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Multifamily Development Faces Disruptions, But Many Projects Push Ahead

Opportunities remain for HNWIs and other players to invest in opportunistic funds or as L.P.s with private multifamily developers.

Bendix Anderson | Apr 18, 2023

Eager to invest in new apartment developments, wealth managers and high-net worth individuals are still making deals work, despite high financing and construction costs, worries about overbuilding and even more worries about a potential recession.

Individuals are investing with active developers and private equity funds to build new apartment properties in a time of uncertainty, when some developers are putting plans on hold.

"We believe there is a window of opportunity to start projects in 2023 and 2024 that will be delivered into the market during a time of undersupply and increasing demand," says Josh Purvis, managing partner for Thompson Thrift Commercial, a full services real estate firm that focuses on development and construction. "We still see ample opportunity to complete successful multifamily development projects and generate solid returns."

Shoreham Capital, based in West Palm Beach, Fla., is another company that's pushing forward. It recently closed a construction loan for a $120 million project to build 412 new, luxury apartments in Cape Coral, Fla. The firm often partners with family offices and high-net-worth individuals to fund its developments.

Shoreham planned its Cape Coral project to have a high, 7% development yield (which represents the likely annual income from a development as a percentage of the development cost). So, the project still makes sense for its investors even as costs rise. And it chose a market to build where demand for apartments is likely to keep growing long into the future—and it plans to hold its Cape Coral project for 10 years.

"Whatever disruption we see in the near term will be more than made-up for by the rent growth that continues to happen," says Doug Faron, co-founder and managing partner at Shoreham Capital.

Other developers are also stepping forward. In February 2023, developers started construction on the largest number of new apartments in 10 months, or since interest rates began to rise, according to Marcus & Millichap. Multifamily permits also surged to a seven-month high.

Uncertainty and rising rates delay many projects

But not all developers are moving ahead with their projects.

“There is a meaningful percentage of people who are putting a pause on their plans,” says Dave Borsos, vice president of capital markets for the National Multifamily Housing Council, based in Washington, D.C. “One of my developer members said they cut their pipeline 50%—and the 50% they are going ahead with are things that are already committed.”

Some investors in apartments are also worried that a flood of new apartments could drive down rents.

“The large supply of units expected in 2023 and 2024 has given Titan some concerns about absorption—but we believe any oversupply will be very short term,” says Josh Rogers partner at Titan Development, working in the firm's offices in Albuquerque, N.M. Titan has a “robust” pipeline of 800 apartments in the works and manages its own discretionary private equity fund to help finance projects, says Rogers.

“Without question over the next 12 to 24 to 36 months we're going to see some disruption in the market,” agrees Faron. “If you're timing a project to perfection in the short term you may run into some issues.”

Developers are now finishing work on a gigantic number of new apartments started in the brief window after the worst year of the coronavirus pandemic in 2020 and before the rise in interest rates in 2022. They are likely to complete about 400,000 new apartments in 2023—a new annual record, according to Marcus and Millichap. Developers are likely to complete another huge number of apartments in 2024. They had nearly one million (925,000) actively underway as of the first quarter of 2023—that’s the most in about 50 years, according to data from the U.S. Census.

“2023 and 2024 will bring high deliveries of annual multifamily housing units due to a high volume of project starts in 2021 and 2022,” says Thompson Thrift’s Purvis.

Of course, back in the 1970s, a million new apartments had a much bigger impact, because there were fewer in existence. New apartments are expected to increase the existing inventory by just 2.2% during the peak year of this cycle, according to an analysis of Census data by RealPage, a software and data company based in Richardson, Texas.

“One million units today has nearly one-third the impact that it had back in the early 1970s,” says Jay Parsons, senior vice president and chief economist for RealPage.

Cost of capital strains development budgets

Interest rates on construction loans have risen hundreds of basis points since officials at the Federal Reserve first began to hike up their benchmark rates a year ago in an attempt to beat back inflation.

"We haven't seen an interest rate increase move this fast this high since the Volker years," says Lawrence "Larry" Taylor, CEO of Christina, based in Malibu, Calif., a developer working with

accredited real estate investors to build apartment properties held long-term in extremely exclusive submarkets of Los Angeles.

