END OF YEAR COMMENTARY

Marcus & Millichap
DINIUS—WARSINSKE
MULTIFAMILY GROUP

WRITTEN BY: SIDNEY WARSINSKE & RYAN DINIUS

DECEMBER 2023

The Puget Sound experienced an incredibly turbulent investment market in 2023. Through interest rate volatility, and increased multifamily development for the first time since the Great Recession, we experienced true fear. Through this letter, we hope to provide our guidance and perspective while we summarize many of the conversations we've heard during the course of the year.

Year-End Thoughts from a Top Producing Multifamily Team

The investment landscape in the Puget Sound region witnessed considerable upheaval throughout 2023, marked by fluctuations in interest rates and a resurgence in multifamily development for the first time since the Great Recession. In a year fraught with uncertainty, our aim through this commentary is to offer informed guidance and perspective, encapsulating the prevalent discussions that have shaped this eventful period.

It is imperative to move beyond the surface narrative propagated by headlines. Throughout this year, investment groups have frequently wagered on various outcomes, attempting to strategically time sales or purchases. Whether explicitly stated or implied, these decisions often echo sentiments gleaned from media sources like CNBC, King 5 – Seattle News, NY Times, and CoStar Research. Statements such as "prices are declining, perhaps I should delay selling," or "there's a scarcity of available properties to purchase, so why proceed with a 1031 exchange?" have reverberated within these circles. If you find yourself swayed by such notions to justify retaining an underperforming asset, it is crucial to pause and critically evaluate your rationale. Have you thoroughly researched the market or asked advice of industry experts?

The predicament lies in the discrepancy between data collected by major entities and the operational realities of small to mid-sized property owners. Statistics amassed by these organizations more accurately reflect the performance of large-scale operators who regularly disclose their data. For instance, consider CoStar's assertion that the average cap rate in the Greater Seattle Area stands at 4.6% in 2023. However, this metric fails to holistically represent the nuanced variations in cap rates, which encompass trailing, actuals, adjusted, and proforma figures. Relying solely on a cap rate to gauge value is, therefore, inadequate. Consider further, this statistic encapsulates all sales, with no cadence toward value-add, new construction, light value add, covered land, the list goes on…

A comprehensive evaluation entails balancing the cap rate with the debt coverage ratio, augmenting the assessment with price per door and price per square foot metrics. Consequently, when sales occur, questions arise about the sources of this data and its compilation. Most private property owners seldom divulge their information to these large corporations. Our approach involves direct engagement with these entities to grasp the broader landscape and furnish our clients with accurate insights. Never feel hesitation to ask our team to put together an analysis. It's a wonderful way to build working relationships, collaborate, and understand ways to create more value for you.

Value-add

Predicting pricing within a narrow margin has proven exceedingly challenging this year. The bid and ask spread has notably widened, primarily due to the lack of buying pressure in the private markets. Often, investors negotiate prices considering the absence of competing bids, leveraging the belief that no other prospective buyers are in contention. Many properties linger on the market for extended durations, compelling buyers to grapple not with each other, but with the sellers' propensity to postpone transactions.

Furthermore, determining acceptable returns to finalize property acquisitions has been ambiguous. Market apprehensions compounded by recent legislative developments in Tacoma, Seattle, Burien, and Bellingham have added complexities, particularly concerning renovations in properties occupied by tenants.

To this effect, we have also seen many groups who started a large renovation a year or two ago, and found themselves in tough situations whereas upon trying to get non-payers out, they have been "dragged through the mud" trying to evict bad tenants. This isn't just limited to those who don't pay. Criminals and troublemakers alike are finding that as long as they pay a portion of rent, they can continue to operate illegal activity out of owner's units. This creates a dangerous environment for other tenants and another obstacle to retain and court new tenants.

The complications in leasing and operations have repercussions on the financial bottom line. Investors resorting to rehab, bridge, or hard money financing on properties find themselves grappling with missed loan deadlines, incurring additional fees to extend loans, and seeking stability through refinancing.

In essence, the investment landscape in the Puget Sound region, specifically within Value-Add communities, in 2023 has been defined by intricate dynamics that challenge traditional valuation methods. Interest rates coupled with underperformance have added further complexity to this terrain.

Development and New Construction

Plagued by similar obstacles to Value-Add, development and New Construction are continually fighting timelines through permitting, legislation, cost of labor and materials.

The permitting process through all larger counties in Washington State has experienced longer and longer wait times to get through planning and permitting. While we could simply draw the conclusion to inefficient policies and procedures with the municipalities as they are mostly working remotely with inefficient communication, there is a systemic issue with the process to submit and collect all necessary approvals to do so. With response time from the city largely taking multiple days to respond to an email request, or scheduling meetings with certified inspectors taking weeks or even months, from start to finish, you could expect to get from raw land, to a completed project in 2-4 years, depending on size and scale. The city is doing better work to incentivize developers through the MFTE Program(s) and Opportunity Zones, however, when you're a developer, time itself is your worst enemy. Incentives can be a wonderful reason to do a project, but without a firm understanding of how short or long a process can take from start to finish, developers are faced with wagering on potentially multiple years of interest carry.

Legislation has continually been a battle for developers and landlords alike. With the ever-changing goals of the municipalities, developers can get all the way through design to only have one department make cause for major revisions in order to allow for and advocate for their department. For instance, let's say you're building a 100 unit property in the heart of Capitol Hill or the Heart of Tacoma. You get through the design of the property only to realize the amenity space you planned on your rooftop deck didn't allow for any green space. This could take you back a month while you redesign and coordinate with the proper divisions to approve the revisions. Whether good or bad, this is a reality, and with time being the worst enemy of the developer, this is a hinderance to the process. This can also cause the developer to go over budget as there are additional labor and material cost that is associated with the revision.

