Stormfield Capital

STORMFIELD INSIGHTS

Valuation Disparities Create Opportunities In Lower-Middle Market Multifamily Lending

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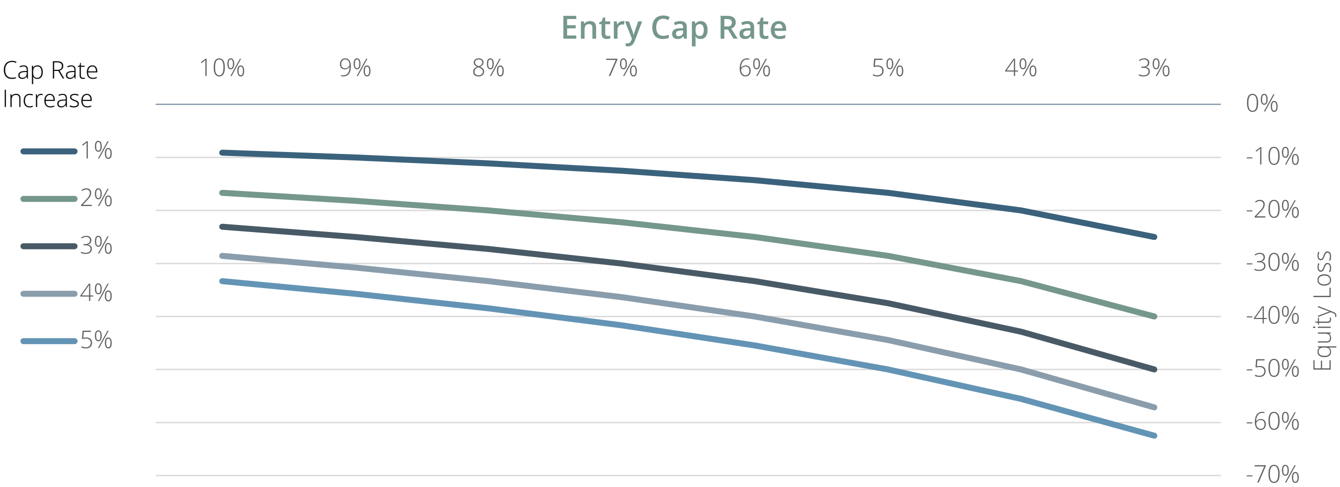
Commercial real estate has certainly garnered its fair share of attention over the past 18 months, with seemingly daily headlines (and even a *60 Minutes* feature) obsessing over the fate of downtown office properties struggling with the dual challenges of low occupancy and higher interest rates. More recently, even darling real estate asset classes such as logistics and multifamily have come under increased scrutiny from market commentators. As active market participants and practitioners know, it can be unproductive to cast broad generalizations about sub-asset classes, let alone entire asset classes such as logistics or multifamily housing.

It is widely known that the United States has a significant housing shortage. New production coming online in 2024 and 2025 will not be sufficient to keep pace with household formation. Furthermore, a slowdown in housing starts following the Fed's rate raising cycle should only cause this shortage to persist into 2026. Time to buy multifamily? Not so fast. Even amidst this favorable backdrop, not all properties are similarly well positioned. In particular, some larger multifamily properties (which for the purposes of this piece we will define as 250+ units) have more recently made their way into CMBS special servicing, foreclosure or foreclosure auctions. For those who may not live in the day-to-day world of real estate investing, this could naturally cause some level of consternation. However, as we will describe below, the multifamily real estate sub-sector is far from a monolithic mass of Class A, B and C properties that can be easily compared across or even within various geographies.

Rather, much like Stormfield's private mortgage lending strategy where smaller loans generally offer more favorable economics per unit of loan-to-value risk, smaller multifamily properties generally trade at higher capitalization rates ("cap rates") than larger multifamily properties even after adjustments for property operating margins have been made. This fact has significant implications for both the value and volatility of value for the real estate in question. For those more familiar with bond math, one can think of cap rates as the inverse of duration. All else equal, the longer a bond's duration, the more sensitive a bond will be to changes in interest rates – making a 30-year bond far more volatile than a 3-month bond. Similarly, as the graph below illustrates, a property with a 10% cap rate will be far less sensitive to changes in interest rates than a property with a 4% cap rate.

