for all major property sectors over the last year. The increases have generally ranged from 25-60 bps, but the central business district office asset class is an outlier with an expansion in cap rate of nearly 90 bps.[2]

A deep dive into the effects of these trends on the multifamily space reveals unique dynamics. Apartment cap rates are on the rise from the period of low interest rates and excess liquidity in 2021 and 2022. Cap rates for both garden apartments and mid/high-rise buildings have risen about 60 bps from a record low in Q1 2022, the most of any of the main property types other than office.[2] Rent growth has softened nationally, decelerating from 3.8% at the close of 2022 to 1.2% in Q1 2023.[3] Although CIM expects to see attractive investment opportunities across the various CRE sectors, CIM believes the convergence of multifamily cap rate correction, record quantities of maturing debt, and a constrained CRE financing market has created an interesting environment for multifamily investment, a high conviction sector with strong long-term fundamentals.

## Multifamily Capital Markets Outlook

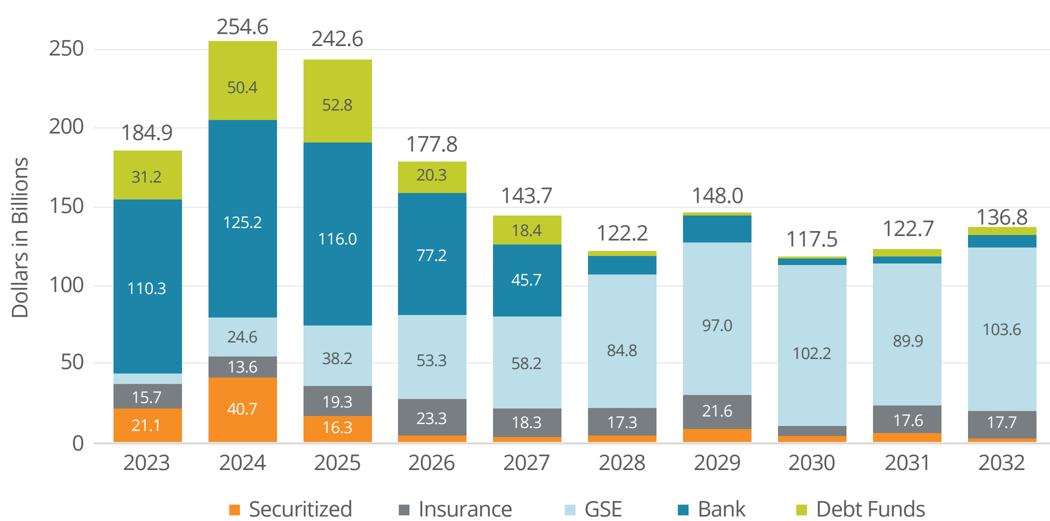
*Bank Exposure to Multifamily Lending*




*Source: Federal Reserve – federalreserve.gov website accessed April 2023*

Following a period of heavy investment in the sector, regional bank balance sheets have been left overexposed to CRE loans and specifically multifamily secured debt. According to data published by the Federal Reserve, small bank exposure to loans secured by multifamily properties increased by $89 billion from January 2022 to January 2023.[1] CIM does not expect small banks to repeat this performance in the foreseeable future, as multifamily debt originations have decelerated in the first quarter of 2023 and are down 61% year-over-year.[4]

*Multifamily Mortgage Maturities by Lender*




*Source: Newmark United States Multifamily Capital Markets Report – Q1 2023*

Note: All pages of this white paper must be viewed in conjunction with the Important Disclosures and Disclosure Statement, beginning on Page 10.

Multifamily maturities are significantly elevated over the next several years with an estimated $1 trillion in multifamily loans set to mature in the next five years, with banks accounting for $474 billion (47%) of the total.[4] CIM believes this substantial impending maturity presents both unique opportunities and challenges in the multifamily sector. While the "extend-and-pretend" practice of exercising extension options to delay the loan repayment deadline was employed by many owners and lenders in the aftermath of the global financial crisis,[5] the strategy is becoming less viable. Prevailing economic uncertainty makes borrower recovery more difficult to predict.

