Seeking cash flows

The case for direct investment in permanent multifamily whole loans in institutional portfolios

by Clive Lipshitz

Today's macroeconomic environment is one of geopolitical uncertainty, persistent inflation, higher interest rates and elevated levels of capital market volatility. Against this backdrop, many institutional investors are looking for easy-to-understand investments yielding predictable cash flows with limited downside and low correlation with other asset classes. We believe permanent loans on U.S. multifamily properties underwritten to strict lending criteria and held to maturity meet these objectives. A diversified pool of such loans should be evaluated as a viable permanent addition to portfolios, and as ballast to protect against the buffeting impact of strong headwinds.

Investment characteristics of permanent multifamily loans

Permanent loans on stabilized (well-leased) multifamily properties are compelling for several reasons:

- **Predictable yield:** These loans generate steady monthly cash flows backed by relatively secure rental income with a coupon that is generally priced at a spread to similar duration U.S. Treasury bonds. At typical LTVs, a pool of such loans can be expected to generate yield between that of BBB and BB bonds with arguably lower risk.

- **Low downside risk:** Loans secured by first-lien mortgages on well-leased apartment buildings are less risky than loans collateralized by most other commercial property types and by GDP-sensitive corporate earnings. Vacancy rates are typically low, rental income is predictable even during recessions, and, in the hands of an experienced loan servicer and asset manager, recovery rates are high in the rare case of default. (For example, peak-to-trough rental losses during the global financial crisis were less than 4 percent on multifamily properties compared with losses of more than 6 percent for industrial properties, more than 8 percent for retail properties and about 13 percent for office properties, according to data from CoStar and Cushman & Wakefield.)

- **Reduced reinvestment risk:** Loans are typically structured with call protection, further described below.

Demand for multifamily housing

To understand why loans on multifamily housing are so attractive, it helps to start with context on where Americans live and how multifamily properties are financed.

The ideal of homeownership — central to the American ethos — has been under pressure since the global financial crisis, when the homeownership rate peaked at approximately 69 percent, according to the U.S. Census Bureau. From the current vantage point, with higher interest rates and increased construction costs, homeownership is expected to plateau at 64 percent for the next few years, according to a forecast from the National Multifamily Housing Council.

Given constraints on Agency lending, we believe alternative lenders will play an increasingly significant role in filling the gap in multifamily finance.

More and more households are — by necessity — turning to multifamily rental housing. About one-sixth of U.S. households (19 million of 122 million, per an analysis by NMHC based on Census Bureau data) live in multifamily rental units, defined as those with five or more housing units (properties with two to four units are not financed as commercial real estate). A further 10 percent of households rent single-family houses, and a final 10 percent rent other forms of housing. Multifamily housing includes a range of real estate categories, from high-rise urban properties to mid-rise suburban properties and garden apartment complexes.

The primary driver for new housing demand is household formation, which the Census Bureau reports has averaged about 1 million new units annually. It is expected to remain at that level for the foreseeable future, according to Moody's Analytics.

Because supply of new multifamily housing typically follows demand — speculative development is the exception — vacancy rates are typically low and ranged between 6 percent and 7 percent between 2010 and 2022, according to CoStar. (The outlier was 2021, when elevated demand for rental units during the pandemic led to a sharp decrease in the vacancy rate to below 5 percent.) Overall, this is a comparatively low-risk property type.

Financing of multifamily housing

We turn now to financing of multifamily properties. The multifamily debt market is very large. Annual loan origination for 2023 is projected to be $450 billion, similar to the volume in 2022, according to the Mortgage Bankers Association (MBA). New loan origination meets several market needs:

- **Refinancing of maturing loans:** $574 billion in multifamily loans is expected to mature by 2026, according to the MBA.

- **Acquisition financing where existing debt is not assumed by the purchaser:** $335 billion of multifamily properties changed hands in 2021, according to MSCI Real Assets, formerly known as Real Capital Analytics.

- **Permanent financing of newly constructed properties:** 300,000 new units are projected to be required annually through 2035 to meet household demand, according to Yardi Matrix.

The Federal National Mortgage Association, or "Fannie Mae," and the Federal Home Loan Mortgage Corp., or "Freddie Mac," provide the lion's share of financing to the multifamily market, as they do for single-family housing. Other sources of financing include banks, life insurance companies, credit funds and the CMBS market. Fannie Mae and Freddie Mac are private-sector government-sponsored entities operating under the conservatorship of the U.S. federal government and are commonly referred to as the "Agencies." They purchase loans from approved third-party loan originators, securitize those loans into mortgage-backed securities that they issue into capital markets, and provide a guarantee to bondholders for full payment of principal and interest.

