Exploring the possibilities of multifamily investment in 2014 - Is it still a "no-brainer?"

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Multifamily has been the favored asset class during the recovery as both institutions and private investors have capitalized on the trend away from homeownership and toward renting apartments in urban environments. Investors flush with capital to invest but wary of volatility in the other asset classes have flocked to this sector to park their money in a "safe" investment that throws off a decent yield as well as appreciation from rent growth as the economy continues to recover...pretty much a "no-brainer," right?

2013 has seen at least two significant increases in interest rates (the 10-year treasury yield started the year at 1.8% and is now around 2.8%), a ton of new supply added and the rent increases that have spiked in some markets are now showing signs of tapering off. In addition, taxes and operating expenses have continued their ascent, pretty severely in some New York Metro markets. Despite all of this, however, multifamily cap rates have remained relatively stable, as the competition for deals has become stiffer and the pent up demand for investment property continues to keep capitalization rates on multifamily at historic lows.

Will this change in 2014? The consensus is that interest rates will continue to rise and that higher rents will not be achievable in many markets, due to stagnant income levels. We have already seen expensive rental housing in Manhattan, causing a boom in rental markets outside the CBD such as Brooklyn, Jersey City, Hoboken (more affordable locations). Some of this has even fueled demand for rental housing in "urban suburban" locations like Yonkers, New Rochelle, White Plains and Stamford, Connecticut. We have also witnessed a surge in condominium prices in New York City and sales volume of entry level single family homes in the suburbs.

The value-add strategy of purchasing properties with below-market rents, subsequently strengthening occupancy and increasing rents, and then selling the property for a handsome profit in two to three years is becoming harder to execute. Most of this type of opportunity in major U.S. Metros has been exhausted, leaving investors to determine where to turn next. Some value-add investors are deciding to take a longer-term view and some are exiting this business entirely due to that lack of available product that "makes sense."

Meanwhile, many of the institutional core investors have adopted a "build to core" strategy to meet their yield requirements (buying shovel ready development projects) and others are broadening their search for properties that have higher risk profiles and greater potential for significant value appreciation like the secondary and tertiary submarkets. Secondary and tertiary U.S. Metros continue to gain favor with equity investors in their search for properties with higher yields than their counterparts in the nation's most prominent urban centers.

New equity capital has continued to emerge in the multifamily segment, spurred by the lack of adequate returns available in other asset classes. Some of the other asset classes are now starting

to become more in vogue, particularly CBD retail and hospitality and New Jersey industrial. So far, the momentum gained in other asset classes and higher treasury yields have not impacted multifamily demand. However, interest rates appear certain at some point to affect pricing, particularly on class A assets in the major markets. Class B properties in the secondary and tertiary markets shouldn't see much in the way of price adjustments, but should see an uptick in sales volume.

Multifamily cap rates will eventually have to rise to compensate for the higher cost of financing. As mortgage rates rise steadily in the coming years, today's compressed cap rates will need to adjust upward as well. Of course, higher debt costs affect some investors more than others. Institutions will have the clear advantage here over the private investors that need to maximize leverage. As a result, the private investors will have an even tougher time competing for prime assets.

While nobody really knows when this current market will cool off and when multifamily values will peak, the interest rate movement and momentum in other asset classes seems likely to convince some owners to move properties sooner rather than later. While the strong rental market and low vacancy environment seems here to stay, price appreciation due to cap rate compression and rent spikes do not seem plausible when considering all of these fundamentals.

One thing is for sure - multifamily investment in 2014 is not exactly a "no-brainer."

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