Concurrently, increased scrutiny from regulators and investors concerning potential risks associated with extended loan terms and inflated property valuations is leading to stricter lending standards and tighter banking capital requirements.[4] This shift means that many of the borrowers facing impending maturities will likely encounter a significantly less liquid and stricter lending environment when they try to refinance or sell, compared to the conditions when their loans were originated. CIM believes these conditions are likely to persist into the foreseeable future, creating a gap in the financing market that will be difficult to fill.

***CRE and Construction Concentration Ratios By Bank Size***

*As of Q4 2022*

| Bank Size (Assets) | Number of Banks | | |
|---|---|---|---|
| | Total | Banks that exceed at least one ratio threshold (% of total banks) | |
| > $50 Billion | 50 | 2 | 4.0% |
| $10 to $50 Billion | 108 | 25 | 23.1% |
| $1 to $10 Billion | 828 | 245 | 29.6% |
| $0.5 to $1 Billion | 772 | 181 | 23.4% |
| < $0.5 Billion | 2,998 | 310 | 10.3% |
| **Total** | **4,756** | **763** | **16.0%** |

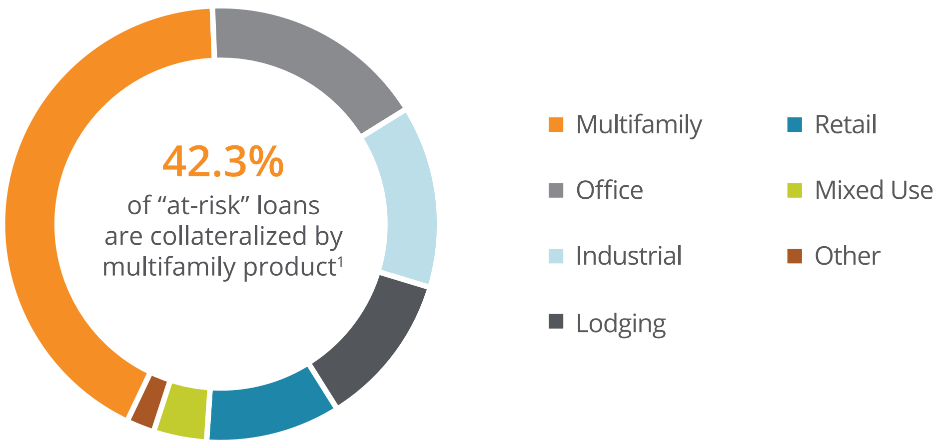
*Source: Trepp- Assessing Loan Portfolio Risk for Mid-Sized Banks? Look to CRE Concentration Ratios*

**Concentration ratios will likely lead banks to mitigate risk.**

Bank stress testing guidance levels set by regulators reflect a 300% concentration ratio for all CRE loans and a 100% concentration ratio for construction loans. These ratios are calculated by comparing the total value of a bank's loans in these categories to its Tier 1 and Tier 2 equity, which together form its total risk capital and represent one barometer for potential risk in the banking sector. A significant number of banks, particularly small to mid-sized banks, exceed guidance for at least one of these ratios. Exceeding these thresholds could invite regulatory scrutiny, leading banks to take action to mitigate concentration risk.[6]

This dynamic places additional pressure on the "extend-and-pretend" strategy as banks lose their flexibility to extend loans. In the face of regulatory pressure, CIM believes that there could be an uptick in opportunities to acquire debt from regional partner banks at below par. Indications of this emerging trend can already be seen in recent market activity, such as Kennedy Wilson's purchase of a portfolio of CRE loans from PacWest Bank.

