# Urbanization by Millennials and Baby Boomers Propels Multifamily Market

Apartment demand has remained strong throughout the economic recovery. When Americans lost their homes during the recession, eventual renewed job growth provided the financial wherewithal to form new households by way of the rental market. While many individuals are too burdened by debt to buy, more people are increasingly making the lifestyle decision to rent, further ensuring that the recovering for-sale housing market has not sapped rental demand.

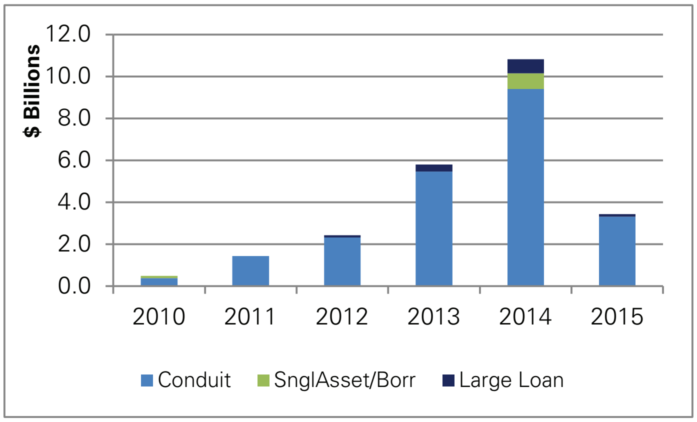
Healthy demand has preserved apartment market fundamentals in spite of an influx of new construction. First quarter 2015 apartment vacancy was around 4.0% according to Reis, Inc. As rents and property values have increased significantly, apartments have become a favored asset class, drawing capital to the market.

Multifamily lending has ramped up in 2015, propelled by growing apartment sales volume, refinancing maturing loans, and the conversion of construction loans to permanent financing. Several types of lenders are active in the multifamily sector. Banks and thrifts represented 36.7% of outstanding multifamily mortgage debt at the end of 2014, while CMBS, CDO, and ABS issues together accounted for 20.2% of outstanding debt according to the Mortgage Bankers Association. At over 20% of the market, CMBS is a critical source of capital.

## CMBS Originations

Multifamily CMBS origination has increased steadily in recent years, reaching $10.8 billion in 2014 and approximately $3.4 billion year-to-date. While conduit deals that are comprised of a number of smaller loans have been the primary source of activity in 2015, a few large loan portfolio deals have been completed. Single asset/single borrower deal volume has increased dramatically since the recession, but are backed mostly by retail, office, or lodging loans.

**Figure 1. Multifamily Issuance by Deal Type**




This spring, Fannie Mae and Freddie Mac increased interest rates and tightened underwriting to slow lending activity, as it appeared the GSEs would reach their $30 billion annual production caps for market rate multifamily lending by the third quarter of 2015. The move benefitted CMBS and banks, which were able to increase lending. In May, however, the Federal Housing Finance Agency (FHFA) ruled that the agencies could finance an additional $15 billion. It is too soon to see the impact of the decision on the CMBS market, but new issuance could slow as Fannie and Freddie become more active in the market.

The majority of the recently securitized deals are collateralized by partial interest-only loans. These notes have a specified number of interest-only periods, after which the loan begins to amortize, ending with a balloon payment of the remaining principal in the last period. Amortizing balloon loans, whereby the note amortizes over a longer period than its maturing term and leaves a balloon balance in the last period, have also become common of new multifamily CMBS loans.

## Maturing Loans

A large number of maturing multifamily CMBS loans will be up for refinancing over the next two and a half years. Between 2015 and 2017, $40.5 billion in legacy multifamily CMBS are set to mature, $7.6 billion of which come due in the final seven months of 2015. Maturities will peak at $17 billion in 2016 and will fall to $15.6 billion in 2017.

Of the loans maturing in the next four years, occupancy exceeds 95% in more than half of the underlying properties. For about 15% of the properties, occupancy is below 85%. It is these loans with higher vacancy rates that are more likely to become troubled.

As property rents and values have increased, distressed assets are far less common than several years ago. Multifamily CMBS delinquencies (30+ days delinquent) peaked around 16.5% in 2011 but have since dropped to 8.6%. Of the $60.2 billion in outstanding multifamily loans, delinquencies are reported on $5.2 billion in loans, $3 billion of which is tied to the Stuyvesant Town-PeterCooper Village complex in New York.

