UBS

# Real estate markets

## US multifamily market: Density matters

**Chief Investment Office GWM** | 09 September 2020 11:19 pm BST
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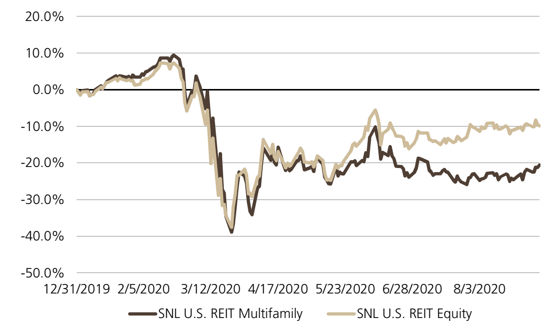
- REITs have significantly underperformed the S&P 500 year-to-date, and the multifamily sector has significantly underperformed the REIT sector.
- The bulk of the underperformance has come from those multifamily REITs that are more heavily exposed to dense, urban, coastal markets that are expensive and have experienced significant out-migration and remote working impacts.
- In general, more dense, urban markets have seen greater pressure on rents, occupancy, and the use of concessions as compared to their suburban and Sun Belt peers.
- Rent collection remains relatively strong across the sector, but delays in additional federal stimulus and an unfavorable regulatory environment could potentially add to rent collection challenges if employment does not continue to pick up.
- Possible positives for the industry include reduced new supply, lower turnover rates, and the increased adoption of technology.


To say this has been a challenging year would likely rank as one of the more obvious statements. Given their economic sensitivity, we are not surprised that REITs have had a challenging run, underperforming the S&P 500 by more than 1,000 basis points year-to-date as of 8 September. What has been a bit more surprising to us is the struggles of the multifamily sector and the significant relative underperformance of the group (Fig. 1). However, the underperformance has not been uniform. As the data in Fig. 2 highlight, most preferred names Camden Properties (CPT) and Mid-America Apartments (MAA) have significantly outperformed AvalonBay (AVB, Bellwether), UDR (UDR, Bellwether), Equity Residential (EQR, Bellwether), Essex Property (ESS, Bellwether), and AIMCO (AIV, Not Rated).

In our opinion, the relative outperformance of CPT and MAA as compared to their multifamily peers is driven largely by market exposures. Fig. 3 highlights the geographic exposures for the seven largest multifamily REITs (by market capitalization). As the data indicate, both MAA and CPT have substantial exposure to the Sun Belt markets and limited exposure to the dense, coastal markets of California, Seattle, Boston, and New York.

**Fig. 1: Total return for the SNL US REIT multifamily REIT indexes**

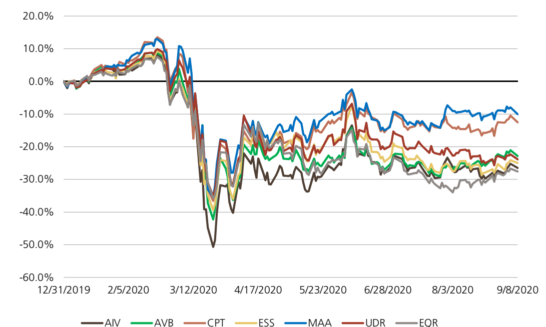
1 January 2020 – 8 September 2020




Source: SNL Financial, UBS

**Fig. 2: Total returns for the seven largest publicly traded multifamily REITs**

1 January 2020 – 8 September 2020




Source: SNL Financial, UBS

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**Fig. 3: Geographic exposure by NOI for the seven largest publicly traded multifamily REITs**