***"At-Risk" Loans by Property Type***




*Source: Trepp, "at-risk" loans include loans maturing in the next 24 months where the debt service coverage ratio (DSCR) based on net cash flow (NCF) is less than 1.25x (as of April 2023)*

**Multifamily financial distress could increase over the next two years.**

Over 40% of securitized loans maturing in the next two years are backed by multifamily properties. Key risk metrics, including debt yield, debt service coverage ratio (DSCR), and loan-to-value (LTV), suggest substantial refinancing risk. Approximately a third of these loans have a DSCR of less than 1.25x, about 29% have a debt yield of less than 6%, and around 8% of these loans have an LTV of 85% or greater.[6]

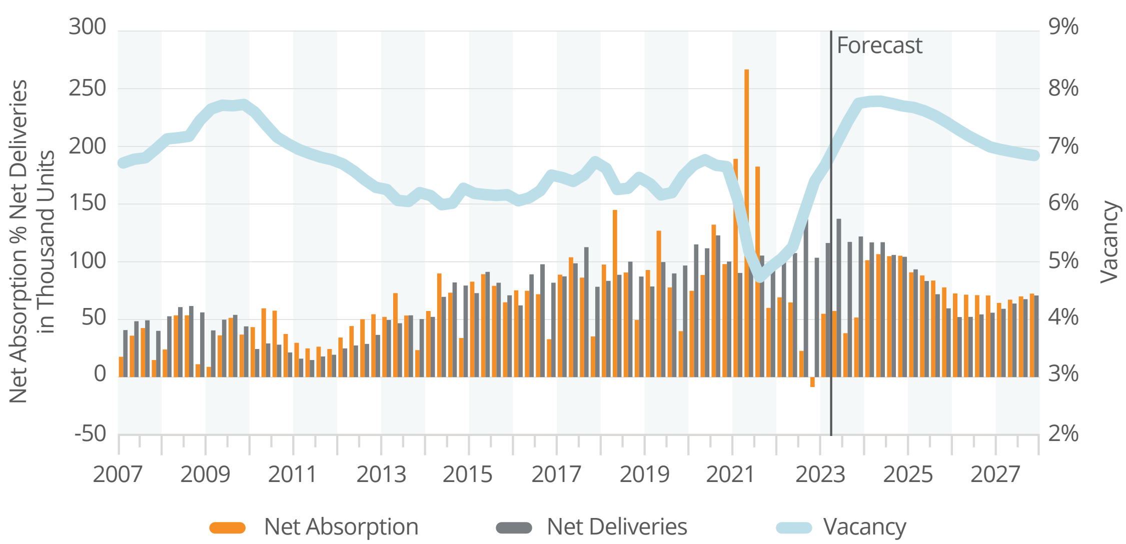
An area of note is commercial real estate collateralized loan obligations (CRE CLOs), which have played a significant role in the multifamily financing market in recent years. CLOs currently represent over 60% of the at-risk multifamily loans maturing in the next two years.[6] CLOs are often backed by transitional properties and are typically structured with floating interest rates.[6] With the softening of rental demand in Q1 2023 and capital markets pressures, CIM believes there is a strong possibility that financial distress will materialize across the capital stack in multifamily-backed deals in the near term.

**Long-term multifamily fundamentals are encouraging.**

CIM believes that the current capital markets landscape will drive distress within the CRE sector. Despite the challenges that the broader CRE sector is facing, we are optimistic about the multifamily property type due to observed strength in the underlying long-term market fundamentals. This may create compelling opportunities to deploy capital opportunistically into a high conviction sector, translating to the potential for achieving outsized risk-adjusted returns.

CoStar data reveals that the absorption rate for Q1 2023 amounted to approximately 62,000 units. This figure is notably lower than the pre-pandemic five-year average of 82,000 units. It is balanced by roughly 120,000 newly launched units. CoStar projections illustrated in Figure 1 suggest that net deliveries will continue to surpass net absorption until the first half of 2025, resulting in a short-term increase in vacancy rates. As depicted in Figure 2, multifamily construction starts reached their zenith in 2022, with these units set to enter the market in the following four to six quarters. While CIM anticipates a brief period of oversupply, recent complications within the banking sector are expected to tighten construction liquidity, thus constraining the growth of supply in 2025 and 2026. Additionally, CIM believes the increasing interest rate landscape is prompting homeowners who benefited from historically low rates in the past decade to hold onto their properties rather than list them for sale, thereby further limiting housing supply.