While loss severity on multifamily CMBS loans that have taken losses has hovered around 30% since 2012, the balance of loans taking losses has

**Figure 2. Multifamily Issuance by Loan Type**

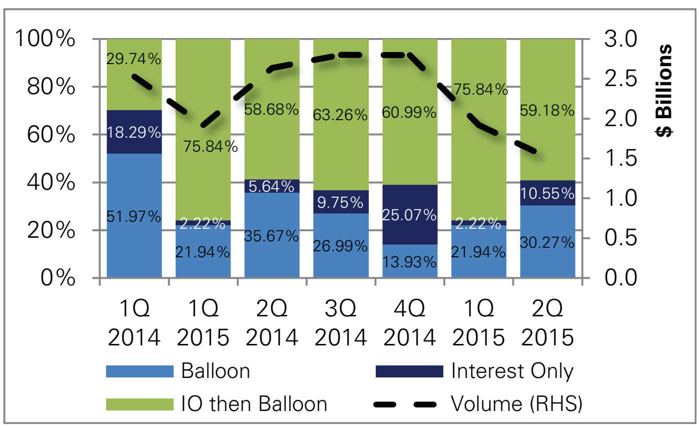



**Figure 3. Maturing Multifamily Loans**

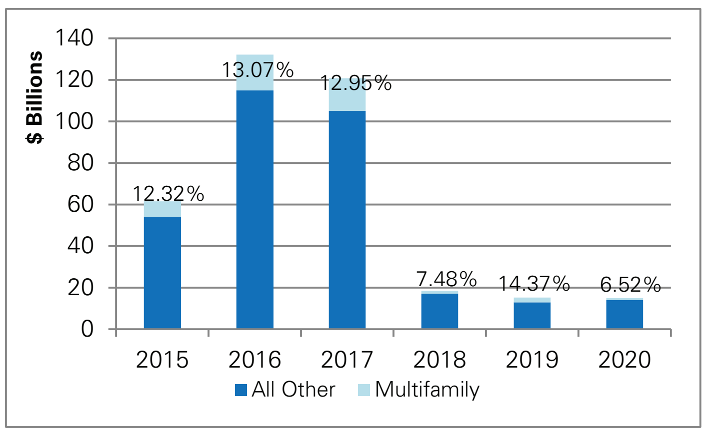



**Figure 4. Maturing Multifamily Loans by Status**

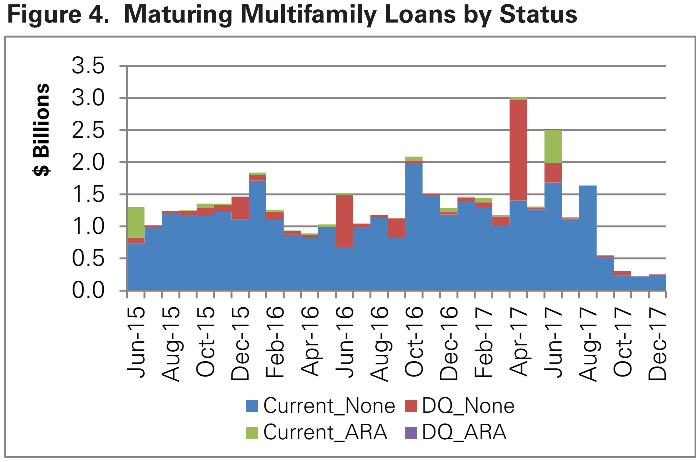
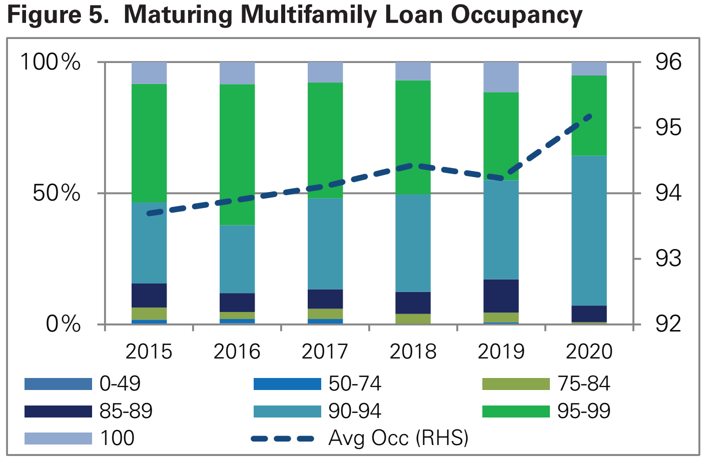



