WHITE OAK PARTNERS

A REVIEW OF

EXIT CAP RATE METHODOLOGY IN A PERIOD OF ECONOMIC UNCERTAINTY

White Oak Partners Research Team
May 2024

KEY HIGHLIGHTS

- ***Crafting a robust business plan for multifamily investment is challenging, especially amid current market uncertainties.***
- ***Multifamily properties remain resilient, as it is a need-based housing option with strong demographics and investor support, featuring adaptable lease terms for managing vacancies and rent growth based on market conditions.***
- ***Despite the intricate nature of business plans, underwriting models rely on a few key factors including NOI growth and exit assumptions, offering avenues for investor success across various scenarios.***

INTRODUCTION

In multifamily investment, key determinants of unlevered, property-level returns include purchase price, rent growth, expenses, and exit price. Recent interest rate volatility has caused a slowdown in investment activity as market participants pause to reassess return assumptions and attempt to interpret the imperfect data and economic uncertainty today. As the Federal Reserve debates how to proceed with its fight against inflation, two main scenarios have arisen:

1. If the economy shows signs of weakening among increased borrowing costs, the Fed will likely cut short-term rates to prevent a major downturn.
2. Should inflation remain above the Fed's 2% target, they are likely to keep short-term interest rates elevated.

In today's uncertain environment, it is critical to consider multiple scenarios when modeling a prospective investment to properly assess potential performance and risk. Developing and executing a defined business plan to drive NOI growth is crucial to promote performance regardless of interest rate conditions. The following is an analysis of real estate performance given both higher for longer rates and near-term cuts.

MACRO SENSITIVITIES

Widely different macroeconomic scenarios can lead to similar multifamily performance for a given asset due to nuances in supply and demand fundamentals and successfully executing a well-developed business plan. Regardless of economic conditions, identifying and executing a business plan is a key differentiator in multifamily performance. Even in a lower growth environment, operational efficiencies can lead to outperformance and produce attractive risk-adjusted returns. Broadly speaking, NOI growth combined with capital flows and investor sentiment determines the exit price. Consider the following deal metrics reflecting the modeled performance of the same Class A multifamily property in two different macroeconomic environments. Note the following assumptions, low to medium growth appears more likely than a high growth environment or recession, and strong demographic supported multifamily demand appears poised to support steady to strong performance as new supply is absorbed.

FIGURE 1
Analysis Considers a 5-Year Hold

5-YEAR HOLD SCENARIO	**SCENARIO 1:** NEAR-TERM CUTS	**SCENARIO 2:** HIGHER FOR LONGER
Purchase Price Per Unit	$260K	$260K
Debt (LTV%)	60%	60%
Interest Rate	SOFR + 225bps	SOFR + 225bps
Average Asking Rent Growth	3.2%	3.7%
Average Effective Rent Growth	3.01%	3.42%
NOI CAGR (%)	3.37%	3.9%
Cap Rate (Acq.)	5.63%	5.63%
Cap Rate (Yr. 3 Stabilized)	6.14%	6.18%
Levered IRR	15.33%	15.35%
Unlevered IRR	10.73%	10.74%
Exit Cap Rate	5.25%	5.5%
Exit Price Per Unit	$341k	$341k
Exit CAGR (Acq. Price)	5.49%	5.45%
Exit CAGR (Replacement Cost)	3.35%	3.31%

Source: White Oak Partners Investment Team Underwriting

SCENARIO 1: NEAR-TERM CUTS

Record new supply and sustained high interest rates has stalled rent growth, significantly reducing future supply pipeline as new development yields don't pencil at development costs and interest rates today. If interest rates decline in the short term, investor and developer activity is likely to improve, creating similar conditions that compressed cap rates throughout the 2010 decade. Normalized new supply will likely result in effective rent growth closer to the historical average of 3% later in the hold period. A lower cap rate environment upon exit offsets lower NOI growth with project returns attributed to higher appreciation.

In the immediate aftermath of the Global Financial Crisis (GFC) the Federal Reserve initiated an unprecedented era of quantitative easing, an aggressive monetary policy aimed at reviving the struggling economy. By purchasing large quantities of Treasury bonds and mortgage-backed securities, the Fed significantly increased the money supply and lowered interest rates, with the federal funds effective rate dropping to nearly zero.[3] As a result of these lowered interest rates, the cost of borrowing decreased dramatically, which, when combined with depreciated real estate values, created unique investment opportunities. These factors began to catalyze a recovery in the real estate sector by 2010, particularly noticeable in markets that had experienced significant price declines during the crisis.