*Figure 1: Multifamily Fundamentals: Base Case Forecast*




*Source: CoStar U.S. Multifamily report, May 2023*

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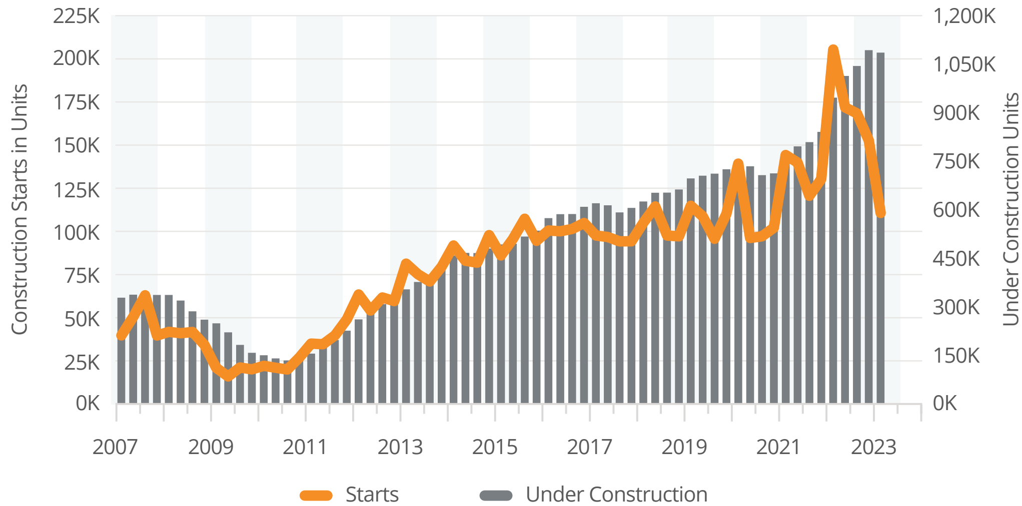
*Figure 2: Starts and Under Construction Units*

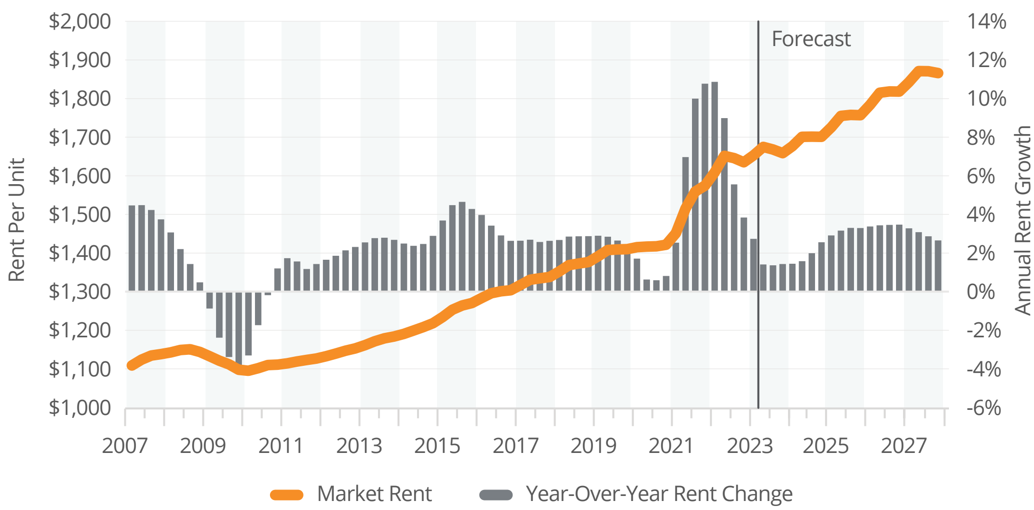



*Source: CoStar U.S. Multifamily report, May 2023*

**While rent prices have softened, the escalating cost of home ownership may lead to higher demand for rental properties.**

