Aegon Asset Management

Real Assets
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AEGON **INSIGHTS**

Navigating Multifamily Short-Term Headwinds with a Long-Term Perspective

Commercial Mortgage Loan Production Team

In today's uncertain US commercial real estate (CRE) market, multifamily stands out as a resilient asset class. While we observe short-term trends such as decelerating rent growth, increasing expenses, and lower transaction volumes, it is important to consider them within the context of structural housing-market challenges, including an overall shortage of housing and increasing barriers to ownership. In light of this, we view long-term debt as a compelling option to access the multifamily asset class.

Deceleration in rent growth

Deceleration in rent growth has become a point of concern making headlines in 2023. While factors such as slower job growth, reduced household formation, and weaker in-migration may contribute to the deceleration, our primary focus is on the supply pressures affecting various markets. Generally, we observe that markets with higher new deliveries as a percentage of existing inventory are experiencing slower rent growth (exhibit 1). In the near term, we expect that rent growth in these markets will continue to be constrained as projects in construction reach completion.

Exhibit 1: Nine out of the 10 MSAs with the most supply experienced below average rent growth

	YoY effective rent Change	Annual supply as a % of inventory
Top 50 US MSA (metropolitan statistical area) average	2.15%	2.12%
Top 10 MSAs Where Supply Increased the Most		
Nashville-Davidson--Murfreesboro--Franklin, TN	1.10%	5.81%
Jacksonville, FL	-0.70%	5.21%
Charlotte-Concord-Gastonia, NC-SC	2.54%	5.06%
Salt Lake City/Ogden/Clearfield, UT	0.06%	4.83%
Austin-Round Rock, TX	-1.58%	4.55%
Phoenix-Mesa-Scottsdale, AZ	-4.03%	4.20%
Raleigh/Durham, NC	0.74%	4.17%
Orlando-Kissimmee-Sanford, FL	1.90%	3.43%
Fort Worth-Arlington, TX	1.90%	3.42%
Atlanta-Sandy Springs-Roswell, GA	-0.27%	3.01%
Tampa-St. Petersburg-Clearwater, FL	0.40%	2.70%
Denver-Aurora-Lakewood, CO	1.72%	2.69%
Minneapolis-St. Paul-Bloomington, MN-WI	1.83%	2.48%

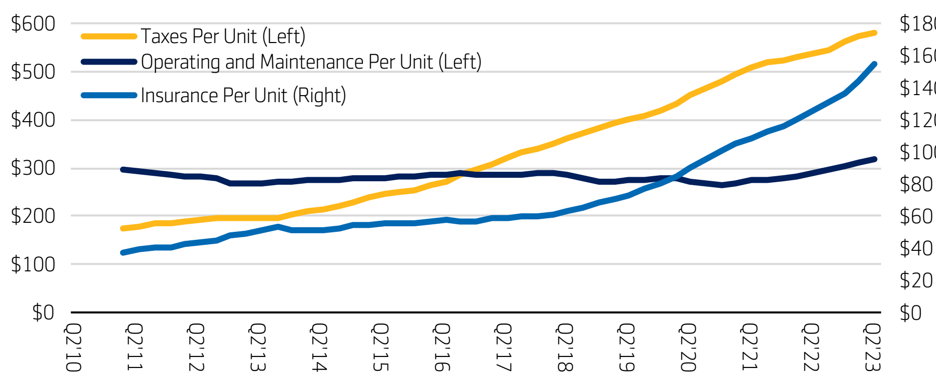
Source: Realpage Financial Data. As of June 30, 2023

Expenses continue to increase

In addition to decelerating rent growth, expenses continue to increase. Reports of insurance cost increases in the southern and western regions continue to permeate throughout US CRE for good reason. Operating expenses across markets typically track inflation, with certain factors beyond borrower control such as taxes and insurance. Major expense categories have shown quarterly growth since 2019 that significantly outpaces the average quarterly expense growth since 2010 (exhibit 2). Stagnating rent growth, coupled with continued expense growth, are expected to weigh on expense ratios in the short term.

Exhibit 2: CRE expenses increase since 2019 significantly outpacing long-term average

4-quarter rolling average

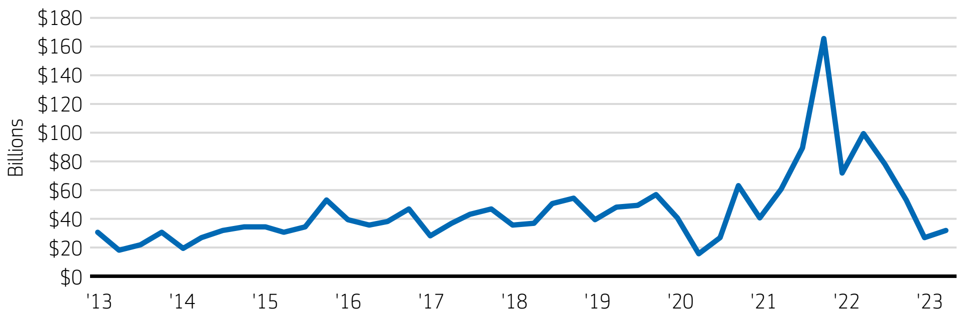


Source: Realpage Financial Data. As of June 30, 2023

Valuation gap impeding transactions

Property owners are holding onto property values from 2021 and 2022, while buyers are attempting to earn increased target IRRs to keep up with higher interest rates. This disconnect has led to a significant slowdown in multifamily transaction volume (exhibit 3). Green Street's CPPI suggests that CRE values have also declined 16% from the recent peak in 2022, despite a lack of transactions that are skewing actual results higher.[1] This slowdown has created uncertainty related to property values when evaluating new opportunities due to a lack of comparable sales information.

