VANAMOR
Investments

Multifamily Market Update

2Q2022 Report

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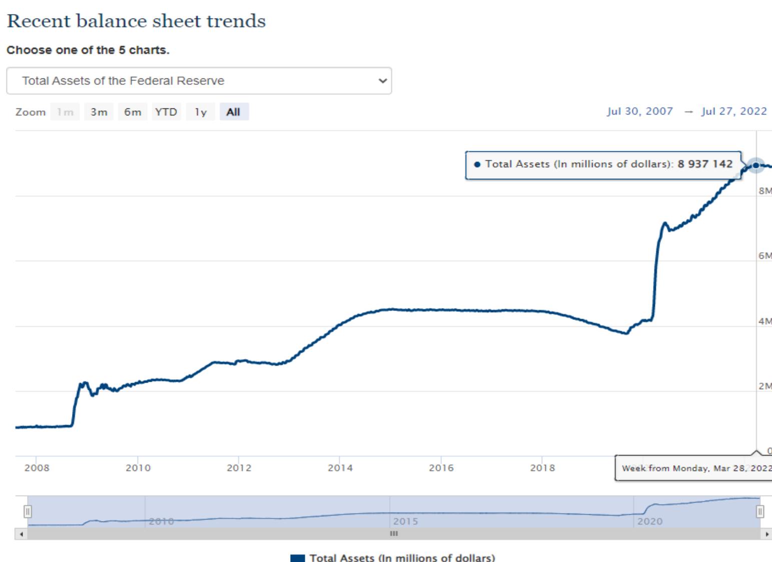
"It's liquidity that moves markets."

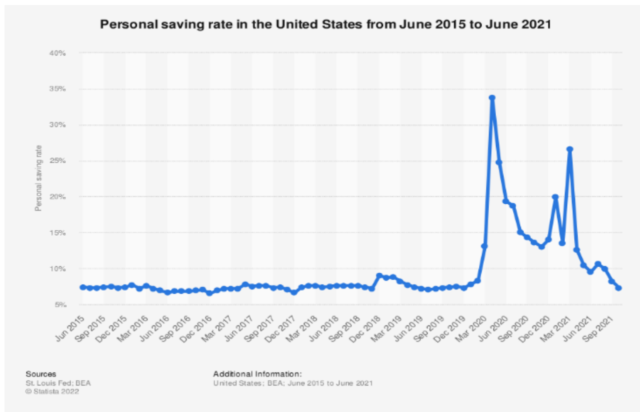
–Stanley Druckenmiller

Perhaps the shortest quote that we've opened with but it's all that's needed to explain the recent volatility in markets that are otherwise claimed to be efficient in just about every textbook I've ever read. Those five simple words not only explain the fear over the past 3-months, but the euphoric investment craze produced in the aftermath of the pandemic lockdowns.

If five words are too long, we can also use a four-letter quote, which has the exact same meaning as the quote from Mr. Drunkenmiller, to pinpoint what has perhaps had the single greatest impact on markets: "*Don't fight the Fed*". At the onset of the pandemic, the Fed and the Administration pumped a significant amount of liquidity into the market; increasing their balance sheet from ~$4 trillion to ~$7 trillion overnight and finally peaking at ~$9 trillion in April of 2022. This represented a $5 trillion increase to the Fed's balance sheet. For comparison, the Fed increased their balance sheet $1.3 trillion to rescue the economy during the Great Financial Crisis.



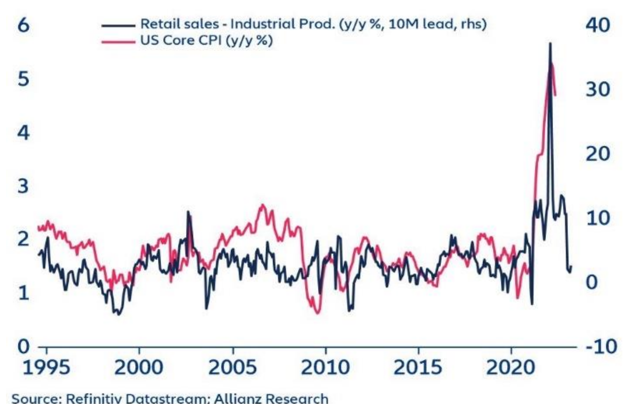
What happened? Stocks traded at all-time high multiples, interest rates dropped to their lowest on record, and real estate cap rates compressed to levels never before seen. To be fair, this liquidity also filtered down to the consumer and for



a brief period produced some of the strongest consumer fundamentals ever seen as well. However, consumer fundamentals alone were not enough to justify the compression in cap rates (increased prices) so by May of 2021, Vanamor was being outbid on new multifamily acquisitions by 10% to 20%.