| Submarket | AIV | AVB | CPT | EQR | ESS | MAA | UDR |
|---|---|---|---|---|---|---|---|
| San Francisco/San Jose | 11.8% | 20.4% | 0.0% | 20.4% | 44.0% | 0.0% | 13.8% |
| Los Angeles/Ventura | 19.7% | 19.5% | 7.5% | 19.5% | 22.0% | 0.0% | 4.0% |
| Orange County | 0.0% | 4.8% | 0.0% | 4.8% | 10.0% | 0.0% | 13.6% |
| San Diego | 7.1% | 4.2% | 4.2% | 4.2% | 8.0% | 0.0% | 0.0% |
| Seattle | 0.8% | 10.2% | 0.0% | 10.2% | 16.0% | 0.0% | 6.8% |
| Greater NY Area | 3.4% | 14.1% | 0.0% | 14.1% | 0.0% | 0.0% | 7.8% |
| Greater DC Area | 12.5% | 16.1% | 16.9% | 16.1% | 0.0% | 6.7% | 18.6% |
| Atlanta | 0.9% | 0.0% | 8.6% | 0.0% | 0.0% | 13.0% | 0.0% |
| Boston | 13.2% | 9.6% | 0.0% | 9.6% | 0.0% | 0.0% | 11.5% |
| Denver | 4.8% | 1.1% | 5.7% | 1.1% | 0.0% | 0.0% | 0.0% |
| Miami/SE Florida | 5.9% | 0.0% | 6.4% | 0.0% | 0.0% | 0.0% | 0.0% |
| Philadelphia | 9.3% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Chicago | 4.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Dallas/Ft. Worth | 0.0% | 0.0% | 7.0% | 0.0% | 0.0% | 12.9% | 4.5% |
| Houston | 0.0% | 0.0% | 11.2% | 0.0% | 0.0% | 4.5% | 0.0% |
| Austin | 0.0% | 0.0% | 4.3% | 0.0% | 0.0% | 6.7% | 1.5% |
| Phoenix | 0.0% | 0.0% | 7.4% | 0.0% | 0.0% | 3.2% | 0.0% |
| Orlando | 0.0% | 0.0% | 5.7% | 0.0% | 0.0% | 6.2% | 3.2% |
| Charlotte | 0.0% | 0.0% | 5.6% | 0.0% | 0.0% | 6.9% | 0.0% |
| Raleigh | 0.0% | 0.0% | 5.0% | 0.0% | 0.0% | 4.4% | 4.1% |
| Tampa | 0.0% | 0.0% | 4.5% | 0.0% | 0.0% | 6.5% | 2.8% |
| Nashville | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 4.6% | 0.0% |
| Jacksonville | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 3.3% | 0.0% |
| Charleston, SC | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 2.7% | 1.9% |
| Richmond, VA | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 2.2% | 0.0% |
| Greenville, SC | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 1.6% | 0.0% |
| Memphis | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 1.5% | 0.0% |
| Other Markets | 6.6% | 0.0% | 0.0% | 0.0% | 0.0% | 13.1% | 5.9% |

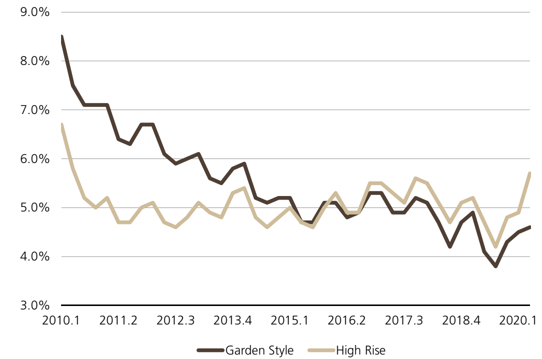
Source: Company Documents, UBS

The combination of COVID-19-related job losses, the desire of some to move to less dense surroundings, and the ability to work remotely for an extended period of time has led to widely disparate rent and occupancy results for dense coastal cities versus more suburban and lower-cost Sun Belt markets. As the data in Fig. 4 highlight, vacancy for high-rise apartment buildings has risen much more sharply than that of more suburban garden-style apartments. In addition, rents for apartments in more expensive, denser markets have decreased at a faster pace than those of more suburban and Sun Belt markets (Figs. 5 and 6).

We would note that the data in Figs. 5 and 6 are based on major market as opposed to submarket data. We would note that in some of the submarkets of these dense metros, asking rents have declined significantly further than is indicated in the charts. In addition, these figures do not include the impact of concessions such as free rent. As such, the net effective rents in many of the dense metro markets are significantly lower than indicated in the charts.

