BEYOND INSIGHTS

Is The Trophy Asset Still Winning?

Evaluating relative multifamily performance by property class through and after the Covid-19 pandemic

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THOUGHT LEADERSHIP

BERKADIA®

Executive Summary

Class A buildings have historically carried higher valuations – not only on a price-per-unit basis but as a multiple of earnings, as evidenced by lower cap rates. These higher multiples would only be justified to the extent Class A buildings provided higher returns via excess growth or carried lower volatility and risk.

To answer these questions, we leveraged Berkadia's data infrastructure to measure several facets of investment performance across numerous information sources with a common definition of property class.

We found that, at an individual property level, there is some justification to higher-class properties carrying higher valuations as they tend to exhibit less volatility around average performance – in essence avoiding the extreme highs and lows. Digging deeper, this seemed to result from both lower and more predictable operating expense levels in Class A than Class B, and Class B relative to Class C.

However, higher-class properties exhibited more sensitivity to macro risk. Since Class A buildings must always compete with the newest deliveries, they also display the greatest sensitivity in rents. We found that this trickled through to property income, as Class A showed both the largest decreases through the Covid-19 pandemic, and the strongest recovery as masks were removed.

We see evidence that price premiums are eroding in the highest-end product. The basis between Class A and Class C cap rates has never been tighter.

This presents investors with a way to trade their convictions. If they feel bullish on the economy and believe Class A will regain its historical pricing advantages, it presents a buying opportunity. However, those wary of deliveries continuing to outpace supply or who are less sanguine about a soft landing may want to trade out of Class A positions or into middle-market product.

Introduction

Property Class has long played a significant role in multifamily valuation, with Class A being valued more dearly not only as a function of higher rents and incomes, but multiples of that income – earning not only cachet but the moniker of "institutional quality."

But do they always make better investments?

In this analysis we'll evaluate several facets of investment performance, including trends in rents and property incomes through different periods. We'll also look at the inherent risk of that income stream, by looking at both market sensitivity and property-level idiosyncratic risk. Finally, we'll see whether there have been any changes in market sentiment based on changes in relative cap rates in recent transactions.

As these components of the analysis draw on many types of data – for example survey data for rents, investor reporting for property cash flows, and transaction data for cap rates – we'll naturally be forced to use different data sources which would typically present significant limitations.

Berkadia's best-in-class proprietary data infrastructure can map the same properties across sources and dramatically reduce these limitations. For example, we'll use Yardi's Improvement Score – the best and most consistent indicator in the market – as our proxy for property[i] class, then apply this identification not only to Yardi's reported rents but also to properties in Real Capital Analytics' transaction data and our own investor reporting.

We'll primarily analyze the period from late 2019 through today – the Covid-19 era and its aftermath. On one hand, this time period is ideally suited for analysis because we can see in quick succession the pandemic's mixed impacts to demand, followed by an onslaught of demand at the national level following stimulus checks, in turn followed by a wave of new supply via new deliveries. This also lets us analyze substantially the same properties throughout using a same-store approach, which is more useful to evaluate discrete investments than commercial indices which typically include new supply. We acknowledge the limitation, however, that we cannot look at prior eras including the Great Financial Crisis through the same lens, as available data decreases and the property mix would have changed over that period[ii].

Same-Store Rents

We begin by evaluating same-store rents reported by Yardi, using effective rents reported at the unit type level for more than 52,000 properties and 10 million units[iii].

This shows a clear pattern: in relatively weak periods, including the height of lockdowns and again since the middle of 2022, Class A was by far the weakest performer and Class C the strongest. Conversely, when rents were accelerating most quickly, between year-end 2020 and the middle of 2022, Class A was the standout performer while Class C posted more tepid – if consistent – gains. Class B was consistently in the middle.

We believe that this can be simplified by saying that in loosening markets – periods where there is excess supply over net absorption or outright negative net absorption – Class C outperforms Class A. Conversely, in tightening markets – where demand outstrips supply – Class A fares relatively better.