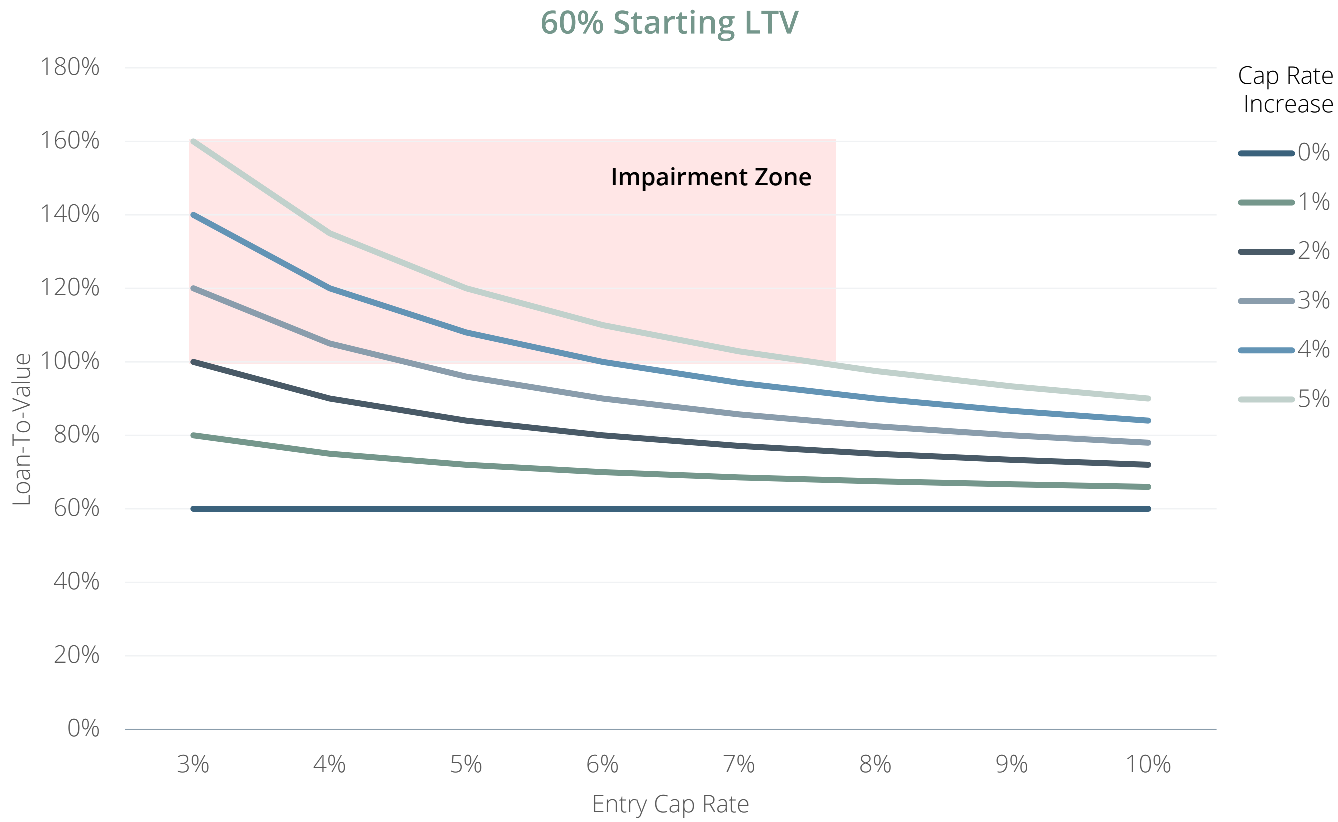


1. A capitalization rate ("cap rate") is a ratio used to measure an investor's potential return on a property. Is calculated as follows: Capitalization Rate = Net Operating Income/Current Market Value

Now, some may be thinking, "what does this matter – real estate is a long-term investment, short to intermediate term valuation changes should be irrelevant." That sentiment would be true for the unleveraged real estate holding; however, the vast majority of multifamily properties are financed with ample amounts of debt. This debt generally carries a 10-year term. Should interest rates increase significantly as debt is maturing, the resultant mark-to-market loss on the property could cause the equity sponsor to have to make a significant cash contribution to defease the debt to a level where a counterparty would be willing to roll the debt for another 10-year term. In scenarios where the mark-to-market loss is more severe, the equity may be wiped out entirely, leaving the equity sponsor unwilling or unable to inject enough fresh equity into the property to prevent a default and/or foreclosure.