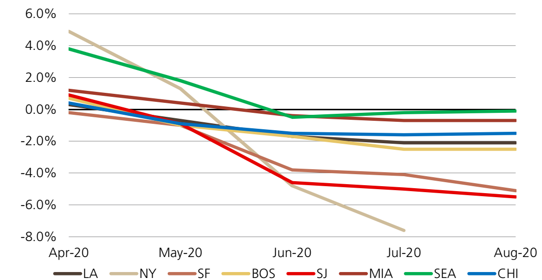
Vacancy rates in these denser markets have grown faster than their suburban and Sun Belt peers (Figs. 7 and 8). We believe if it were not for the significant rent reductions and concessions in these dense metro markets, vacancy rates might be higher. Should more permanent remote work options arise for employees currently located in these expensive, dense metros, further increases in vacancy (or further net effective rent declines) could materialize.

**Fig. 4: Vacancy rate trends for garden style and mid-/high-rise apartment buildings**



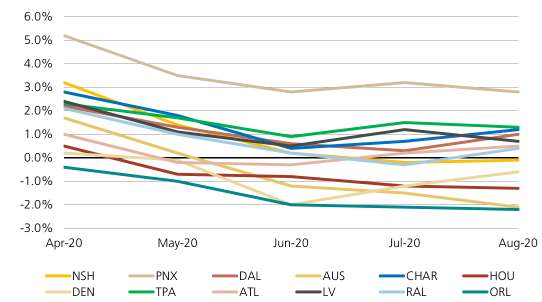

Source: CBRE, UBS

**Fig. 5: Rent trends in select dense, coastal markets**




Source: Miller Samuel, Yardi Matrix, Elliman Report, UBS

**Fig. 6: Rent trends in select non-coastal and Sun Belt markets**




Source: Miller Samuel, Yardi Matrix, Elliman Report, UBS

The one non-coastal market that does stand out from an elevated vacancy perspective is Houston. Houston has experienced several years in a row of elevated supply, some of which were in lease up when the dual storm of COVID-19 and declining oil prices hit. It is likely that vacancy rates could remain elevated and rent growth could be depressed in a number of Houston submarkets for the foreseeable, until the new capacity is absorbed and oil prices stabilize.

As of the writing of this report, the August data for New York was not yet available.

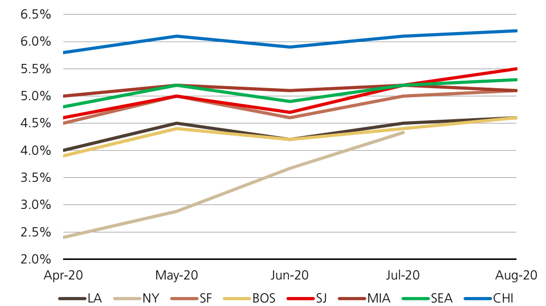
**Is the rent being paid?**
Surprisingly, so far the answer is generally yes. According to data from the National Multifamily Housing Council (NMHC), rent collections for more than 11.4 million apartment units across the US remain solid (Fig. 9), despite the expiration of the extra USD 600 a week in federal unemployment benefits that expired at the end of July, and are not far off the pace of the comparable 2019 periods. In addition to outright rent declines in a number of markets, many landlords have been proactive in working with tenants on more flexible payment plans. These actions, combined with tenant assistance programs that exist in several large metros, have likely contributed to the higher-than-expected rent collection trends. Continued declines in the rate of unemployment, combined with potential additional government stimulus programs, could further support a strong level of rent collections.

**Are demographic trends still favorable for multifamily?**
The strength of the single-family housing market, driven in large part by the older portion of the millennials, has some investors wondering if the demographic wave has passed for the apartment industry. As the data in Fig. 10 indicate, there are more than 66 million people between the ages of 15 and 29—the younger millennials and Generation Z. In our view, this considerable portion of the population, combined with student debt balances of some USD 1.6 trillion and declining housing affordability as prices continue to rise much faster than incomes, portends a favorable backdrop for the multifamily industry.