On the demand side, rents have begun to soften after a period of aggressive growth. Nationally, rent growth has decelerated from 3.8% at the close of 2022 to 1.2% in Q1 2023, according to CoStar data shown in Figure 3. Despite this slowdown, it is predicted that rent growth will continue to show a positive trend due to persistent demand dynamics. This is largely fueled by the escalating cost of home ownership, which is pushing mortgage-to-rent ratios toward pre-2008 levels.[8] CIM believes that this financial barrier will retain potential home buyers in the rental market, where their elevated income-to-rent ratios provide a conducive environment for sustained rent growth.

*Figure 3: Multifamily Rent Growth: Base Case Forecast*




*Source: CoStar U.S. Multifamily report, May 2023*

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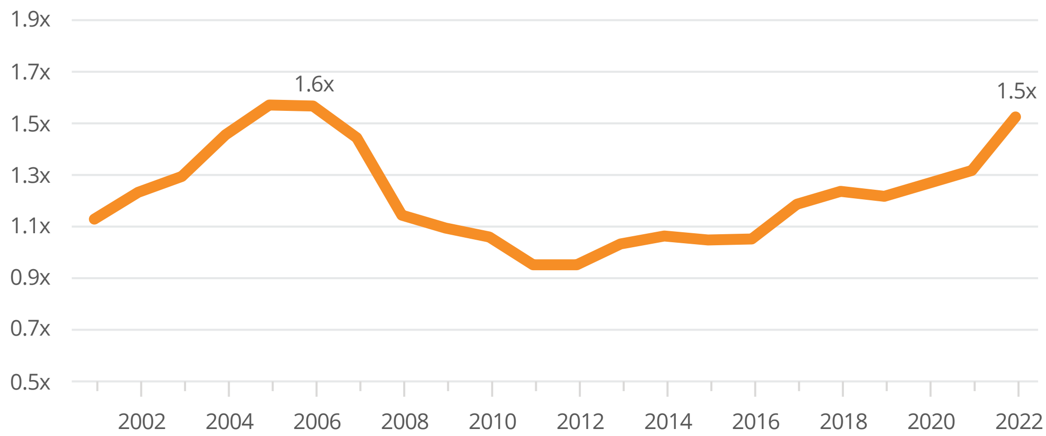
*Figure 4: Mortgage vs Rental Payment Ratio*




*Source: Greenstreet – Fundamentals and Valuation Data (Apartment), accessed July 2023*

## Near-term Opportunities

CIM views this moment of dislocation in the capital markets as a potential catalyst for attractive risk-adjusted opportunities in the multifamily sector across our real estate equity strategies. The convergence of cap rate correction, liquidity constraints in the financing markets, and elevated quantities of debt maturing over the next 24 months is expected to drive a significant need for rescue liquidity throughout the capital stack.[4] We believe there are opportunities to provide creative solutions to address dislocation across the capital structure, with the goal to support our communities' and partners' recovery from the impacts of underlying distress. Additionally, as regulators increase pressure on banks to reduce balance sheet exposure to CRE, CIM will evaluate opportunities to provide needed liquidity to our lending partners via the purchase of existing notes at a potential discount to par.[6]

Outlined below are the opportunities we've identified as particularly compelling entry points within the present investment environment and macroeconomic conditions. Please refer to Figure 5 for an example of how we expect financial distress to impact asset capital stacks amid rising interest rates and cap rate expansion.

- **Forced Credit Sales:** Individual and portfolio debt investments, purchased below par, sourced from lending partners experiencing liquidity demands (e.g., regional banks)
- **Gap Equity Investments:** rescue liquidity solutions for high quality sponsors to fill gaps in the capital stack via mezzanine debt or preferred equity investments.
- **Forced Equity Sales:** Full acquisition of assets at an attractive basis via lender-owned or forced sales.

