2023 upstate New York apartment market - by Brian Heine

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In the largest upset of the multifamily industry since the financial crisis of 2008 the Federal Reserve has raised the fed funds rate over 400 basis points in 10 months to 4.5%, the highest level in 15 years. According to chairman Powell the goal is to create enough unemployment to reduce inflation down from 6% to 8% annually back to the 2% range and at the same time reduce asset price appreciation including real estate. The immediate effects will be felt in the interest rate sensitive portions of the economy, including new buyers of single-family homes. So far in 2023 prices and capitalization rates for investment quality apartment complexes are yet to be affected, sellers of high-end investment properties don’t forego several million dollars in profit over what may be a very short-term fluctuation in interest rates, rapid increases can be followed by rapid declines. These interest rate increases have been characterized as temporary but some level of higher rates seems permanent.

The 10-year treasury note traded above 4% for a short time and buyers of multifamily investment properties were seeing mortgage interest rate quotes near 7%. The spread between the 10-year rate and mortgage interest rates varies, typically between 1.5% to 2.0%, but has moved up to 3% recently adding to the increase. The Federal Reserve only targets short term overnight rates between banks, long term mortgage rates reflect the supply and demand of credit between borrowers and lenders, and the market has pushed the long end down. Investment real estate closings decreased through the end of 2022 in response to the higher rates and consequently the 10-year has since traded down to 3.5% before rising again. Note that this was the level of the 10-year for most of the last decade. Higher rates on fixed rate investments, such as bank certificates of deposit, also attract smaller owners of apartment complexes to the sale market as replacement investments for their actively managed apartment properties sold for retirement, bringing additional properties to market in an environment that lacks sale inventory.

To make the numbers work, buyers now constrained by the cost of servicing new debt at these higher rates, deals will require more equity (lower loan to value) and/or the assumption of an existing fixed rate mortgage, those originated over the past five years when rates were lower. The debt-service coverage ratio (DSC) which measures the ability of the net operating income (NOI) to service the debt now controls, the loan to value percentage is less meaningful. Loan assumptions lead to lower leverage and lower short term returns but will work fine for long term investors. Also, as these existing five-year or older mortgages, typical bank commercial mortgage terms, start to mature and renew at current rates we’ll get a better read on where bank underwriters stand with cap rates. Apartment investment is the most inflation resistant of all the real estate classes, short annual apartment leases allow immediate adjustment to current market conditions and rents have increased substantially the last two years. This increase in the NOI blunts the effect of higher interest rates on prices as a higher cap rate supports the same price with a higher NOI. Those frozen out of the single-family housing market have to rent apartments instead. Growth in NOI is the main attraction to multifamily investment, there are always buyers looking for apartments. Investors with rents at market should have no trouble underwriting maturing debt at current interest rates. Expect some upward pressure on cap rates this year until interest rates stabilize, there is no direct relationship between interest rates and cap rates, and the spread between the 10-year and long-term mortgage rates returns to its normal level.

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