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CMBS Research

Inflection Point: What's Behind the Recent Uptick in Multifamily Delinquencies?

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Morningstar Perspective

Since hitting a postcrisis low of 0.30% in June 2018, delinquencies among multifamily loans packaged in commercial mortgage-backed securities have inched up to 0.40%, while delinquencies for all other CMBS product types have fallen. Several factors suggest that the multifamily delinquency rate, which is the lowest of the major property types, has reached an inflection point and will continue to slowly creep up, tempered by a lack of affordable options. Rent growth is slowing as new construction has rebounded to precrisis levels, and job growth may be stalling. According to the U.S. Bureau of Labor Statistics, three-month rolling average job growth fell to a near two-year low in July. In addition, student housing, nonagency loans, 2013-16 vintage loans, and loans in markets that are facing oversupply concerns are underperforming, while risk, as measured by declining underwritten debt yields, is rising.

For the purpose of our analysis, Morningstar Credit Ratings, LLC focused on $279.85 billion of multifamily loans. We removed $4.09 billion of cooperative apartment loans and $157.40 billion of loans without 2018 or 2017 12-month net cash flow figures from the $441.34 billion that comprises the multifamily CMBS universe.

Positive Fundamentals

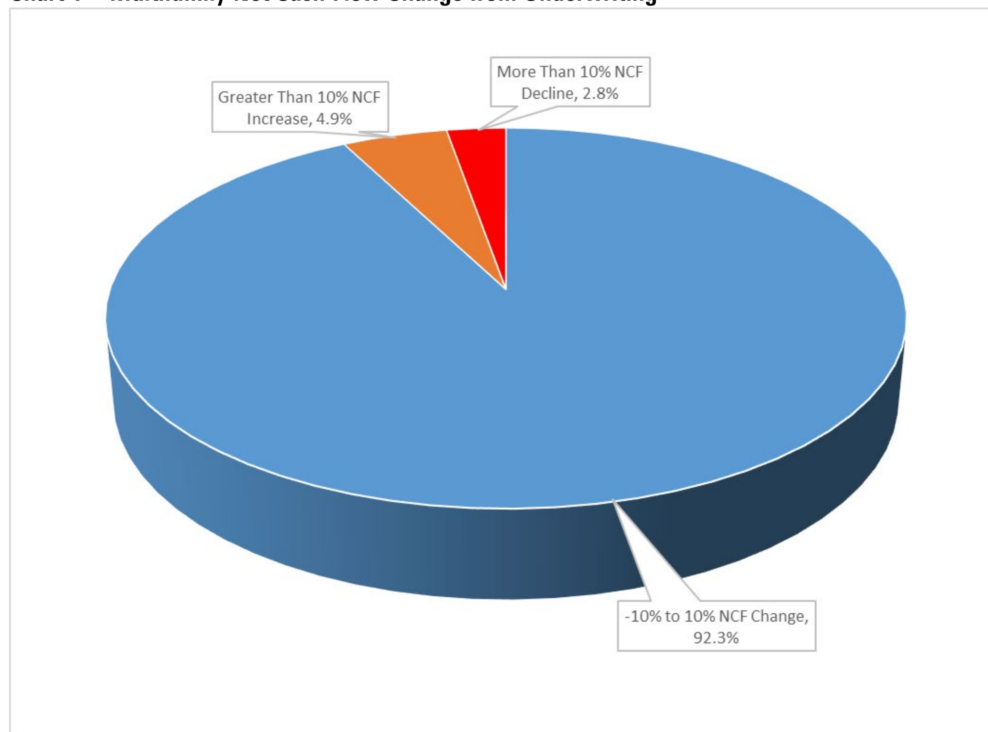
Among the property types backing loans in CMBS, multifamily is the most common, with more than $400 billion in outstanding balance, representing just over half of all CMBS outstanding. It has also been the best-performing property type over the past seven years amid the longest expansion on record. As continuing job growth, increasing demand from millennials, and the rising cost of

homeownership have all contributed to a surge in demand, performance of CMBS loans backed by apartments has rebounded to precrisis levels. Multifamily CMBS loans have the lowest delinquency, special servicing, and Morningstar Watchlist rates. These benchmarks have not returned to precrisis levels for the other property types.

The multifamily delinquency rate soared above the other property types during the last recession, topping out at 10.2%. But it began to recover earlier and declined at a faster pace. It now sits at 0.40%, well below the second-lowest 1.14% delinquency rate for industrial loans. Factors include swifter liquidation of troubled multifamily loans, CMBS lenders originating higher-quality multifamily properties, and surging employment growth.

Driven by healthy fundamentals, most multifamily loans are stable, with less than 3% by balance experiencing an NCF decline for the most recent 12-month period of more than 10% from underwriting (see Chart 1). That's impressive, considering that 17.0% of the overall CMBS universe reported more than a 10% NCF decline.

Chart 1 – Multifamily Net Cash Flow Change from Underwriting



Source: Morningstar Credit Ratings, LLC

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Strong apartment demand continues to push down the national vacancy rate, even with multifamily construction returning to its prerecession peak. More than 160,000 units were absorbed in the second quarter, which easily outpaced the 72,000 new units that were completed. The U.S. Census Bureau reports that the homeownership rate sank to 64.2% in the first quarter of 2019 from 69.2% in 2004. As a result, quarterly multifamily vacancy has improved or held steady for the past nine years, according to CBRE Econometric Advisors, and it reported a healthy vacancy rate of 4.3% for the second quarter of 2019, a level not seen since before the recession. Along with improving occupancy levels, the sector has experienced steady rent growth, with first-quarter national rents about 30% higher than first-quarter 2010 levels.