Throughout the 2010s, the influx of capital from institutional investors helped drive multifamily cap rates lower. Cap rate compression during this decade can largely be attributed to the robust investment demand, as investors sought to capitalize on the growing discrepancy between housing supply and demand. The sustained low-interest rate environment further fueled this trend, as borrowing costs remained minimal, allowing investors to leverage their purchases extensively while still achieving attractive returns. The low interest rates associated with home mortgages also increased the difficulty of home purchases for first-time buyers as bidding wars for homes drove price increases, further supporting demand for multifamily housing.

Institutional interest also brought increased operational efficiencies and technology, further contributing to higher real estate values. Increased demand for multifamily real estate, backed by strong institutional support and favorable monetary conditions, laid the groundwork for the sector's robust growth and compression of cap rates well into the next decade. Due in part to the reduced investor interest in the office sector, capital flows are projected to continue to favor multifamily, as well as industrial assets, over the near to medium term.

SCENARIO 2: HIGHER FOR LONGER

In this scenario, rent growth is likely to be above historical averages in the later years of the hold period, due to declining levels of new supply combined with elevated demand for housing. Higher interest rates typically drive further wage growth and with it, the ability to absorb rent increases. Despite higher exit cap rates, the modeled property achieves markedly similar performance to the lower cap rate environment due to enhanced NOI growth.

The construction slowdown following the GFC combined with a very large millennial population, significantly contributed to a national housing deficit of 3.2 million units as of 2022.[4] In the migratory boom following the pandemic, developers scrambled to fulfill a sudden spike in demand. Many multifamily developments were initially delayed amid worker and material shortages, further contributing to a spike in apartment supply when these projects resumed. As the average multifamily property takes 18 months to build, the supply currently delivering began construction under very different economic conditions. Higher for longer rates, rising regulatory and insurance costs, and continued inflationary pressure would make many of these projects infeasible today. Multifamily construction costs, not including labor, have increased more than 35% since the start of 2020.[5] These cost increases have been exacerbated by rapidly increasing short-term rates that directly impact development financing.

These increased cost pressures are already presenting themselves in multifamily unit start data. Construction starts in Q1 2024 have declined sharply, just 46,000 nationally, 25% below the long-term average since Q1 2000 and comparable to 2011 construction volume (a similar period of economic uncertainty).[2] While this current supply wave has helped alleviate some near-term housing shortages, the United States is still several million units short of meeting housing demand.[4] If interest rates remain elevated, development is likely to remain muted, and current deliveries will be followed by supply scarcity, which has not been seen since the GFC. During the recovery period between 2011 and 2016, year over year rent growth averaged above 4%.[2] Low supply, increased rental demand, and higher-than-average inflation should result in strong rent growth over the next few years while cap rates remain relatively static. Lower liquidity for development and a 50% increase in multifamily construction costs since 2014 will further limit new supply.[5] In addition, many of these same pressures are also affecting prospective homeowners, making the average single-family house that much more unaffordable for most and resulting in households renting for longer.

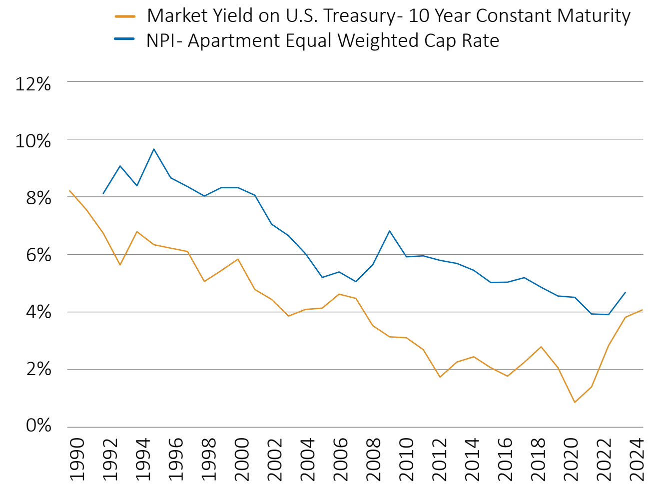
WHITE OAK EXIT CAP METHODOLOGY

- Recent volatility and rate risk have resulted in many marketed and off-market Class A assets trading at or below replacement cost. The White Oak investment team has underwritten a wide range of development opportunities and the discount to replacement cost delta ranges from 5-20%.
- Growing today's replacement cost (specific to market and construction style) 3% annually establishes a baseline for future replacement costs at the end of the hold period. This is supported by multifamily costs increasing 50% since 2014 (A CAGR of ~4%).[5]
- Under this scenario, the buyer at the end of White Oak's underwritten hold period would be buying near or slightly below estimated replacement cost (0-10% discount), which would be attractive to the next buyer who would likely pursue a value-add business plan.

