Opinion Piece

MULTIFAMILY: A RECESSION RESILIENT ASSET CLASS

Investing in middle market multifamily provides stability, predictability and resiliency relative to investing in industrial, office and retail.

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"Middle market multifamily is driven by the basic and essential human need for safe, clean and moderately priced housing."

Middle market multifamily is attractive because it provides a combination of cash flow durability, pricing efficiency and operational control which is difficult to find in other property types. With typical deals in the $15 million to $70 million purchase price range with 125 to 300 units, this segment of the multifamily market provides investors with strong risk adjusted returns relative to other commercial properties. Demand drivers, resident diversification, lower capital intensity and liquidity all contribute to middle market multifamily's ability to generate current returns, create value and provide downside protection.

BASIC NEEDS DRIVE DEMAND AND INCOME STABILITY

Middle market multifamily is driven by the basic and essential human need for safe, clean and moderately priced housing. Office, industrial and retail demand is more discretionary and more directly impacted by secular headwinds and changeable macro and micro-economic trends. Demand for retail space is driven by consumer spending and is subject to pressures from online spending, while industrial demand drivers include manufacturing, distribution and logistics. Office demand derives mainly from corporations, which has faced significant structural headwinds with the rise of hybrid work and new technology which facilitate remote work arrangements. Demand for all real estate is, of course, linked to broader economic factors. However, the need for moderately priced housing is simply more basic and non-discretionary relative to demand for other property types.

While all real estate segments face macro headwinds during different economic cycles, multifamily demand remains the most stable given its correlation with basic human needs. We saw this principle play out in real time during the GFC where multifamily rebounded first and experienced the smallest dip, despite large scale macro-economic disruption.

RESIDENT DIVERSIFICATION, ADAPTABILITY AND LOWER CAPITAL INTENSITY

Compared to commercial properties which may have significant individual credit exposure, reliance on a much smaller number of tenants and concentrated lease term expirations, a typical middle market multifamily property has a highly diversified resident base.

A typical apartment community has a hundred or more residents with diverse income sources and employers. Real time, individualized credit screening also provides the ability for property managers to reduce the likelihood of adverse credit events.

Multifamily leases typically last only for a single year, which means that rents can reset quickly, allowing for a natural hedge against inflation and the potential for increased cash flow relative to industrial, office and retail properties.

Commercial lease terms are significantly longer (i.e. 5 to 10 years) and may provide for rent increases which are lower than current market rates.

Furthermore, if a multifamily resident breaks a lease or relocates, that unit can be quickly turned and relet to a new resident with minimal capital investment. Commercial leases often require significant upfront investment from the property owner to refit a space for a new tenant. As a result, if a tenant defaults, landlords are often hit twice. They may be unable to recover sunk fit out costs and simultaneously need to spend significant dollars to attract a new tenant, which may take an extended time depending on market conditions.

MIDDLE MARKET MULTIFAMILY PROVIDES OPPORTUNITY FOR VALUE CREATION

Middle market multifamily properties assets are often older (1970s–2000s vintage), undermanaged or undercapitalized and owned by smaller operators or families. These factors create multiple opportunities for meaningful value creation with executable business plans.

In many markets, the industrial, retail and office sectors are highly competitive, efficient and dominated by large institutional owners. These owners typically have strong operational capacity and direct access to capital markets to raise debt and equity, making outperformance more of a challenge. As a result, particularly in the case of core or Class A investments, cap rates are compressed, many assets are optimized and upside potential primarily depends on market rent growth and cap rate compression.

On a comparative basis, middle market multifamily features multiple avenues to create value. Interior renovations, exterior and amenity enhancements create the potential for rent premiums, while expense reductions generate cost savings, all of which result in growth in net operating income.

Although similar value add strategies may exist in commercial assets, relative to multifamily, leasing risk is higher, tenant demand is more uncertain and capital costs are higher, all of which tend to heighten the risk associated with successful business plan execution.

MIDDLE MARKET MULTIFAMILY PROVIDES DOWNSIDE RISK

Residents at middle market multifamily properties may elect to upgrade or downgrade but the overall steadiness of demand for moderately priced apartments makes the sector a defensive asset class. In addition, rents can be quickly adjusted downward to maintain occupancy in the event of softer economic conditions.

Since consumer spending has a discretionary component, retail sales typically decline in a recession, which negatively impacts retail tenants.

Although industrial occupancy may be somewhat more resilient than retail, it is also more cyclical and more directly exposed to slowdowns in trade and manufacturing that may be driven by external factors. With

potentially longer vacancies and even higher build-out costs and leasing commissions, office properties may be subject to even more downside risk.

Middle market multifamily also features an embedded hedge in the event of an economic downturn. If homeownership becomes more out of reach for the typical consumer, demand for moderately priced apartments could actually rise.

MIDDLE MARKET MULTIFAMILY PROVIDES LIQUIDITY ON EXIT

Middle market deals benefit from multiple exit options, providing the opportunity to sell both to larger institutional buyers seeking stabilized assets or to smaller or other middle market buyers that may pursue a value-add or tax exchange strategy.

Commercial properties typically have larger sales prices which could limit the buyer pool given the significant amounts of equity required to purchase those types of properties.

More manageable sales prices of middle market multifamily properties may also be attractive to an entire group of medium sized investors, including family offices or individuals seeking a tax-advantaged property exchange. Those purchasers also benefit from access to the lending backstop provided by agency financing even in economic downturns when debt may be relatively scarce for commercial properties.

LEM'S INVESTMENT STRATEGY IS TAILORED TO MIDDLE MARKET MULTIFAMILY

The attributes that distinguish middle market multifamily from industrial, office and retail are central to why the firm invests exclusively in this asset class.

LEM's focus on suburban Class B apartment communities directly targets the essential needs driven demand for housing that insulates middle market multifamily from the cyclical and structural headwinds facing commercial property types. Multifamily properties have diversified resident bases and annual lease structures that provide income stability and inflation hedging characteristics that commercial leases cannot replicate. The older vintage and undermanaged profile of LEM's target assets create executable value-add opportunities that are largely absent in more institutional commercial properties. Finally, LEM's target deal size provides liquidity at exit, with sales prices accessible to a broad range of buyers and the backstop of agency financing.

In sum, LEM's middle market multifamily investment strategy is built to provide downside protection while offering risk adjusted returns superior to other commercial property types.

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