By May of 2022, the Fed realized that inflation was not transitory and pivoted to increasing the Fed Funds Rate and implementing quantitative tightening which snapped back liquidity like a rubber band. The inexpensive short-term debt that fueled the investment craze evaporated overnight and cap rates increased, sending prices down anywhere from 5% to 20% with the most aggressive markets getting hit the hardest. And just like that, Vanamor found itself closing two new investments in June 2022 at prices believed 10%+ discount to two months earlier and at cap rates comparable to pre-pandemic levels.

Inflation – Just how bad is it?



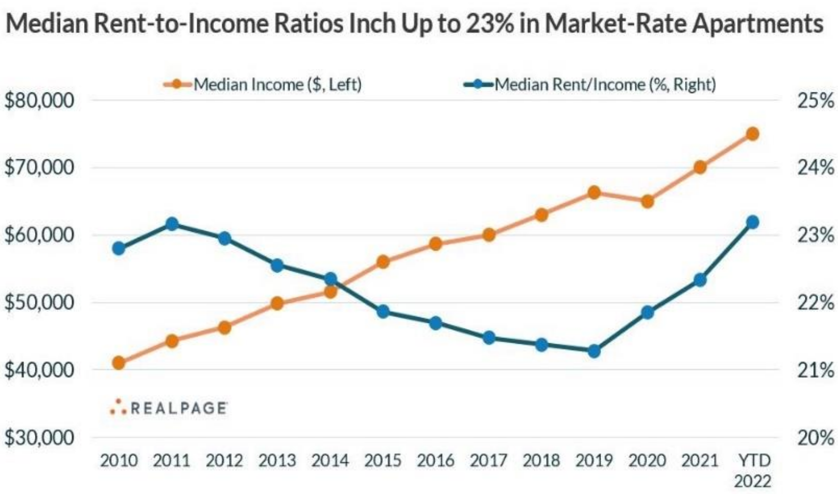
Inflation is currently at a 40-year high with June's CPI reading coming in at 9.1% and the question remains as to whether it is being caused by supply constraints (supply chain issues, worker shortages, Russia/Ukraine) or demand (excess liquidity, higher wages, strong consumer balance sheets). Vanamor believes that year-over-year reading are likely to remain elevated for some time while month-over-month numbers will decline rapidly over the next 3- to 6-months, although remain firmly above the 2% target

over the next 12-months. As we have already seen across retail sales and commodity prices, price corrections are happening rapidly. While inflation readings are inherently lagging indicators, the normalization in real-time data is already well under way.

In the meantime, lower income households are likely to be disproportionally impacted as the bulk of their income is spent on non-discretionary items. As a result, rental rates on lower income households are likely to hit a ceiling versus higher income earners. Higher income earners will save less as more of their income goes towards expenses, but they are unlikely to feel as much burden.

Labor Market

Now for some good news! While the economy overall is sending mixed signals, the labor market is very strong. So strong that it is actually the primary target of the Fed to reduce inflation. Employers added 372,000 jobs in June and the unemployment rate remains close to a 50-year low at 3.6%. Mitigating some of the impact on inflation, wages increased 5.5% over the past 12 months with those in the lower income bracket experiencing larger increases. As a result, the median rent-to-income ratio nationally has increased back to 2011 levels at just over 23%. This represents a high over the past decade but less than what is expected after two years of double digit rent growth.



New Housing Supply

Perhaps the most market specific factor going forward is new housing supply vs. demand. According to research from Yardi Matrix, 420,000 apartments are expected to be completed in 2022, an increase of 2.8% and the highest number since before the global financial crisis. Areas within the Sunbelt, where it's less expensive to build, are expected to experience the highest level of construction. They also have the highest levels of demand, so Vanamor does not anticipate rents to decline, rather a slowdown from the unstainable levels experienced the past 2 years.

2022 Forecast Supply Growth by Metro

Metro	2022 Forecast Deliveries	2022 Forecast Deliveries as a % of Inventory
National	420,274	2.8%
Dallas	23,571	2.8%
Miami	19,125	5.7%
Austin	18,288	6.7%
Phoenix	15,988	4.8%
Seattle	14,147	5.1%
Washington, D.C.	12,096	2.1%
Denver	12,031	4.0%
Los Angeles	11,266	2.5%
Raleigh	10,136	5.9%
Charlotte	8,732	4.4%
Chicago	8,573	2.3%
Tampa	8,447	3.6%
Salt Lake City	6,429	5.6%
Twin Cities	6,336	2.7%
San Antonio	5,820	2.7%
Philadelphia	5,539	1.8%
Boston	4,842	1.9%
San Diego	3,937	2.0%
SW Florida Coast	3,872	4.7%
Las Vegas	2,928	1.6%
Inland Empire	1,458	0.9%
Central NJ	1,361	1.0%
Orange County	1,089	0.5%
Sacramento	751	0.6%
Pittsburgh	610	0.7%