The potential to outperform underwriting assumptions increases if:

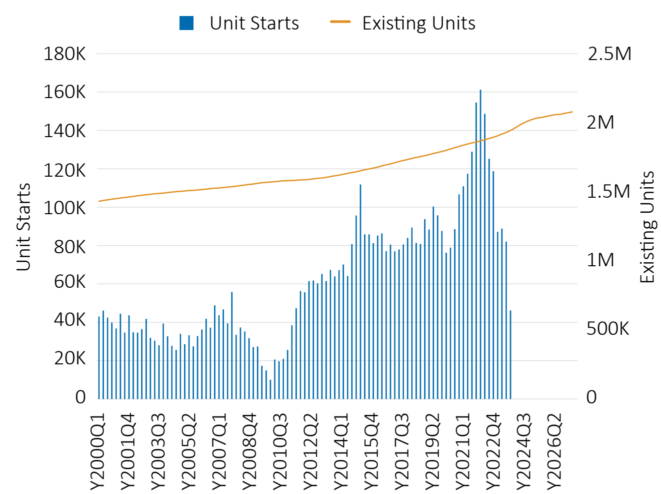
- The market normalizes and developers resume transacting at a premium to replacement cost.
- Cap rates compress due to increased capital flows into multifamily from other asset classes, such as office.
- Rate cuts resulting in increased deal flow and competition among investors.
- Stronger than anticipated rent growth in the outyears of the hold period driven by fewer deliveries/new supply.
- Selling into a deep pool of value-add capital chasing a finite number of opportunities.

FIGURE 2
NPI Cap Rates Vs. 10 Year Treasury Yeild



Source: NCREIF/FRED

FIGURE 3
Quarterly Starts Vs. Existing Inventory



Source: RealPage

CONCLUSION

Navigating the uncertain terrain of interest rates requires adept financial modeling and a keen understanding of multifamily real estate dynamics. Our analysis of two contrasting scenarios—near-term rate cuts and sustained high rates—underscores the importance of strategic flexibility and thorough market analysis in optimizing investment returns. In either scenario, the ability to adapt and execute a robust business plan is paramount. By preparing for various interest rate scenarios and focusing on operational excellence, investors can enhance their prospects for robust performance regardless of external economic conditions.

---

[1] *NCREIF*
[2] *RealPage Analytics*
[3] *FRED*
[4] *[Axios]*
[5] *BLS*

WHITE OAK
PARTNERS

White Oak Partners is an experienced owner-operator specializing in institutional-quality multifamily housing. Based in Columbus, Ohio, White Oak has acquired over 18,500 multifamily units, with a market value in excess of $4.3 billion, since inception under the direction of its leadership team, which averages over 25 years of experience. White Oak builds on the track record of its Founder, Michael J. Menzer, who owned and managed approximately 100,000 multifamily units in 47 states while building his prior multifamily firm, Paramount Financial Group, from 1987-2004.

TO LEARN MORE

CONTACT US

MICHAEL MENZER
Chief Executive Officer
mmenzer@whiteoakpartners.com
614-741-7790

JAMES CRAMER
Partner, President
jcramer@whiteoakpartners.com
614-741-7797

BENJAMIN BARNES
Partner, Chief Investment Officer
bbarnes@whiteoakpartners.com
614-741-7628

ANDREW CARR
Partner, Head of Capital Markets
acarr@whiteoakpartners.com
614-741-7736

STEVE PRIBONIC
Director, Capital Markets
spribonic@whiteoakpartners.com
614-741-7724

Certain information contained herein includes forward-looking statements. Such statements can generally be identified by terminology such as "except," "may," "should," "anticipate," "project," "target," "believe," or "intend" or the negative thereof or comparable terminology. These statements are based on certain assumptions made by White Oak Partners, LLC and information obtained from sources we believe to be accurate and reliable. Some or all forward-looking statements may prove to be inaccurate and/or incorrect. The opinions expressed and the material provided are for general information and should not be considered a solicitation for the purchase or sale of any security. Brokerage Services are provided by WOBD, LLC, a registered broker-dealer with the SEC and a member of FINRA and SIPC. WOBD, LLC and White Oak Partners Investment Advisor, LLC, a registered investment advisor with the SEC, are both affiliated entities of White Oak Partners, LLC.