Figure 1: Yardi Same-Store Rents by Property Class

Unit-weighted, December 2019 = 100%

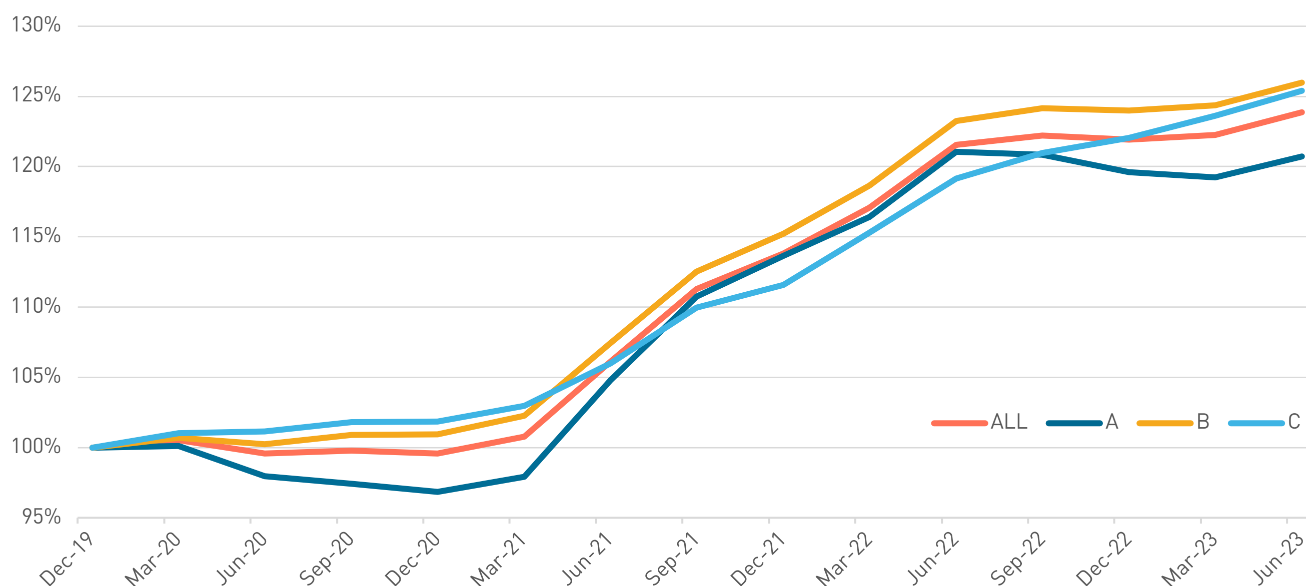


Table 1: Yardi Same-Store Rents by Property Class

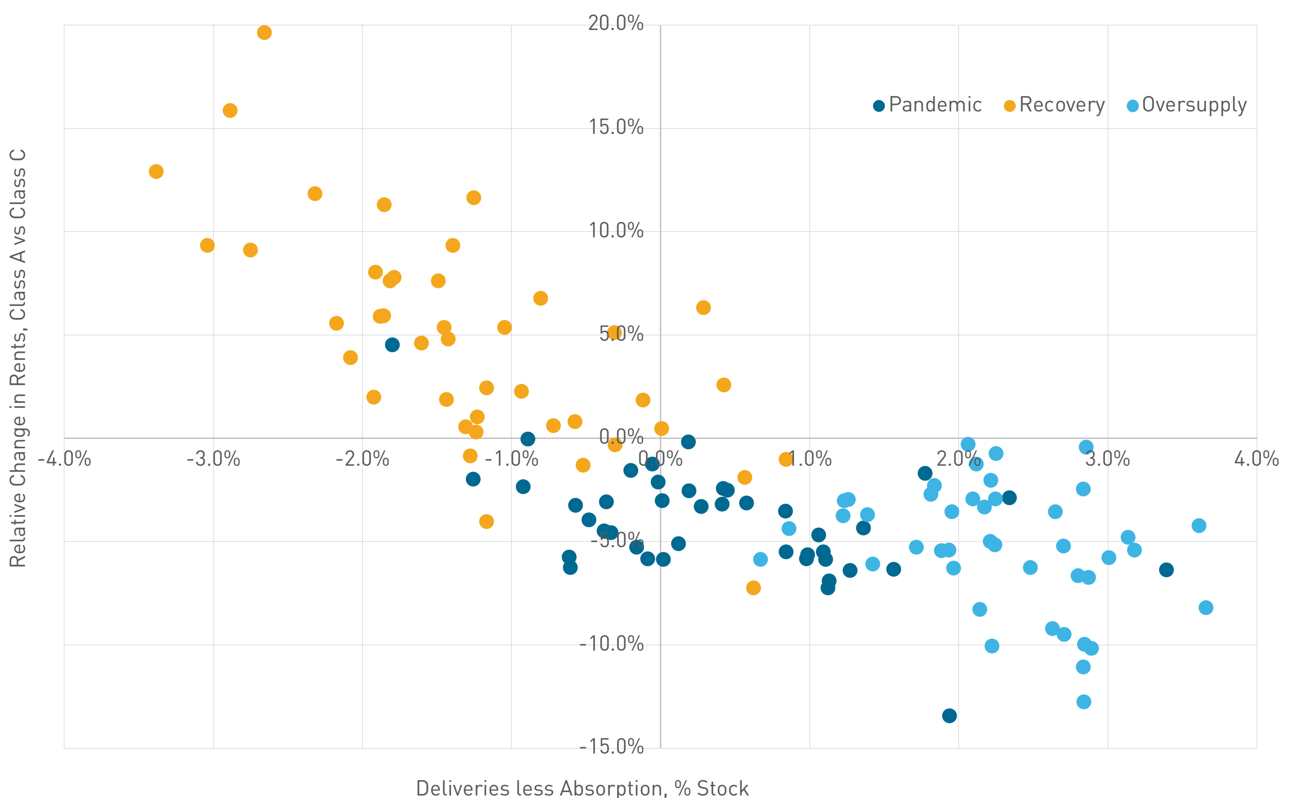
	Buildings	Units	Pandemic Dec '19 - Dec '20	Recovery Dec '20 - Jun '22	Oversupply Jun '22 - Jun '23
Class A	11,010	2,944,617	-3%	25%	0%
Class B	20,990	4,446,324	1%	22%	2%
Class C	20,401	2,840,909	2%	17%	5%
Total	**52,401**	**10,231,850**	**0%**	**22%**	**2%**