Lastly, the cost of labor and materials have increased dramatically through inflation. Since 2015, these commodities, in some cases, have nearly tripled. We've also seen the cost of the labor to install this material increase a staggering 50% in the last 10 years (according to the U.S. Bureau of Labor and Statistics). While we typically see the Greater Seattle Area outpace the national averages (per Mortenson Constructions' Cost Index), we can likely assume that even if we take that 50% increase of the national average, that can lead to compressed returns. Especially if landlords expect a premium for their land in a geographically constrained market, like the Puget Sound.

Interest Rates

The biggest challenge both buyers and sellers alike face are interest rates. Since 2021, interest rates have skyrocketed, making it a very tough market to navigate for those reliant on maturing debt. Don't just take it from us, here is a chart of the 10-Year treasury from the very end of 2020 to today:

What does this mean for an incoming investor?

1. Anything you're buying under a 5.9-6.1% car rate currently would be considered negative leverage, with the assumption you're putting 25-30% down on a property. Regardless of upside, some operators are cautious to deploy this capital.
2. $1,000,000 borrowed costs twice as much as it used to.
   a. (assumption) 3% interest only on a $1,000,000 loan: $2,500 Monthly Payment
   b. (assumption) 6% interest only on a $1,000,000 loan: $5,000 Monthly Payment

With this said, we don't see 50% price cuts, even though the cost of capital is 100% more. Do we know how this will ultimately shake out? No. Do we know that being selective in opportunities is more important than it's ever been? Yes.

Anecdotally, when the 2008 recession hit, liquidity from banks hit an all-time low, and prices fell. Those who still bought during this time period, found that 10 years later, their investments in the Puget Sound doubled, tripled, and even quadrupled in some rare cases. We like to think history will repeat itself and we will be in a better situation three years from now from where we sit today. Maybe this time is different?

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I Am Considering Selling

The landscape for property sellers has undergone a significant transformation, presenting challenges distinct from the ease experienced during the period spanning 2016 to 2021. The evolution in global dynamics coupled with shifts in buyer profiles has ushered in a new era, potentially impacting the equity prospects for property owners. While those who invested in properties during 2021 might have encountered a dip in their equity, long-term property holders of a decade or more are likely to still possess a commendable profit margin.

Crucially, sellers must engage in a continuous self-assessment process, posing pivotal questions such as, "Where could I reinvest my capital if I were to sell?" and "Does retaining equity in my Puget Sound real estate align optimally with the growth potential of this specific property?" An affirmative response to both queries, indicating substantial untapped value within the property, may warrant a decision to retain ownership.

Conversely, introspection might reveal limitations in enhancing property value through cost-effective strategies or reaching the pinnacle of value addition in a project, or successfully stabilizing a new construction endeavor. In such instances, divesting might represent an astute move, signaling that the potential for superior investment opportunity lies ahead.

In summary, sellers must meticulously assess their individual circumstances, gauging the potential for further value creation within their current property holdings. If avenues for meaningful growth persist within the property, retaining ownership might be the prudent course. However, recognizing when the zenith of potential has been achieved or when superior investment prospects beckon may signal that the time is ripe for a strategic sale.

I Am Considering Buying

Presently, prevailing discussions often center around a trifecta of common objections encountered by investors:

1. Negative leverage
2. Interest rate volatility
3. Adopting a "wait and see" approach

Engaging with the prospect of negative leverage demands a shrewd understanding of the underlying potential within a property. Acknowledging that an underperforming property doesn't preclude the possibility of cultivating a highly profitable venture is pivotal. Astute investors discern that inherent value might exist despite current setbacks.

Addressing interest rate volatility, recent indicators from the Federal Reserve suggest this phenomenon may be transient. Deploying longer-term financing strategies when purchasing property can mitigate this risk, facilitating comprehensive planning for enduring success.

Opting to adopt a passive "wait and see" stance mirrors a state of complacency. Even amidst market volatility, the real estate industry offers ample scope for proactive decision-making. Crafting a strategic roadmap in collaboration with investment professionals and seeking counsel from industry experts can unveil tailored opportunities aligned with individual objectives.

In essence, confronting these challenges demands a proactive and informed approach. Recognizing the potential for growth within seemingly adverse scenarios, leveraging long-term financial strategies, and actively engaging in strategic planning can empower investors to navigate the intricacies of the volatile real estate market.

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Looking forward

The current pace of the market has accelerated, bringing in a paradigm shift propelled by platforms like ours that have substantially altered the flow of capital. This transformative landscape is defined by a highly collaborative industry, enabling brokers and investors to seamlessly navigate transactions across geographical boundaries. A scenario unfolds where professionals negotiate deals in Downtown Seattle while concurrently engaging in property acquisitions in Toronto or refinancing ventures in Denver. The fluidity of capital movement between the United States and Canada underscores the expansive exposure, widespread opportunities, and the emergence of national management entities.

Anticipations for the forthcoming year promise a wealth of opportunities for both sellers and buyers. Insights from the recent Federal Reserve Meeting suggest a plausible trajectory of rate relief throughout 2024, potentially heralding lower interest rates. Such a financial environment could foster increased liquidity for sellers and more favorable financing options for prospective buyers. However, waiting for diminished interest rates might inadvertently exclude those who have been biding their time for the opportune moment. A prudent strategy, often proven effective, involves a dollar-cost-averaging approach over time, particularly within asset classes like real estate that generate income and allow for profitable reinvestment.

In summary, the evolving market dynamics coupled with potential forthcoming rate adjustments set the stage for an eventful year ahead, emphasizing the need for strategic foresight and a proactive approach to capitalize on emerging opportunities within the real estate sphere.

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