Exhibit 3: Multifamily transaction volume is down 68% in 2Q 2023 compared to last year



Source: MSCI Real Capital Analytics. As of June 30, 2023

Across the investment landscape, borrowers continue to seek shorter loan terms coupled with some level of interest-only and flexible prepayment options. These preferences reflect borrowers' mindset that rates will decrease once the US Federal Reserve (Fed) is finished with the rate hikes, allowing for increased cash flow/loan proceeds in the future.

However, despite market expectations, the Fed's projections indicate rates will remain elevated for longer than expected. According to the Federal Open Market Committee (FOMC) projections in September, short-term rates in 2025 are expected to be 3.9%, compared to a 3.4% estimate in June.[2]

A long-term Investment horizon can help mitigate short-term risks

We believe the risks identified above appear to be short term in nature and can be mitigated by adhering to a disciplined underwriting approach and focusing on longer-duration investments to weather the short-term disruptions in the multifamily market. Longer-investment horizons will allow for more time for market fluctuations to stabilize.

Rental income growth, while slowing, typically aligns with long-term demographic trends and local demand dynamics. In our view, expense increases are expected to return to levels closer to the long-term inflation rate, and the uncertainty surrounding valuation rates today can be mitigated through strategic investment decisions.

The relationship between compounded quarterly rent growth since 2Q 2018 and new quarterly construction completions indicates that markets experiencing the highest completions relative to overall supply tend to encounter a larger increase in rents

The multifamily sectors' sustained appeal is rooted in fundamental factors like evolving homeownership patterns, affordability concerns in the housing market and shifting demographics.

over the same period. This relationship suggests that developers responded to strong housing demand by building more units, indicating that current supply levels will be absorbed, despite the short-term lack of pricing power.

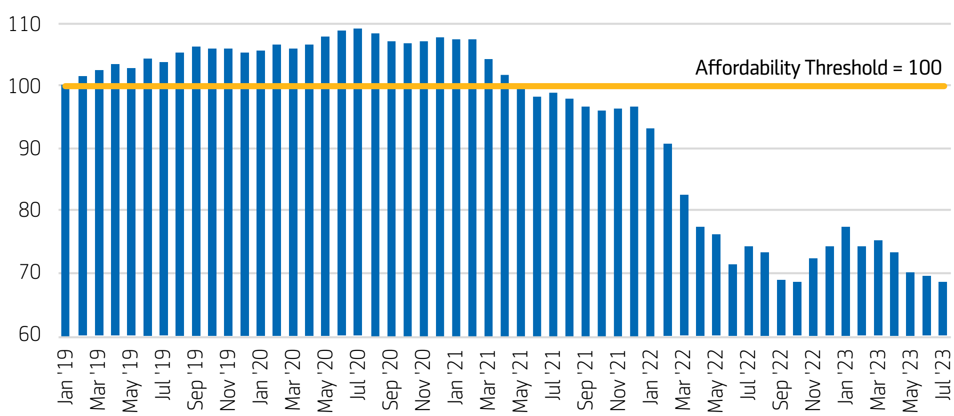
Expense Inflation is being driven by the repricing of insurable risks, municipal budget adjustments in response to growth and inflation, and general inflation that may not have been experienced immediately across all expense categories.

Property values may take more time to stabilize as investors adjust to higher borrowing rates and identify properties for sale within their portfolios. We believe strategic investments that prioritize downside protection, disciplined underwriting of the property and business plan, and careful sponsor selection will help drive performance during the investment period.

The multifamily sector's sustained appeal is rooted in fundamental factors like evolving homeownership patterns, affordability concerns in the housing market (exhibit 4) and shifting demographics. These factors collectively indicate that multifamily real estate remains well positioned for stability and growth in the years ahead.

We believe strategic investments that prioritize downside protection, disciplined underwriting, and careful sponsor selection will help drive performance during the investment period.

Exhibit 4. Home ownership affordability monitor index at lowest point since 2018



Source: Federal Reserve Bank of Atlanta. September 20, 2023.

As we navigate the uncertainties of the present, we believe it is crucial to maintain a forward-thinking mindset, recognizing the multifamily sector's potential to provide durable value and investment opportunities over the long term.

[1]Green Street Property Insights. September 11, 2023
[2]Board of Governors of the Federal Reserve System. FOMC Projections. September 20, 2023

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