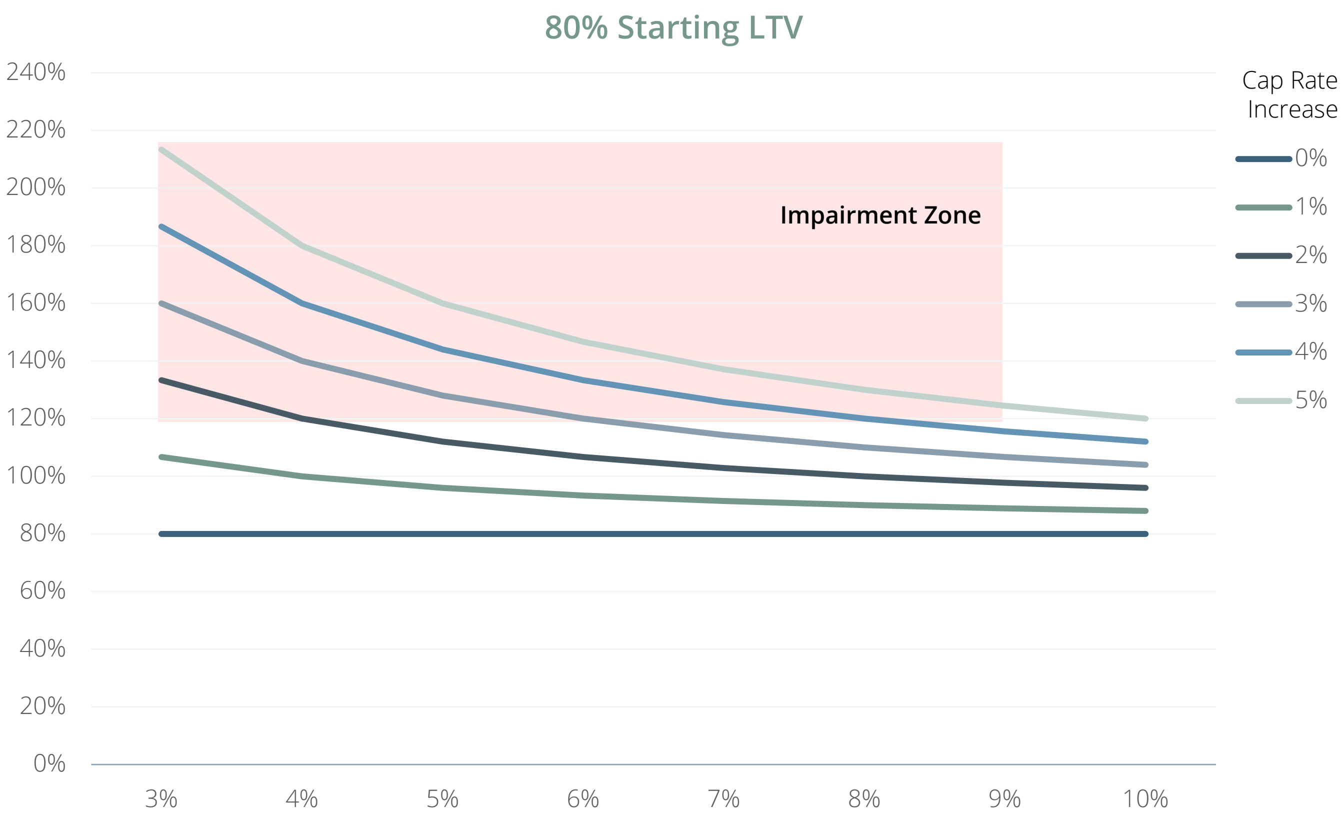
Why larger multifamily properties trade at higher valuations (and thus lower cap rates) can be a topic of debate; but the most likely answer is the greater ease at which large pools of institutional capital can be deployed. If you are the portfolio manager of a $5B USD real estate equity fund, it is far easier to purchase multifamily properties in $50M and $100M increments than the $500,000 to $2.5M increments required to participate in the 5 to 50 unit marketplace where Stormfield actively lends. Simply stated, the competition for larger properties is more intense. This valuation disparity creates what Benjamin Graham would have referred to as a "margin of safety" in many smaller multifamily properties. If we underwrite a property to a 7.5% cap rate, we can be off by 50 basis points in our estimation of the terminal cap rate without a material consequence to our sponsor's ability to sell or refinance. If we underwrite to a 4.0% cap rate, we had better be spot on.

The following two charts illustrate this math. In these charts, we depict the impact on loan-to-value ("LTV") ratios across various entry cap rates when subjected to various cap rate expansion scenarios (ranging from +100 basis points to a more draconian +500 basis points). In the first chart, we also depict this set of scenarios relative to Stormfield's long term average LTV of approximately 60%.



To interpret this chart, select a starting cap rate. One can then interpolate the resulting impact on LTV ratios by triangulating upwards to the line that corresponds to one's cap rate expansion scenario. For example, a 5% entry cap rate can tolerate a 300 basis point widening of cap rates before the LTV exceeds 100%. However, an 8% starting cap rate can tolerate a 500 basis point widening of cap rates before LTVs reach 100%.

Conversely, the next chart depicts the impact of changes on cap rates when one's entry LTV is 80% (closer to the longer term average of mortgages provided by banks or CMBS). In this case, LTVs approaching and exceeding 100% happen much more swiftly across a range of smaller cap rate shocks – hence the pickle that some banks and CMBS holders find themselves in with large multifamily properties that were underwritten to the toxic mix of aggressive cap rates and high LTV ratios.



These two charts speak to the core of Stormfield's investment philosophy – underwrite properties to cap rates that provide a margin of safety and, perhaps even more importantly, maintain low LTV ratios such that our investments can withstand the inevitable shocks that one regularly encounters over the course of an investing career.

Real estate investors must be highly tactical as they navigate the multifamily markets over the next several years. While there will likely be opportunities to provide liquidity to troubled or overleveraged sponsors of larger multifamily properties, we believe the smaller end of the multifamily market will experience less price volatility and continue to offer more compelling risk adjusted returns to both real estate equity and debt investors in the years to come.

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