Christina is currently building two apartment properties that took 10 years to get entitled, both in the hills North of the Sunset Strip in West Hollywood with views of the city. "We are always building something. When you are in a high demand market, your product can only become more valuable over time... we get $12,000 a month, $14,000 a month for some apartments." But many developers have slowed their plans because of rising rates. . “The cost of capital has increased nearly 4.5x in the last 12 months.” says Titan’s Rogers

Loans are not just more expensive, that also tend to be smaller and are harder to find.

“Even if you can get bank financing, it is expensive and, more significantly, lower in proceeds (loan-to-cost), with mezzanine and preferred equity sources also much lower in proceeds,” says David Webb, vice chairman of debt and structured finance for CBRE, working in the firm’s offices in Washington, D.C. “The result is more equity is needed, which dilutes the returns.”

Many banks had already reduced the amount of money they lent to apartment developments—even before interest rates began to rise. Many banks had loaded their balance sheet with real estate loans earlier in the pandemic recovery. Rising interest rates put further stress on many banks—several failed, including in March 2022 Signature Bank, a lender favored by many real estate developers.

“We expect lending conditions to further tighten—given the fallout of the Signature Bank collapse,” says King. “That will affect not only debt financing on potential investments this year, but also the total number of developments that are able to be capitalized and move forward.” Some developers have turned to other types of construction lenders.

“A number of insurance companies are getting more active in the construction debt space,” says Marina Malomud, partner and chief operating officer of Subtext, a vertically integrated developer of multifamily and student housing headquartered in St. Louis. “Terms are comparable to balance sheet lenders, she says. Insurance company loans often cover 55% to 65% of the cost of development, with interest rates floating 300 to 350 basis points over SOFR.

Private debt funds continue to offer relatively larger loans with higher interest rates. A few unlevered buckets of capital have been raised, with pricing around SOFR plus 450 basis points and covering 60 to 65% of the cost of development, says Malomud. “Additionally, levered funds often price loans at SOFR plus 475 to 600 basis points and covering 75% of the cost of development.

“The cost of bank capital has started to merge with the debt fund cost of capital—it's really not that different,” says Shoreham. Banks used to offer all-in interest rates for loans to apartment properties with interest rates floating between 3% or 3.5%, compared debt fund loans with rates floating about 9%. “Now rates at like 7.5% or 8% from banks versus 9% or 10% from that debt fund.”

Construction costs are easing
At least construction costs are no longer rising through the roof.

"Construction costs are settling, which may be another factor that led to the recent increase in multifamily project starts and permits," says John Chang, senior vice president and national director of Marcus & Millichap's Research Services. "More stable material costs may allow more developers to formalize plans and start on projects."

Costs dropped 0.2% between March 2023 and the month before, according to the producer price index for multifamily construction from the federal Bureau of Labor Statistics. That's a big change from the 4.8% rise in the index in 2022 and the shocking 15.5% increase to the index in 2021.

"There was an enormous amount of cost volatility and escalations across all construction line items over the last few years," Logan King, director, investment management at CP Capital US, based in New York City. "This has resulted in us underwriting larger hard cost contingencies in our budgets."

Developers like Subtext are also extending the timelines of some developments to allow construction pricing to stabilize and purchasing some materials ahead of time to lock in costs.

Rising construction costs have also helped restrict the number projects that work. "Development projects are viable only in markets where the pace of rental rate growth has kept up or exceeded the pace of construction cost growth," says Natalie Mason, executive vice president of development at Capital Square, based in Glen Allen, Va.

"When evaluating a deal we always want to see an attractive spread of about 125 basis points between the trended yield and projected exit cap rate," says CP Capital's King. CP targets suburban, ground-up development deals such as garden apartments in growth markets—which generally offer attractive yields from the high 5% range to the low 6% range.

In its Cape Coral project, Shoreham Capital achieved its strong development yield by negotiating a good price for its development site, with utility infrastructure already in place.

Other developers are shopping for land in metro areas that are small but growing quickly. "We are focusing on secondary and tertiary markets that have compelling supply and demand dynamics and which have been historically underserved by institutional capital," says Capital Square's Mason. "While we develop high-rise and mid-rise, we are currently focused on lower density, garden-style and podium-stick opportunities given the current construction cost environment."

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