To further test this, we broke down performance by individual market and by sub-period and plotted the basis between Class A and Class C rent growth against the amount by which net absorption outpaced new deliveries. We utilized CBRE Econometric Advisors' market definitions and reported net absorption and deliveries[iv].

This reinforces the generalization that tightening periods and locations tend to favor Class A, while weaker areas and locations favored Class C. Overall, these paired observations showed a statistically significant relationship with a P-Value of <0.001% (i.e., >99.999% significance) and an R-Squared of 0.59 (i.e., 59% of variation explained).

Figure 2: Relative Class A Performance vs Excess Supply

Across time and markets



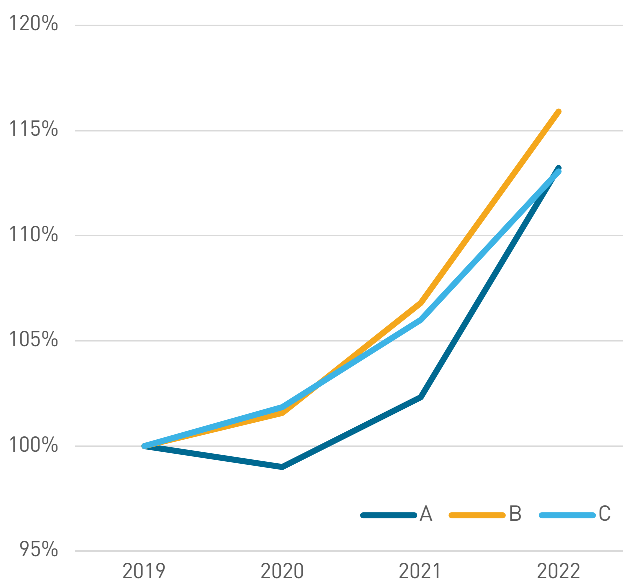
Property Performance

Of course, performance begins rather than ends with rent levels, so there should not be an expectation that rents alone dictate property income.

To maximize our vantage point on the market, we combined investor reporting across a large part of the multifamily universe – Fannie Mae data for DUS; Trepp data covering Freddie Mac, CMBS, and CLO; and our own in-house servicing data for other assets where we have visibility. Each property was only used once, and an advantage of our approach is that we can track same-property performance across refinancings and even ownership. This yielded a sample of nearly 12,000 properties[v].