**Figure 5. Maturing Multifamily Loan Occupancy**



decreased 29% annually from 2012 to 2014. Through the first five months of 2015, $5.4 billion in multifamily loans have been disposed with 13.7% taking losses and a strikingly low 8.4% loss severity. The low severity was helped by some very large multifamily loans paying off with small losses so the precipitous decline is will likely not last as more loans dispose with losses throughout the year.

## Outlook

By the end of 2015, total CMBS volume could hit $90 to $100 billion. Multifamily issuance should reach between $9 and $11 billion if its share of the market is consistent with historical levels.

Healthy underlying property fundamentals will continue to drive the lending market. Continued job growth and demographic trends make current apartment demand more sustainable than in previous upcycles. As the large millennial cohort has started to enter the workforce over the last few years, the population of renters has grown. High student loan debt increases the likelihood that millennials will be renters, and remain in the rental market for a longer period.

Both millennials and baby boomers alike are increasingly choosing to rent, especially in cities, to take advantage of an urban lifestyle. In addition, some baby boomers are choosing to downsize with the convenience of minimal maintenance as the generation ages. The resulting low vacancy rates for existing units puts upward pressure on rents, making development feasible. So far, that demand has been sufficient to absorb construction deliveries. As of now, it is too soon to tell if future deliveries will lead to oversupply, which could negatively affect rent growth.

Higher interest rates are a cloud on the horizon that will impact the multifamily CMBS market. In June, the Federal Reserve elected not to start raising rates yet, citing slower growth ahead. However, interest rates are expected to begin rising slowly before year-end. Higher interest rates are unlikely to derail the sector because they make homeownership less affordable and drive people to the rental market. Still, increased rates will make refinancing maturing loans more challenging as borrowers will find it harder to achieve required debt service coverage ratios. Sales transaction volume could also decrease because a higher cost of capital will lower investor returns.

**Figure 6. Multifamily Delinquencies**

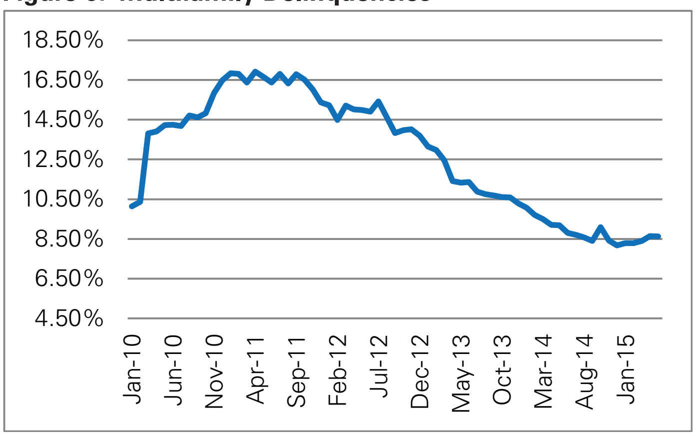
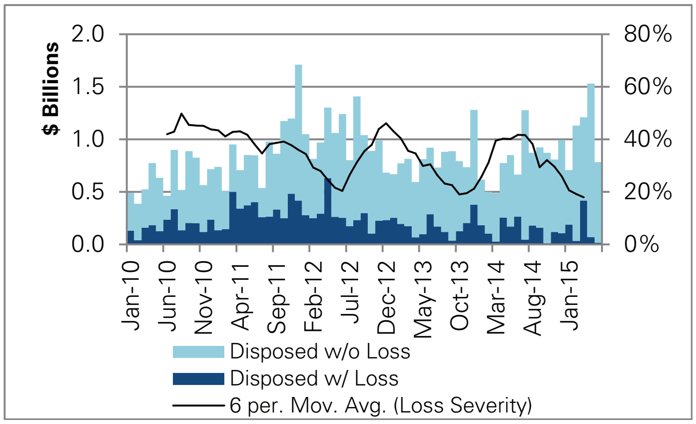



**Figure 7. Losses on Disposed Multifamily Loans**

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For more information about Trepp's commercial real estate data, contact info@trepp.com.

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