**How is private market performance relative to the public REITs?**
Private market apartment values have (so far) held up much better than their publicly traded peers. As measured by the Moody's Commercial Property Price Index (CPPI), multifamily continues to far outpace the overall commercial real estate CPPI (Fig. 11). In the spirit of full disclosure, transaction volumes in the private market have declined precipitously since the onset of the pandemic (Fig. 12). This should not be surprising given the substantial economic uncertainties that currently exist.

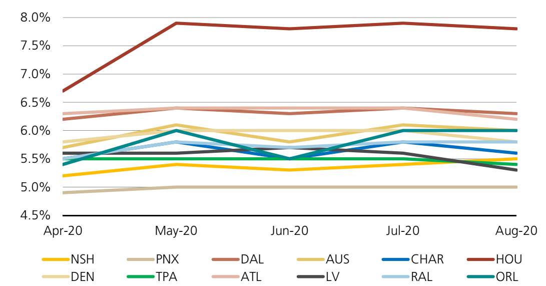
Multifamily transactional cap rates remain compressed and among the lowest in the commercial real estate world. One observation we would make is the compression of garden-style apartment cap rates relative to mid-/high-rise apartments (Fig. 13).

**Fig. 7: Vacancy trends in select dense, coastal markets**



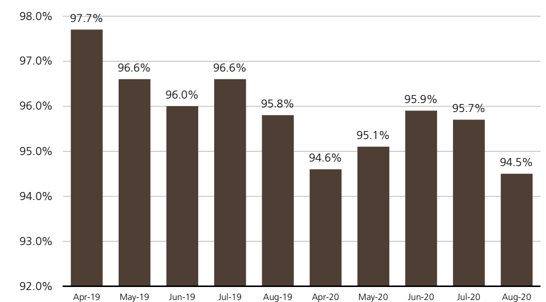

Source: Miller Samuel, Yardi Matrix, Elliman Report, UBS

**Fig. 8: Vacancy trends in select non-coastal and Sun Belt markets**




Source: Miller Samuel, Yardi Matrix, Elliman Report, UBS

**Fig. 9: Rent collection data**
April – August 2019 and 2020




Source: NMHC, UBS

Significant amounts of institutional and private equity capital are being reallocated to secondary and tertiary multifamily markets, many of which have a heavier concentration of suburban, garden-style apartments. This is a trend we expect to continue going forward, particularly based on population and job migration patterns away from some of the larger coastal cities to more secondary and tertiary locations.

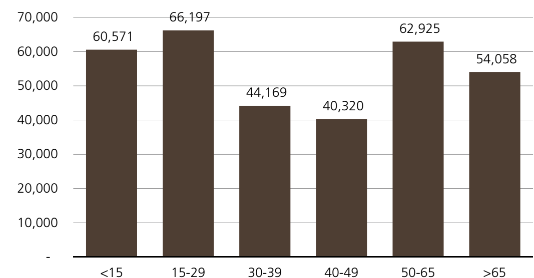
**What about job growth?**
Without doubt, a stable job growth market is essential to the long-term health of the multifamily business. Following the initial unemployment shock that occurred earlier in the year, job growth has begun to rebound. Interestingly, a significant portion of the job losses occurred in the service sector, many of which were concentrated in vacation and destination-oriented cities as opposed to office-using jobs that have been more concentrated in dense urban cities.

We highlight the indexed job growth data for select coastal cities (Fig. 14) and for select non-coastal and Sun Belt markets (Figs. 15–16) between January 2010 and July 2020. Despite the rebound in job growth in the coastal cities, particularly San Francisco and San Jose, rent and vacancy trajectories remain negative for these markets. We suspect a significant contributor to this is the aforementioned remote working situation where a number of employees of companies in these expensive cities are working remotely and have either moved back with their parents or have moved to more affordable markets. The majority of the non-coastal and Sun Belt markets have begun to see a pickup in employment, something that we believe is reflective of the relative outperformance of rent and occupancy trends in these markets.