The first chart depicts Effective Gross Income and generally tracks with our rental analysis, though this is based on full-year financials and is influenced by in-place leases. During the early stages of the pandemic,

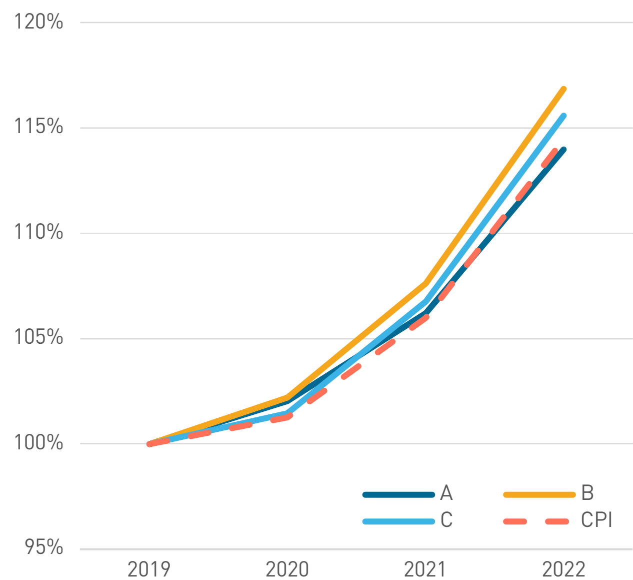
Figure 3: Annual Property EGI vs 2019
Same-Store, 2019 = 100%



Class A clearly lagged Class B & C;however, at the height of growth in 2022 it was the best performer.

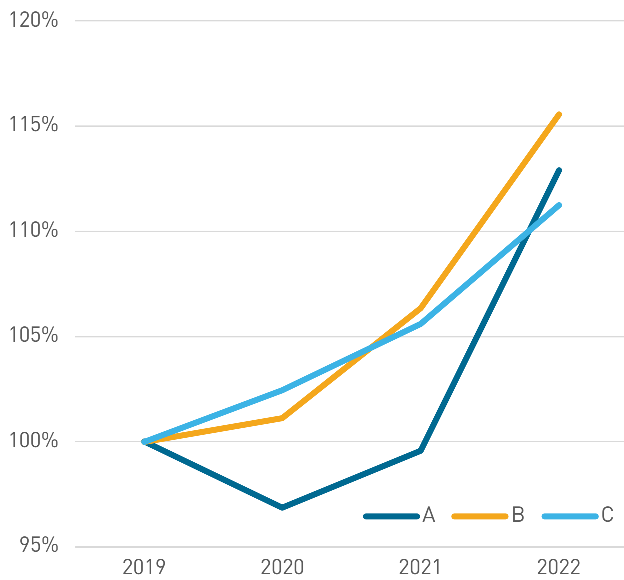
In the aggregate, property expenses showed much less differentiation. All three property types were closely huddled around annual CPI, though Class B did somewhat worse than the others.

Figure 4: Annual Property Expenses vs 2019
Same-Store, 2019 = 100%



Unsurprisingly, then, we can see that Class A showed outright declines in 2020 where Classes B & C posted increases, then showed the largest growth in 2022. Its overall performance was between Class B and Class C. From an investor's standpoint, at a high level we interpret this as Class A being the most exposed to systematic risk, without commensurately higher growth which would justify lower cap rates.

Figure 5: Annual Property NCF vs 2019



While the above underscores different sensitivities to systematic risks, we do see some justification for lower cap rates among higher property classes with respect to individual asset-level performance. The first three charts on the following page graphically show the ranges of performance among the property classes – the middle 50 percent denoted by the shaded boxes, and the “whiskers” the full range exempting outliers. This clearly demonstrates that Class A properties generally show less variability at a property level than Class B, and Class B than Class C, regardless of the environment.

Figure 6: 2020 vs 2019 Net Cash Flow[1]

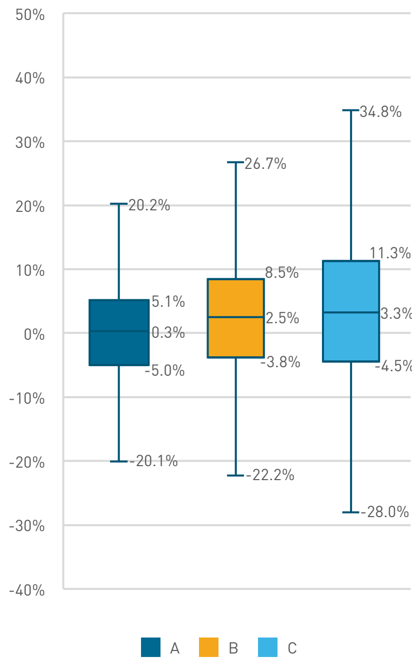


Figure 7: 2021 vs 2020 Net Cash Flow[1]

