The Manhattan Multifamily Opportunity

July 13, 2020

We hope this update finds you safe and healthy. As a follow-up to HWE's prior think pieces, the data below outlines historical cap rate trends for Manhattan multifamily that suggests a unique buying opportunity.

A Recipe for Returns
An abundance of liquidity in the market, a flight to safety, and benchmark interest rates well below 1.00% create a tremendous opportunity for multifamily investors. HWE has analyzed the cap rate spread to benchmark U.S. Treasury rates to quantify our thesis.

The Buying Opportunity

- An investor buying a Manhattan multifamily asset at 4.00% or higher would be acquiring the asset at the widest spread to the 10-year UST in the last 18 years – wider than during the Great Recession *(approx. 335 bps above a 0.65% 10-YR UST).*
- During the recovery and growth phase of every cycle, the cap rate spread to Treasuries has tightened dramatically.
- In Manhattan, the spread has averaged 1.82% since 2002 and fell below 1.00% in each of the last two cycles (2006-07 and 2018).
- Most economists believe Treasury rates will remain low for the foreseeable future with the 10-YR UST struggling to reach 1.50% in most yield curve projections.
- With the amount of liquidity in the RE market, <u>it is likely that cap rates will compress more quickly than Treasuries will rise – that is the opportunity!</u>

Generating Outsized Risk-adjusted Return
Based on a conservative set of assumptions, the tables below depict a scenario with the potential for outsized returns on a risk-adjusted basis while having strong downside protection. Key takeaways:

- The upside presents **as good a buying opportunity as we have seen the last two cycles** with the potential for 13.00%-14.00% unleveraged IRR's.
- **Phenomenal downside protection** – low-end projections of ~6.00% unleveraged IRR's in a low-growth, no cap rate compression scenario is consistent with base case pricing, pre-COVID.
- **Returns can be materially enhanced with moderate leverage,** producing total returns in the high-teen's - more akin to value-add deals but with a core risk profile.

ASSUMPTIONS - UNLEVERAGED

Investment	-$100.0	
Going-In Cap Rate	4.00%	*Approx. 335 bps above the current 0.65% 10-YR UST*
NOI Growth - 7 yr CAGR	3.00%	*Assumes NOI growth is low in the early years & higher thereafter*
Exit Year	7	
Exit 10-YR UST Rate	1.50%	*Upper end of forecasts*
Exit Cap Rate Spread	1.82%	*Avg. historical spread from 2002-2019**
Cost of Sale	4.00%	

UNLEVERAGED CASH FLOW

Year	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
NOI	-$100.00	$4.00	$4.12	$4.24	$4.37	$4.50	$4.64	$4.78	$4.92
Residual								$142.25	
Net Cash Flow	-$100.00	$4.00	$4.12	$4.24	$4.37	$4.50	$4.64	$147.03	

Unleveraged IRR	**8.94%**

Unleveraged IRR Sensitivity: NOI CAGR / Exit Cap Rate Spread to 10-Yr UST

		Exit Cap Rate Spread to 10-Yr UST			
NOI CAGR		***100 bps***	***150 bps***	***200 bps***	***250 bps***
	2.00%	11.83%	9.29%	7.21%	5.47%
	2.50%	12.36%	9.80%	7.72%	5.97%
	3.00%	12.89%	10.32%	8.23%	6.47%
	3.50%	13.42%	10.84%	8.73%	6.97%
	4.00%	13.95%	11.36%	9.24%	7.46%

ASSUMPTIONS - LEVERAGED

Loan Amount	60.00%	*Debt assumptions based on lender feedback*
IO Rate	3.00%	

LEVERAGED CASH FLOW

Year	0	1	2	3	4	5	6	7
Unleveraged Cash Flow	-$100.00	$4.00	$4.12	$4.24	$4.37	$4.50	$4.64	$147.03
Loan Proceeds	$60.00							
Interest Payment		-$1.80	-$1.80	-$1.80	-$1.80	-$1.80	-$1.80	-$1.80
Loan Payoff								-$60.00
Net Cash Flow	-$40.00	$2.20	$2.32	$2.44	$2.57	$2.70	$2.84	$85.23

Leveraged IRR	**15.62%**

Leveraged IRR Sensitivity: IO Rate / Loan to Value

		IO Rate			
		2.75%	3.00%	3.25%	3.50%
LTV	50.00%	13.80%	13.60%	13.40%	13.20%
	55.00%	14.76%	14.52%	14.28%	14.04%
	60.00%	15.91%	15.62%	15.34%	15.05%
	65.00%	17.32%	16.97%	16.63%	16.28%

**Source of Cap Rate Spread: Real Capital Analytics. Note: 2002 is the earliest year cap rate data is available.*

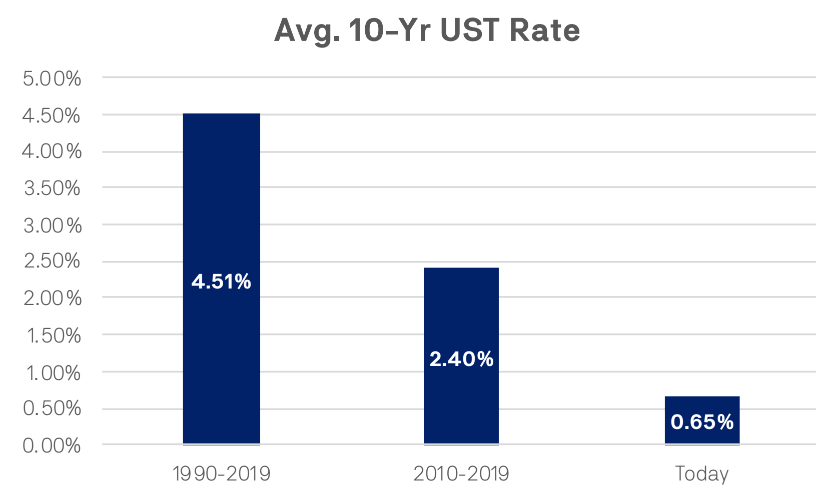
We think investors will do better than the above base case IRR's given excess liquidity in the market, record low Interest rates for the foreseeable future and increasing demand for multifamily that will cause cap rates to compress. While transactions have been scarce, pricing has held up well on those that have been completed like 400 East 58th Street.

"Investors Are Sitting on the Biggest Pile of Cash Ever" – WSJ, June 16th, 2020

- As of YE 2019, private equity funds had close to $320 billion of capital to deploy for real estate investment, well above the long-term historical average.
- Real estate fund raising is continuing at a record pace this year, with 939 funds looking to raise $297 billion.

Interest Rates are at All-Time Lows

- At ~0.65% - the benchmark 10-year US Treasury is at an all-time low.
- For comparison, the 10-year rate averaged 4.51% from 1990-2019 and 2.40% from 2010-2019.



Multifamily Capital Flows

- Despite the vast uncertainty that has been created by the COVID pandemic, one thing is certain – multifamily is viewed as one of the safest property sectors by global investors.
- For 3Q2020 T12, multifamily acquisitions totaled a record $251 billion worldwide, reflecting a >6.5% CAGR since Real Capital Analytics began tracking this data in 2008.
- Because of a dearth of available investment opportunities and the enormous demand for multifamily, some global and national markets have already started to experience cap rate compression in this environment.