The one outlier is Las Vegas. Despite suffering the largest job losses among the markets we have highlighted, rent growth and occupancy trends have performed significantly better than we would have expected. As the data highlights, Las Vegas has experienced a rebound in jobs but continues to lag its non-coastal peers. In the absence of a vaccine and significantly increased inbound travel, we would not be surprised if the rent growth and vacancy data in Las Vegas were to worsen from current levels.

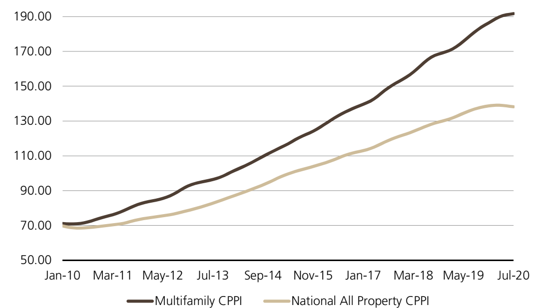
**What about the impact on real estate taxes?**
Real estate taxes represent a significant portion of the operating expenses for multifamily operators as well as a significant source of income for cities and municipalities. We have written extensively over the past several years about the risk of rising real estate taxes for the multifamily sector given the dramatic increase in asset values. Although we continue to believe that cash-strapped municipalities will continue to view commercial real estate as a source of tax revenue, we would encourage landlords to leverage the current economic distress to challenge their assessments.

**Fig. 10: US population distribution by age range**



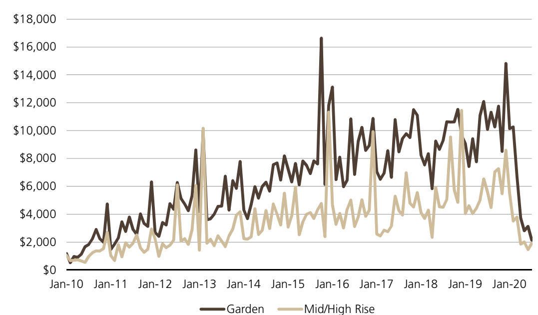

Source: US Census, Haver, UBS

**Fig. 11: All property and multifamily Commercial Property Price Index trends**




Source: Real Capital Analytics, UBS

**Fig. 12: Monthly private market multifamily transaction volume trends**
January 2010 – July 2020, in USD millions




Source: Real Capital Analytics, UBS

**The regulatory environment is not helping**
We have written frequently over the past several months regarding the impacts of various national, state, and local regulatory actions on commercial real estate and multifamily in particular. The most recent blow to the industry came in the form of the nationwide eviction moratorium that was recently instituted by the Trump administration. We understand the need to help those in distress and want to keep people in their homes and apartments. However, in the absence of landlord relief on taxes, mortgage payments, etc., the health of the industry, particularly for smaller landlords, is a very real issue.

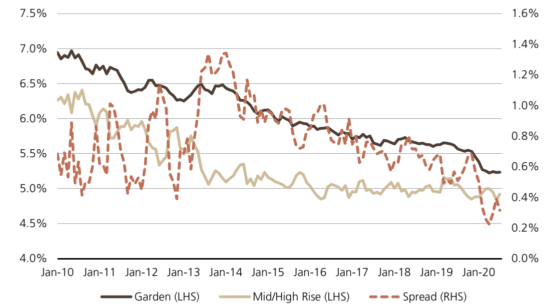
In addition, several states are considering invoking statewide rent control measures. Recall that California, Oregon, and New York all passed various versions of statewide rent control in 2019. Further, California voters are set to vote on several ballot initiatives in November that, if approved, could be incremental negatives for the multifamily industry in the state.

**Concessions are on the rise – generally**
The combination of shelter-in-place restrictions and remote working conditions has led to an increase in the use of concessions by many landlords, particularly in those dense, coastal cities that have seen vacancies rise. In a number of those markets, it would not be unusual to see as many as two months' free rent (or more in some cases) being offered in addition to rent reductions in an effort to maintain occupancy. Based on the data from several public REITs, as well as anecdotal data from various private operators, concessions in a number of Sun Belt markets have begun to decrease, particularly for those markets that are not experiencing significant new capacity additions.