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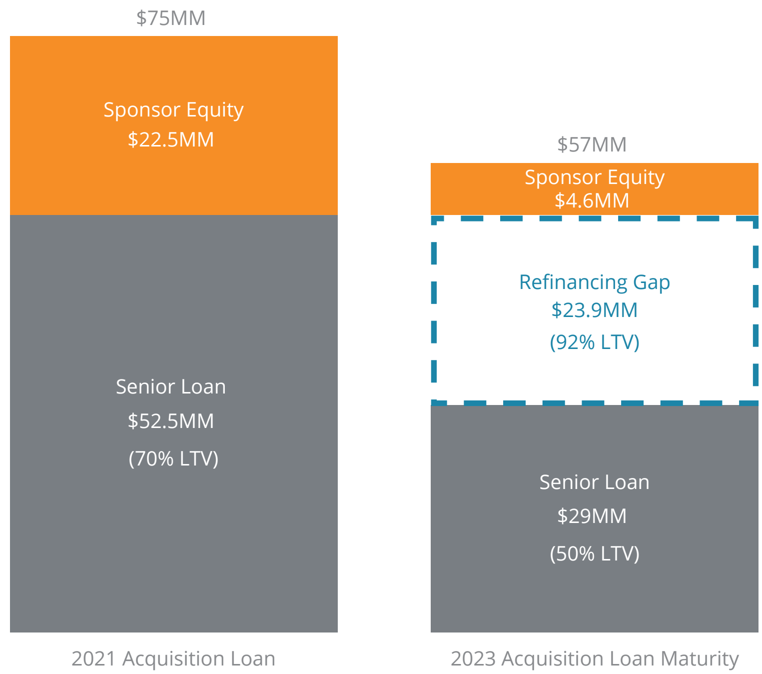
*Figure 5: Illustrative Gap in Capital Stack*




**We believe there are opportunities to capitalize on market dislocation across sectors.**

Given the structured nature of the opportunity set we expect to see, successful underwriting and execution of such opportunities will require expertise in both credit and equity. CIM can leverage its in-house operating expertise and experience investing across the capital structure to execute on opportunities driven by the current market conditions.

For structured opportunities, CIM employs a dual underwriting approach to optimize the investment for multiple outcomes. As an example, opportunities with a credit component (e.g., purchase of an existing note at a discount, origination of a high leverage mezzanine loan, etc.), CIM will deploy its in-house credit investments team to price, underwrite, and structure performing and non-performing loans in both hold-to-maturity and foreclosure scenarios. CIM's real estate equity investments team will simultaneously underwrite and diligence foreclosure and debt-to-equity conversion scenarios, ensuring there is a clear business plan to provide attractive risk-adjusted returns should CIM need to foreclose on the underlying loans. Our comprehensive underwriting approach seeks to identify optimal risk-adjusted opportunities in today's market with multiple attractive potential outcomes.

## Footnotes

1. Federal Reserve – federalreserve.gov website accessed April 2023. Large Banks defined as the top 25 domestically chartered commercial banks, ranked by domestic assets as of the previous commercial bank Call Report to which the H.8 release data have been benchmarked. Small Banks are defined as all domestically chartered commercial banks not included in the top 25
2. RCA – May 2023 Capital Markets Report
3. CoStar U.S. Multifamily, May 2023
4. Newmark United States Multifamily Capital Markets Report – Q1 2023
5. Trepp - Is "Extend and Pretend" Keeping Commercial Real Estate Afloat? Monitor Maturity Wall with Trepp Dashboard"
6. Trepp – Assessing Loan Portfolio Risk for Mid-Sized Banks? Look to CRE Concentration Ratios
7. Trepp - Multifamily Refinance Risk Assessment: Analyzing Performance Metrics & Identifying High-Risk Hotspots
8. Greenstreet – Fundamentals and Valuation Data (Apartment), accessed July 2023

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