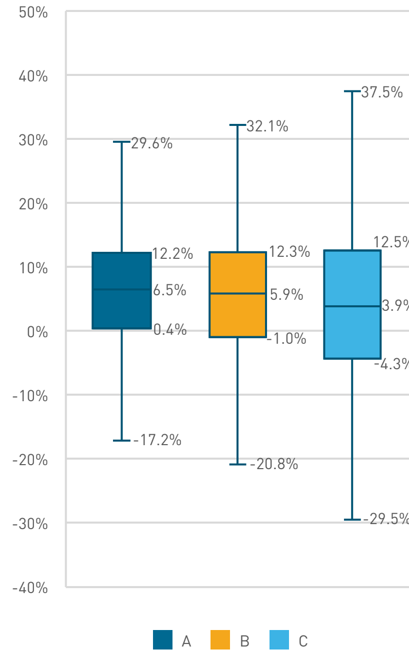
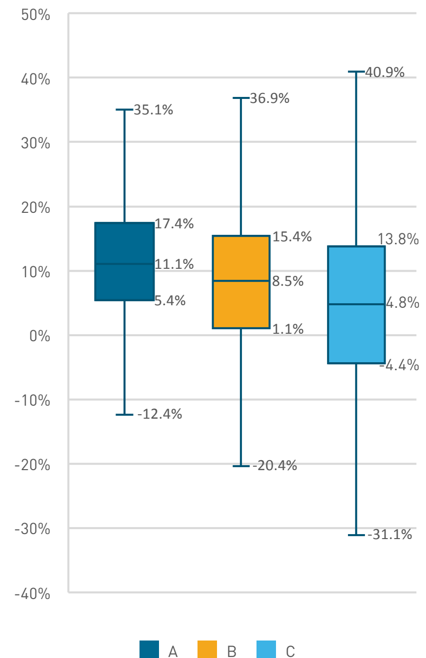


Figure 8: 2022 vs 2021 Net Cash Flow[1]



[1] 25th to 75th percentiles boxed; outliers removed

Table 2: Annualized Standard Deviation Over 3-Year Periods

	Ct	Revenue	Expense	NOI	Expense Ratio	Correl Rev Exp
Class A	1,460	4.5%	5.9%	8.0%	42%	0.29
Class B	4,460	4.5%	6.3%	8.8%	45%	0.27
Class C	2,076	4.5%	6.4%	9.8%	49%	0.25
Total	**7,996**	**4.5%**	**6.3%**	**9.0%**	**45%**	**0.27**

To validate this more formally, we evaluated pairs of financial statements through time after controlling for expected market influences – in spirit, like measuring the alphas on stocks. We controlled for expected market influence on revenues through a combination of rents and occupancy levels at the market level as reported by CBRE Econometric Advisors and controlled for inflation's impacts on expenses (see endnotes for more detail on method[vi] and population[vii]). We then measured residual variation.

This highlighted the following:

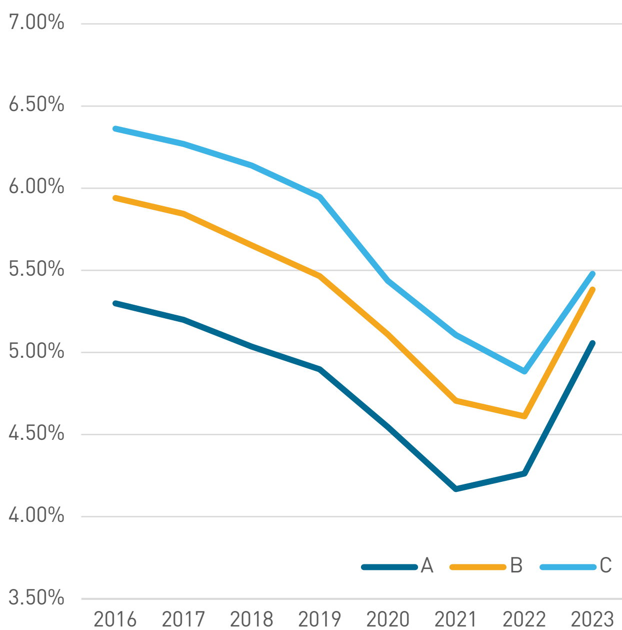
- For revenues, all property classes have about the same level of predictability;
- Expenses are inherently more volatile as we progress from Class A to C; and
- Class C showed the most variability in NOI, impacted by the previously mentioned expense variability. This is exacerbated by having higher operating expense ratios, and lower correlation between revenues and expenses[viii].

In other words, while Class A has been most vulnerable to macro market movements, "your results may vary" is especially true for Class C. But, as this idiosyncratic risk is diversifiable, it should become less important for the largest sponsors.