Both Agencies apply strict criteria on originators from which they purchase loans and require that these firms likewise impose strict underwriting criteria on borrowers, loans and underlying collateral. Fannie Mae further requires that delegated underwriting and servicing (DUS) originators — from which it purchases loans without re-underwriting — share with it in the loss guarantee on all loans.

Central to the mission of the Agencies is support of a market for affordable housing. This is evaluated based on rent expense relative to income in each housing market. The Federal Housing Finance Authority (FHFA), which supervises and regulates the Agencies, mandates that at least 50 percent of their lending be for "affordable" units. Moreover, the FHFA caps each Agency's lending on multifamily properties. In 2023, each Agency will be capped at $75 billion in new loans. Agency lending volume is modulated by way of loan coupon, lending caps, the mission focus, geographic constraints on lending activity, and other factors.

In periods of market stress, the Agencies play a critical role in providing liquidity to the single-family and multifamily housing markets when other lenders are prone to hold back. For this reason, the Agencies accounted for 55 percent to 60 percent of multifamily loan originations during the COVID-19 pandemic, lending $161 billion on multifamily properties in 2020 alone, according to MSCI Real Assets. In more normal times, Agency market share approximates one-third of all multifamily loans.

We believe alternative lenders will play an increasingly significant role in filling the gap in multifamily finance, particularly for those that approximate the Agency terms with which many property owners are familiar. This dynamic will be familiar to investors in the private credit market where alternative lenders have supplemented banks as a source of financing for mid-sized corporations.

Attractiveness of Agency-like loans to owners of multifamily properties

Permanent loans originated on an Agency-like basis are attractive to borrowers. They provide predictability in structure, with terms of five to 15 years, and are typically priced at a fixed spread to equivalent-term U.S. Treasuries. These loans amortize over extended periods (20 to 30 years, with interest-only options), providing borrowers flexibility in cash flow management. To provide clarity to borrowers and protect the interests of lenders, these loans are subject to predictable underwriting criteria and credit terms — loan-to-value is typically 60 percent to 70 percent (potentially higher), and the debt-service coverage ratio is typically above 1.25x. Reinvestment risk for lenders is mitigated by call protection in the form of prepayment penalties, including yield maintenance (an obligation to maintain the lender's projected yield in the case of early loan termination).

Multifamily loans underwritten to these criteria have experienced low levels of default. For example, even during the period from 2007 to 2013, Fannie Mae and Freddie Mac multifamily loans experienced serious delinquencies (60 days overdue) of only 0.8 percent and 0.4 percent, respectively. Contrast this with delinquencies on their single-family loans, which — on a 90-day delinquency basis — were 4.2 percent and 5.6 percent, respectively. (Single-family serious delinquency is defined as 90 days or more past due or in the foreclosure process. Multifamily serious delinquency rate is the unpaid balance of loans 60 days or more past due, divided by the total unpaid balance.)

Investing directly in newly originated Agency-like loans

Investors interested in the predictable yield of Agency loans could invest in the Agency multifamily mortgage–backed securities market. We believe there is also a compelling argument for investing directly in pools of loans on a hold-to-maturity basis. This provides the investor a higher level of total return (Agencies levy a fee on bond investors); less volatility; and some degree of customization by loan size, term, credit characteristics and geography. Because of the scale of this market, an asset manager with comprehensive national coverage can deploy substantial capital for investors.

Adding an allocation to multifamily whole loans to an existing portfolio should improve the portfolio's total risk-adjusted return.

Portfolio positioning

When considering a portfolio of multifamily loans, investors need to determine in which portion of their portfolio to house these loans. Some investors might look at the underlying collateral and select a real asset, real estate or real estate debt allocation. Other investors, considering the loan cash flows — highly predictable and long-duration, especially if held to maturity — might house this exposure in a credit or fixed-income allocation.

Considering the predictability of cash flows, this asset class can be expected to have a high Sharpe ratio. Likewise, the nature of underlying cash flows — tied to rental income on essential real estate assets — can be expected to have limited correlation with capital market–sensitive asset classes. It is, therefore, our view that adding an allocation of multifamily whole loans to an existing portfolio should improve the portfolio's total risk-adjusted return. ❖

Clive Lipshitz is a managing director with **Greystone,** a private national commercial real estate finance company.