**Has COVID-19 provided any benefits to the industry?**
Perhaps an odd question given the overall negative impacts of the pandemic. However, we envision several potential industry benefits as a result of COVID-19, including:

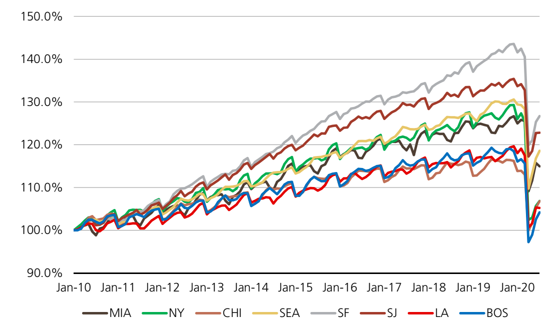
- It is very likely that deliveries of new units will be curtailed and new development starts will decline. New developments have been elevated for the past several years (Fig. 17), something that has been one of the key risks for the number of submarkets across the US. We believe new capacity additions could decline substantially over the next several years as more developments become uneconomic;
- Tenant turnover is likely to decline significantly in 2020. Lower turnover should reduce operating and capital costs associated with prepping for new tenants;
- We believe the industry will increase its use of technology. Historically, technology and real estate have rarely been used in the same sentence. Over the past few years, several multifamily REITs have begun employing more technology into their operations as a way of increasing operating efficiency and margins. It is likely that the post-COVID-19 environment could be the impetus for a greater use of technology by a broader universe of apartment owners. These technologies include key-less entry; moisture and water sensors; remote thermostat and lighting controls; automated self-leasing; and self-guided/virtual property tours.

**Fig. 13: Multifamily private market transactional cap rate trends**
January 2010 – July 2020



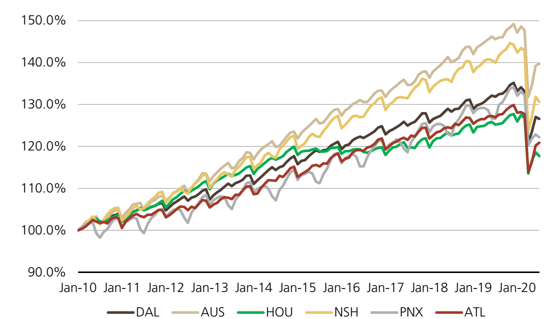

Source: Real Capital Analytics, UBS

**Fig. 14: Indexed job growth trends for select coastal cities**
January 2010 – July 2020




Source: Haver, UBS

**Fig. 15: Indexed job growth trends for select non-coastal and Sun Belt cities**
January 2010 – July 2020



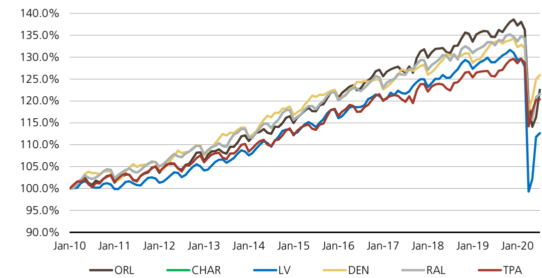

Source: Haver, UBS

The REITs that have employed some of these technologies have already realized some degree of operating margin expansion and relatively attractive cash-on-cash returns.

**How do the public multifamily REITs look on a valuation basis?** In Fig. 18, we highlight select valuation data for the seven largest publicly traded multifamily REITs (data as of 8 September). Based on consensus 2020 and 2021 adjusted funds from operations (AFFO) estimates, the overall group is trading 3–4 multiple points below long-term averages. We would expect this discount to persist until there is more clarity on the rent, occupancy, and regulatory front. One figure that jumps out at us is the almost 16% discount to consensus net asset value (NAV) the group trades at. In fact, several REITs are trading at more than a 20% discount to NAV. Although these discounts appear appealing, we would caution investors that many public market REIT investors place significantly more emphasis on FFO/AFFO growth than they do NAV. As such, it is possible that the wide gap between public and private market values could persist for some time.

