

Walker & Dunlop Investment Sales

MEMORANDUM – DRAFT

The U.S. continues to grapple with the uncertainty related to COVID-19, WDIS is in consistent contact with our top clients to get a live pulse on their perception and sentiments of the rapidly shifting multifamily market. Effects of the economic disruption on property operations and capital markets continue to change daily, and it will take time before there is full clarity into the scope of market dislocation.

A summary of key takeaways follows:

Pipeline

- Most deals that are through due diligence and under-escrow will close. WDIS has roughly \$500 million of product under-escrow closing through the end of march – this pipeline is unaffected.
- Buyers have differing approaches to deals under agreement, but not through DD. Some have made asks for additional time and/or price relief, while others have stepped away from acquisition pipelines entirely. The ratio is fluid and changing daily.

Investor Sentiment and Activity

As of 3/20 – Buyer sentiment largely falls into three categories:

- **FULL PAUSE:** These groups have stepped away from the market for at least 30 days to gauge the full impact of the economic dislocation. Some of these buyers have stepped away from billions of dollars in awarded product. As one institutional client put it, *“The list of questions in the ‘Why buy now?’ column is much longer than the reasons in the ‘This is why we should act’ column.”* It is our view this category accounts for roughly 60% of the market and will likely grow if the severity of the outbreak and shelter-in-place orders expand.
- **ACTIVE REALIST:** These groups are determining how to underwrite near-term cash flows and price operational risk, but they will still engage at reasonable valuations. Capital still needs to be placed, but they still have a fiduciary responsibility to their LPs. The common thread with these buyers is a view that conditions on the other side of the crisis will likely result in compressed cap rates for multifamily and industrial. It is our view this group accounts for roughly 20% of the market.
- **ACTIVE OPPORTUNIST:** These are well-capitalized groups looking to price in near term operational risk and get paid a premium for providing liquidity in a period of uncertainty. They point to the dislocation in public markets (REZ trading off 40%) as a leading indicator for private market pricing. It is our view this group accounts for the remaining 20% of the market.

Lack of Clarity on “Post-Virus” Pricing

With very few data points on new transactions, it is virtually impossible to have firm conviction in pricing an asset in today’s environment. There is an acknowledgement that while total return targets have not changed, there is too much volatility to underwrite a proforma with a high level of conviction. The difficulty in pricing assets lies in two areas: pricing capital markets risk and near-term operational risk.

When discussing a “Post Virus” price correction, it is important to acknowledge the yield compression in multifamily from Q3 2019 to Feb 2020. In our view, during that period, a combination of compressed total return targets, falling cost of debt, and increasing aggression related to residual cap rate assumptions led

a substantial increase in multifamily valuations. While the appreciation varied by market and asset profile, it is fair to say the price appreciation of 5% to as much as 15% was observed in secondary, primary and core markets. As we work our way towards more clarity, benchmarking February 2020 pricing will be important when quantifying the correction. In the meantime, our observations are as follows:

- Increased cost of capital from widening debt spreads has impacted value up to 4-5% for full-leverage buyers. One large private equity investor has seen average cost of debt increase from 2.7% to 3.4% in the past week.
- Agency MBS spreads widen significantly over the past week and liquidity at end of the week auction was ~ 30% of what it was on Monday – corporate bond increased 100-125bps throughout the week – RMBS (single family) spreads came in 50bps as the Fed stepped in to purchase \$35B this past week and is signaling another \$100B of purchases this coming week
- “LIQUIDITY – STABILITY – AFFORDABILITY” is the drumbeat of the Agencies as it relates to new business
- There is no consensus on how to price operational risk. General consensus is that renewal rates will increase, but leasing traffic is likely to abate. Vertically integrated operators, particularly those that own third-party management companies, will be on the leading edge in identifying operational trends.
- Rent growth will mitigate, but the degree to which it slows will depend on the asset profile. Lease-up opportunities are likely to see negative growth to buy occupancy; stabilized assets will remain flat for as long as virus-related restrictions are in place. Most operators are moving away from revenue management in an effort to stabilize occupancy.
- Given yields in alternatives, there is a strong possibility that post-virus cap rates decrease. This will likely be offset by lower NOIs, potential to result in a net neutral impact to asset values.
- Lease-up risk has been fundamentally re-priced, exacerbated by the pull-back of pre-stabilized debt programs.
- Bad debt will increase. There is mounting momentum both at the state and federal level to suspend evictions for up to 90 days. De facto restrictions on evictions will be even greater due to closed municipal offices and courts. Impossible to predict the impact here, next data point will be to gauge bad debt figures 7-10 days into April.

Public-Private Dislocation

- The largest public MF REITS are trading at implied cap rates comfortably above 5%, an increase of as much as 150bps. There are not enough data points to determine private market pricing, most acknowledge the public markets are oversold.
- With REITS trading at a discount to NAV and at outsized implied cap rates, there will likely be public-to-private M&A activity over the next six months.

Product Type Matters

- There is a consensus among buyers that workforce housing could struggle, particularly if the rent roll is composed of workers in the travel and tourism industry. Assets located near airports, or with a heavy service sector exposure, for example, could see a disproportionate impact.
- Core and ultra-core product will be the most liquid during this period of disruption. The durability of rent rolls backed by residents with discretionary income will be attractive.

- Renovation programs are being brought to a halt, and value-add capital is unlikely to be active near-term.

Perception is Geographic, for Today

- Investors located in areas with heavy early impacts of the virus have seen greater personal and business disruption earlier. Namely, the New York metro, the Bay Area, and Washington State have all been at the leading edge of impacts from the virus. Sunbelt cities have largely trailed these gateway markets in day-to-day operational disruption, but this could change in the coming days and weeks.

Opportunity Zones Deals Remain Active

- The time factor will keep the Opportunity Zone space liquid near-term.
- OZ fundraising is likely to decrease year-over-year.

Near-Term Development Issues

- Municipalities like Boston and San Francisco have already halted all non-essential construction activities, including multifamily construction. We anticipate more Shelter-In-Place restrictions implemented at the state level, however, we lack a consistent interpretation related to the essential/non-essential treatment of construction sites
- Regardless of Shelter-In-Place adoption, permitting and inspection delays will mount due to closed municipal offices.

Potential Distress/Forbearance

- At the moment, it is difficult to see a scenario with distress across broad segments of multifamily sector – well capitalized sponsors and conservative leverage levels (relative to the period moving into the GFC) should provide resiliency - Exception here will be markets with heavy energy exposure experiencing the “one/two” punch of virus and sub \$30/barrel oil
- Operators with large hospitality and retail exposure are under immediate pressure
- While there are questions about forbearance, these conversations are ongoing and there is no definitive plan in place. After a 10+ year expansionary cycle, Multifamily sponsors are generally well-capitalized, and lenders of all types have provided significant liquidity. While short term accommodations are under consideration, we do not expect lenders to suffer losses in the intermediate to longer term
- There will be significant stress in the bridge and leveraged lending space - the velocity of note sale offerings has increased substantially early in the week of March 23rd