Property Valuation

We last look at cap rates, as reported in Real Capital Analytics' data[ix]. As shown below, the basis between Class A and Class C cap rates has been shrinking since the onset of the pandemic, from 100 to -110 basis points to just 42 basis points in 2023.

Figure 9: RCA Apartment Cap Rates, by Property Class



Through the period of the fastest appreciation, the conventional wisdom was that Class A cap rates could not reasonably go lower, so money was flowing into Class B and C properties in a desperate search for yield. Following this logic, with cap rates now increasing, we would expect less immediate pressure on Class C than Class A from higher interest rates, but that the entrants who were last to move into Class C might also be the first to exit or rotate into higher-grade product.

Alternatively, we speculate that investors may be questioning whether Class A deserves its trophy status after its lackluster results in the early stages of the pandemic and again today. As that 42 bps premium for Class A product still translates to an additional cost equal to 1.5 years of earnings[x] relative to Class C, it's fair to ask whether buying the trophy asset is still the winning investment strategy.

Conclusion

This analysis determined that over the past three and a half years, Class A has been particularly sensitive to changes in the underlying market.

Like a high-beta stock, it performed best when the market was most supportive, but returned relatively lackluster results when the market was under pressure – exhibiting the most systematic risk. This was shown to flow from rents being relatively susceptible to deliveries exceeding net absorption, and flowed down through property income. We expect that this is due to Class A having to compete with the latest deliveries, unlike Class C. Whether due to its luster wearing off or its leveraged returns have the least cushion to withstand higher interest rates, Class A's pricing premium has eroded to just 32 and 42 basis points versus Class B and Class C properties, respectively.

On the other hand, Class C shows the most property level uncertainty due to its higher and more unpredictable operating expenses.

The rational choice, then, is a function of expectations and portfolio size. Investors who are bullish on rental market fundamentals or who expect the basis in cap rates to revert to historical norms may favor Class A. Conversely, those less optimistic about the rental market solidifying its strong position versus single-family in the face of higher interest rates, or who fear an upcoming recession, may choose Class C – especially if they have a large enough portfolio to diversify away its expense volatility.

Investors without a strong view may find Class B the best balance, as it provides insulation from both Class A's sensitivity to new deliveries and Class C's tenant delinquency issues and property-level volatility. Through the full period studied, Class B provided the best cumulative performance measured by top-line rents and bottom-line net cash flow. This supports the adage of some participants that "Class B is the Place to Be."

In either case, Berkadia has the right teams in place, with unparalleled access to data, to help you formulate and execute your strategy.

Endnotes

[i] This was simplified to A, B, and C from the subgrades; e.g. B+, B, and B- were evaluated as Class B

[ii] For example, over a long period we'd expect to see a substantial shift from former Class A buildings to Class B as new stock is delivered. Also, analyzing the same properties over a long period of time would eliminate newer buildings from the analysis. We tried to maintain a same-store approach, to ensure there was no compositional influence and that measurements would best represent an investment held through the period.

[iii] Properties for which consistent data was available for same unit types. Class D Multifamily and dedicated student housing were excluded from this analysis.

[iv] We omitted any markets where we did not have at least 50 properties to analyze. This gave 43 markets with sufficient data to analyze.

[v] Based on annual, actual financials. Financials from all sources (Berkadia, Fannie Mae, and Trepp) run from property rather than loan-level. Includes only properties that could be mapped to Yardi grades. Student Housing omitted.

[vi] Beginning-period financials were compared against ending financials after adjusting for

- Rental Revenue: By relative changes in market rents and occupancy levels
- Other Income: By CPI and market occupancy levels
- Management Fees: By relative changes in market rents and occupancy levels
- Property Taxes: 3% outside CA; Greater of 2% or inflation in CA
- Payroll, Insurance, G&A, Advertising: By CPI
- All other expenses: By CPI and relative occupancy

[vii] This analysis was based on our Servicing data. To be relevant over an investment horizon, we used 3-year periods to balance sample size against reducing short-term noise. The population was adjusted to remove the smallest loans, and properties with dramatic swings in occupancy and/or revenues. Individual movements capped at ±50% to reduce influence of outliers.

[viii] All else equal, property NOI will be more volatile if revenues and expenses move in opposite directions versus moving together.

[ix] RCA closed sales of apartments with reported cap rates; portfolio transactions ignored; included where these could be joined to Yardi property improvement scores

[x] Class A 5.06% cap = 19.8x; Class C 5.48% cap = 18.3x

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