The Michelson Organization

Who's feeling distressed?

A Q&A with Dan Gibson, vice president, acquisitions, with The Michelson Organization

Are we entering a distressed environment for investing? Where will the distress occur, and how do we capitalize on the opportunity?

Some market conditions may indicate distress currently exists in the investing environment, depending on how the word "distress" is defined. Initial impacts seem to be felt within the value-added sector and with assets that carry floating-rate debt. The value-added sector, characterized by assets that require enhancement or repositioning for increased value, often bears higher risk in uncertain market conditions. Assets with floating-rate debt become more susceptible to financial stress as interest rates rise, which leads to higher borrowing costs and strained cash flows for property owners. The level of distress seems to be asset specific, as lenders have flexibility to work with borrowers as maturity dates loom. New construction projects and assets recently stabilized also present potential investment opportunities, as merchant developers seek liquidity among record deliveries.

Maintaining sufficient liquidity is crucial to seize investment opportunities, especially in a dynamic, fluid market where investment opportunities may become available quickly. In addition to sufficient liquidity, it is crucial to have flexibility and adaptability in decision making to capitalize on the evolving landscape of investment opportunities and unlock value in both distressed and stabilized assets.

What are the largest risks and concerns investors face with their existing portfolios? How will investors and managers handle their existing portfolios in a recessionary environment?

Investors and property owners reliant on robust rent growth and historically low interest rates to primarily fuel returns face significant risks in the current macroeconomic environment, as many of these assets fall short of financial projections. Amplified borrowing costs impact floating-rate loans, which strain cash flows among other concerns. Additionally, expense escalation – notably taxes and insurance – erode cash flows and pose growing challenges to all property owners, especially those in markets significantly impacted by climate change, among other factors.

In the face of these risks, investors and managers must adopt proactive measures to safeguard their existing portfolios during such a fluid macroeconomic period. Investors and managers should prioritize operational efficiency to mitigate rising expenses while they maintain competitiveness in the market. Furthermore, a strategic focus on the balance of occupancy levels and rental rates becomes imperative to ensure properties remain occupied, amid a surplus of new supply. By prioritizing tenant retention and occupancy, investors can stabilize cash flows and mitigate the impact of potential economic downturns on their portfolios. Prudent financial management can also help bolster resilience against market volatility. Overall, a proactive and adaptive approach is essential for investors and managers to navigate the challenges posed by a potential recessionary environment and protect the long-term value of their portfolios.

How has the slowing transaction market changed the way investors and managers are thinking about dispositions?

For investors and managers with time before a loan maturity, it may be prudent to hold onto assets as they anticipate a potential shift toward a lower interest-rate environment in the coming quarters. This strategy aligns with the expectation of reduced borrowing costs and improved cash-flow dynamics, enhancing the appeal of their investments to potential buyers. By exercising patience, they aim to capitalize on favorable market conditions, optimizing their returns. Conversely, for investors and managers facing more immediate disposition decisions, there may be an opportunity to leverage a scarcity premium on their assets. With record amounts of dry powder in the market, investors are hungry for quality investment opportunities, which creates a competitive landscape where assets with desirable characteristics command premium pricing. Acting swiftly in such a scenario might enable investors to capitalize on this heightened demand, maximizing the value of their assets and potentially securing attractive exit opportunities that may not otherwise exist.

While some investors and managers may opt for a wait-and-see approach to benefit from anticipated interest-rate declines, others may seize the current market dynamics to leverage the scarcity of attractive investment opportunities and optimize their investment outcomes. The decision ultimately hinges on individual circumstances, timing considerations and broader market dynamics.

What property types are you most bullish or bearish for in 2024? What investment structures are most interesting to you, to take advantage of these opportunities?

In 2024, we unequivocally like the multifamily asset class. Despite near-term supply concerns, especially in select Sun Belt markets, the underlying fundamentals of this market segment should remain robust over time. Near-term supply concerns should taper over the long term, primarily due to significant increases in construction costs, which will likely curtail new supply entering the market. Moreover, it is worth noting that some of the markets with the highest levels of supply also show robust projections for employment and population growth. This suggests, while there may be an oversupply in the short term, the underlying strength of these markets should absorb the influx of new units over time. Demographic shifts, a growing preference for rental living among both millennials and baby boomers, and a tight single-family housing market, among other factors, continue to drive demand for multifamily properties. Additionally, the enduring appeal of rental income as a stable source of cash flow for investors in uncertain economic times further solidifies the confidence in the multifamily asset class. While we acknowledge the near-term supply concerns, we remain bullish on the long-term growth potential of multifamily investments.

As for investment structures, we find those with discretionary capital readily available to be crucial in today's fluid macroeconomic environment. Funds, separate accounts and/or programmatic joint venture programs offer the flexibility and agility necessary to capitalize on opportunities as they arise. With so much current turbulence, especially in the capital markets, those that have assets to sell should prioritize the ability of a buyer to execute. This heightened focus on execution underscores the importance of having discretionary capital readily available, as it allows investors to swiftly respond to market dynamics, whether it be acquiring undervalued assets or strategically expanding their portfolios. This agility is especially advantageous in navigating the evolving landscape of the multifamily market in 2024 and beyond.