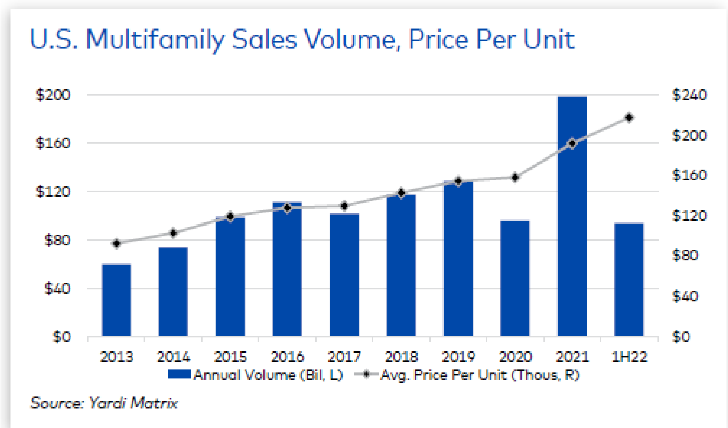
Source: Yardi Matrix

Occupancy rates are maintaining the extremely high levels seen in the second half of 2021. The national occupancy rate in stabilized properties rose by over 100 basis points year-over-year, decreasing by only 15 basis points since the end of 2021. This has allowed for rents to continue to increase, but at lower rates than seen in 2021. The gap in occupancy rates between Lifestyle and Renter-by-Necessity assets ended 2021 at only 29 basis points and has maintained a steady pace at mid-year, with an increase of only 7 basis points. The growth in projects geared toward the upscale segment decreased occupancy rates by 19 basis points by midyear.

Rising Rates Bring Sanity Back to Markets

Robust liquidity and insatiable investor demand has driven commercial real estate's decade-long bullish cycle. Investors allocated a huge sum of capital to multifamily because of its stable cash flow, the favorable supply-demand fundamentals, and the belief that cash flow will grow as rents continue to rise at above-trend levels. While those conditions still largely exist, a major change in equity and debt conditions swept across the market in the first half of 2022 because of inflation and rising interest rates. For the first time in a long time, pricing turned negative, and lenders have become more cautious.

The spike in interest rates in the second quarter put a damper on transaction activity, which started the year as if it were going to match 2021's all-time volume record of $212 billion. Few industries are as sensitive to interest rates as commercial real estate, which is financed with copious amounts of debt. The jump in the cost of borrowing, combined with the growing expectation that a slowdown or even recession is imminent, put investors in a holding pattern.



Bidders at aggressive acquisition yield levels dropped out. Many institutions froze buying activity until they can assess the landscape. Buyers using leverage of 70% or more are having difficulty finding financing. Property values–which rose around 20% in 2021–are down so far by 10% to 15% from the peak. However, the change in pricing has been slow to be recorded because many sellers took assets off the market rather than accept lower bids.

Going Forward

Vanamor is excited about investment prospects going forward, significantly more than we were in the second half of 2021 and first quarter of 2022. We acquired two new properties at the end of June at a discount to 1st quarter pricing and are looking for additional opportunities. Compared to the 12-months before those acquisitions, we analyzed over 200 opportunities and acquired zero properties because we were unable to justify the aggressiveness in the market.

While construction activity has picked up in select markets, apartment fundamentals remain strong and relatively unchanged from the first quarter of 2022. At the same time, property values are down 10% to 20% from the peak so we view the ability to purchase the same strong fundamentals at a discount as opportunity. One of Vanamor's key strengths is finding the needles in the haystacks which has been virtually impossible the past year when 20+ groups were submitting offers on every investment opportunity. We have quickly transitioned from an extreme sellers' market to a buyers' market and while many sellers remain in *price discovery mode* and often deciding not to sell when market prices are realized, there are opportunities to capitalize on.

Liquidity is likely to remain constrained going forward which will keep pressure on all asset classes. In particular, we anticipate stocks and crypto to be very volatile over the next 6 to 12 months. Great for day traders but unpleasant for long term investors. While the bottom may be in on both stocks and crypto, we would not be surprised to see a retest of those lows for as the Fed constrains liquidity.

However, this is not 2008/2009- Consumers and employment remain exceptionally strong. Should those conditions deteriorate, the Fed will have accomplished its mission on inflation and will pivot at least to a neutral policy or perhaps even a supportive policy, if needed. Take comfort in that this slowdown is intentional whereas 2008/2009 was a result of a weak economy and toxic lending practices, neither of which are present today.

Best regards,

Bobby Larsen
Founder of Vanamor

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