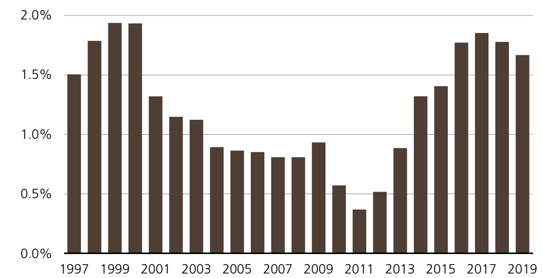
On the positive side of the ledger, the dividend yields are relatively appealing, averaging 4%, and the dividend coverage remains strong at 1.3x on average. Although dividends could potentially be at risk if conditions continue to deteriorate, we believe the multifamily group is among the better positioned REIT subsectors in terms of dividend safety.

**Fig. 16: Indexed job growth trends for select non-coastal and Sun Belt cities**
January 2010 – July 2020




Source: Haver, UBS

**Fig. 17: New capacity additions as a % of existing inventory for the top 63 markets in the US**




Source: CBRE, UBS

**Fig. 18: Selected market and valuation statistics for the seven largest publicly traded multifamily REITs**
as of 8 September 2020

| Ticker | Company Name | Stock Price | Market Cap $MM | Price/FFO 2020E | Price/FFO 2021E | Price/AFFO 2020E | Price/AFFO 2021E | Annualized Div/Share | Dividend Yield | FWD. AFFO Dividend Coverage | Consensus Net Asset Value/Share | Price/NAV |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ESS | Essex Property Trust, Inc. | $221.57 | $14,475 | 17.1x | 17.0x | 18.9x | 18.9x | $8.31 | 3.8% | 1.41x | $266.77 | 83.1% |
| AVB | AvalonBay Communities, Inc. | $158.46 | $22,302 | 17.6x | 17.6x | 19.2x | 19.2x | $6.36 | 4.0% | 1.30x | $194.60 | 81.4% |
| UDR | UDR, Inc. | $34.62 | $10,215 | 16.8x | 17.0x | 18.3x | 18.6x | $1.44 | 4.2% | 1.29x | $41.23 | 84.0% |
| MAA | Mid-America Apartment Communities, Inc. | $115.68 | $13,230 | 18.7x | 18.1x | 21.1x | 20.4x | $4.00 | 3.5% | 1.41x | $117.98 | 98.1% |
| EQR | Equity Residential | $57.39 | $21,361 | 17.1x | 17.5x | 18.9x | 19.8x | $2.41 | 4.2% | 1.20x | $71.86 | 79.9% |
| CPT | Camden Property Trust | $91.04 | $9,073 | 18.7x | 18.1x | 22.1x | 21.5x | $3.32 | 3.6% | 1.28x | $103.52 | 87.9% |
| AIV | Apartment Investment & Management Co Class A | $36.80 | $5,478 | 14.8x | 15.2x | 16.9x | 17.4x | $1.64 | 4.5% | 1.29x | $48.28 | 76.2% |
| | | | **Average** | 17.3x | 17.2x | 19.3x | 19.4x | | 4.0% | 1.31x | | 84.4% |

Source: FactSet, UBS

# Appendix

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Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

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### Statement of Risk

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(1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds;
(2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment;
(3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss;
(4) are long-term, illiquid investments; there is generally no secondary market for the interests of a fund, and none is expected to develop;
(5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer;
(6) may not be required to provide periodic pricing or valuation information to investors;
(7) generally involve complex tax strategies and there may be delays in distributing tax information to investors;
(8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.
Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.
In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:
Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-US securities and illiquid investments.
Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in US dollars, changes in the exchange rate between the US dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a US investor.

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## Appendix

**Required Disclosures**

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US equity sector strategists provide three equity selections:
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*A stock cannot be selected as Most Preferred if it is rated Sell by UBS Investment Bank, while a Buy-rated stock by UBS Investment Bank cannot be selected as Least Preferred.
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# Appendix

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