How long will it take for multifamily to see a revaluation associated with higher interest rates and increased credit standards?

It seems like we have already started to witness a subtle revaluation within the multifamily asset class, albeit at a gradual pace. This adjustment is evident in various aspects, including the movement of cap rates. Relative to trades over the last few years, cap rates appear to be on the rise, indicating a shift in investor sentiment and risk perceptions. However, it is crucial to note the slowed transaction markets make it challenging to precisely discern where cap rates and pricing currently stand. Limited data points due to decreased transaction activity, coupled with scarcity premiums paid by investors with a ticking clock on their dry powder, further obscure the true picture.

Regarding the timeline for multifamily to see a comprehensive revaluation associated with higher interest rates and increased credit standards, it is a complex interplay of numerous factors. While we've observed initial adjustments, the full impact may unfold gradually during the medium-to-long term. Economic conditions, policy changes and market sentiment all influence the pace and extent of this revaluation process. At this point in time, revaluation is also very much asset, market and even submarket specific, as factors such as location, property quality and shifting preferences play significant roles in determining value. Understanding these nuances is crucial for investors navigating the evolving multifamily landscape in 2024 and beyond.

Is overbuilding in certain markets or submarkets leading to potential supply/demand imbalances, as well as dropping occupancy and rental rates?

Yes, overbuilding, particularly in select Sun Belt markets, seems to lead to a short- to mid-term supply/demand imbalance, and overbuilding exerts downward pressure on occupancy and rental rates in certain instances. The influx of new multifamily units in some markets surpasses current demand levels, which leads to increased competition among property owners and developers. As a result, occupancy rates may stagnate or decline, while rental rates remain either flat or experience a downward trend.

It is important to recognize, however, that some of the markets with the highest near-term supply concerns also boast some of the highest projections for population and job growth. While overbuilding may temporarily strain the supply/demand dynamics, the imbalance should gradually erode over time, as these markets absorb the excess inventory and supply tapers. As population and job growth continue to drive demand for housing, especially in vibrant Sun Belt regions, the surplus of multifamily units is likely to be absorbed. While overbuilding in certain markets may lead to supply/demand imbalances and downward pressure on rental rates, the long-term outlook remains optimistic. The inherent growth potential of some of the more dynamic multifamily markets, coupled with sustained demographic trends, suggests an imbalance might be temporary, eventually giving way to a more balanced and stable multifamily market, over time.

Are you positioning your portfolio for further economic headwinds or a soft landing? What are your concerns about the possibility of a recession?

We strategically position our portfolio to navigate with agility and resilience whatever kinds of economic headwinds arise. Our approach entails a multifaceted strategy that emphasizes flexibility and adaptability, among other contributing factors. Access to capital and adhering to regimented and scrupulous underwriting standards allow our platform to swiftly adjust to changing market conditions. Additionally, a heightened focus on asset quality and execution is paramount to safeguard our portfolio against potential headwinds. While we remain vigilant and cognizant of changing market conditions, we show confidence in our ability to weather economic challenges. By proactively managing risk and diversifying our portfolio across resilient assets and geographies, we attempt to mitigate potential downside risks.

Furthermore, our commitment to disciplined investment practices, coupled with a long-term perspective, positions us well for sustained success in the multifamily sector. By focusing on fundamentals and prudent asset allocation, we aim to generate returns and preserve capital over the long term, irrespective of prevailing economic conditions. Our proactive and nimble approach, coupled with a steadfast dedication to excellence, serves as a solid foundation, as we navigate uncertainties and achieve enduring investment success in the multifamily sector.

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At The Michelson Organization, Dan Gibson serves as vice president of acquisitions, with transaction experience of approximately $1 billion. Gibson sources multifamily and industrial investments across geographically diverse U.S. markets. He interacts directly with every aspect of the investment process, including financial analysis, debt arrangement and equity placement.

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CORPORATE OVERVIEW

The Michelson Organization is a St. Louis–based commercial real estate investment firm specializing in the acquisition and asset management of institutional-quality multifamily and industrial assets throughout the United States. With more than $1.5 billion of assets currently under management, The Michelson Organization has leveraged more than 90 years of experience to create a dynamic, vertically integrated investment platform designed to meet the needs of multinational institutional investors.

Michelson acquires core, core-plus and value-added properties in growth submarkets of the more significant metropolitan statistical areas in the United States, with the exception of submarkets in California, New England and Southern Florida. Michelson's outstanding team and local market expertise deliver attractive risk-adjusted returns to its partners and investors. Michelson's track record demonstrates a history of strong returns produced by seasoned investment strategies that focus on asset quality, intricate submarket dynamics, quality buying opportunities and intelligent capital structures.