Slowing Demand

We believe that demand has begun to slow despite these positive fundamentals. America's working-age population is shrinking, increasing at less than half the rate of the rest of the population, according to a University of Virginia report. This demographic shift will tap the breaks on rent growth, which has already showed signs of slowing. While the year-over-year rental growth rate of 1.6% through July is slightly ahead of the 1.2% rate from this time last year, it still lags growth rates from 2014 to 2017, which ranged from 2.3% to 3.6%. The sector will benefit, however, from rent growth that is still well behind growth in average hourly earnings, which have increased by 3.2% over the past twelve months. Consequently, CBRE EA projects the national vacancy rate will begin inching upward at about 10 basis points per quarter as high inventory growth persists while employment growth remains positive but begins to weaken.

Pockets of Risk

While at first glance, the performance of multifamily CMBS loans appears stable, a closer look provides context to our outlook that delinquencies will continue to slowly rise. Below, we delve into performance by property sub-type, vintage, and metropolitan statistical area, as well as agency compared with nonagency loans.

Property Subtype

Lenders have shifted more of their multifamily funds to student housing properties, many of which have underperformed. The annual volume of student housing loans in CMBS has surged, rising to more than $2 billion in 2018 from about $100 million in 2010. With a total outstanding balance of $12.27 billion, ranking third behind garden and high rise, student housing appears least healthy among the multifamily subtypes with a balance of more than $1 billion (see Chart 2). The delinquency rate for student-housing loans more than doubled to 7.0% in June from 3.1% at the beginning of 2018. Further, student-housing loans have the largest percentage, 8.1%, posting a more than 10% decline in NCF from underwriting.

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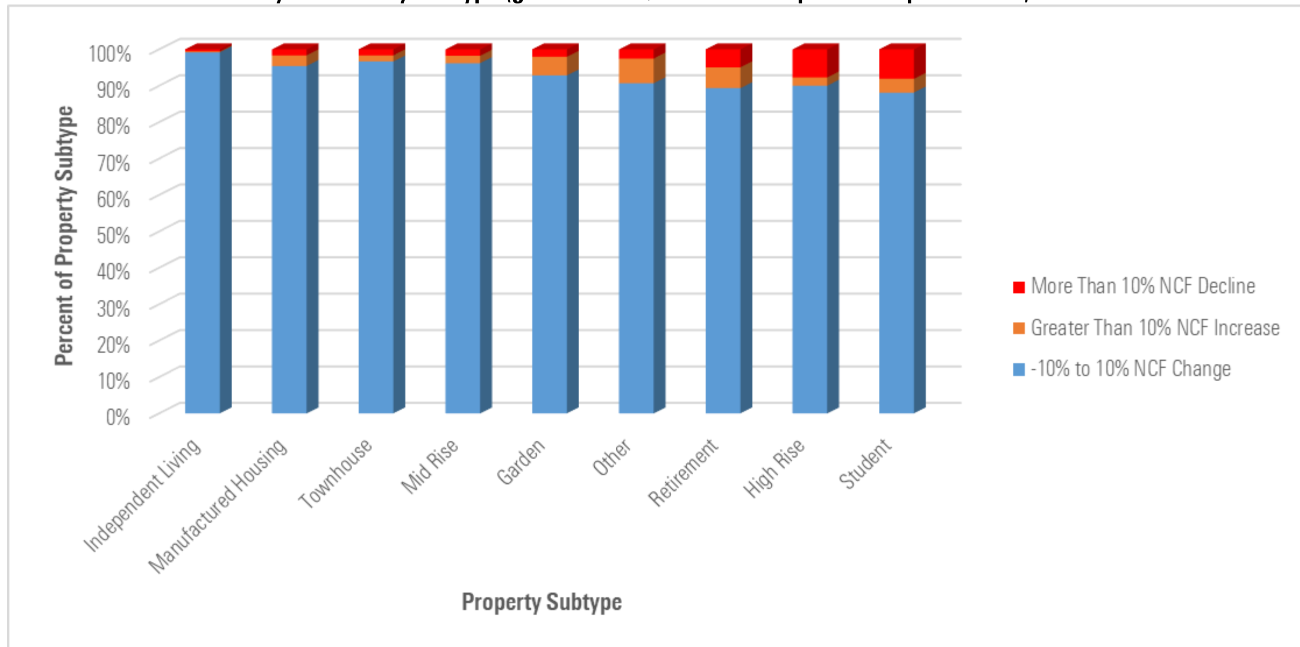
Chart 2 – Net Cash Flow by Multifamily Subtype (greater than $1 billion in Unpaid Principle Balance)



Source: Morningstar Credit Ratings, LLC

It's easy to see why student housing loans are experiencing higher declines in NCF, as student housing is the one of the most tenuous subtypes. The fate of such properties depends upon the policies and development plans of the universities that attract their tenants, competition that affects supply and demand, the whims of student tenants, and U.S. immigration policy.

Leverage on student-housing CMBS loans has risen more than other property subtypes over the past year, and cash flow typically is more volatile than for conventional apartments because student tenants are less likely to renew leases year after year. When cash flow falls so low that a loan is unable to cover debt obligations, these properties tend to fail swiftly.

One particular vulnerability for privately owned, off-campus student apartments concerns changes in school housing policies. To improve students' chances for academic success, more colleges and universities are requiring sophomores, as well as freshmen, to reside on campus. For instance, Ohio State University, one of the largest U.S. universities by enrollment with nearly 45,000 undergraduates at its Columbus campus, recently required sophomores to live on campus since 2016. We found about $153.4 million in student-housing loans associated with Ohio State University, none of which are on our Watchlist.

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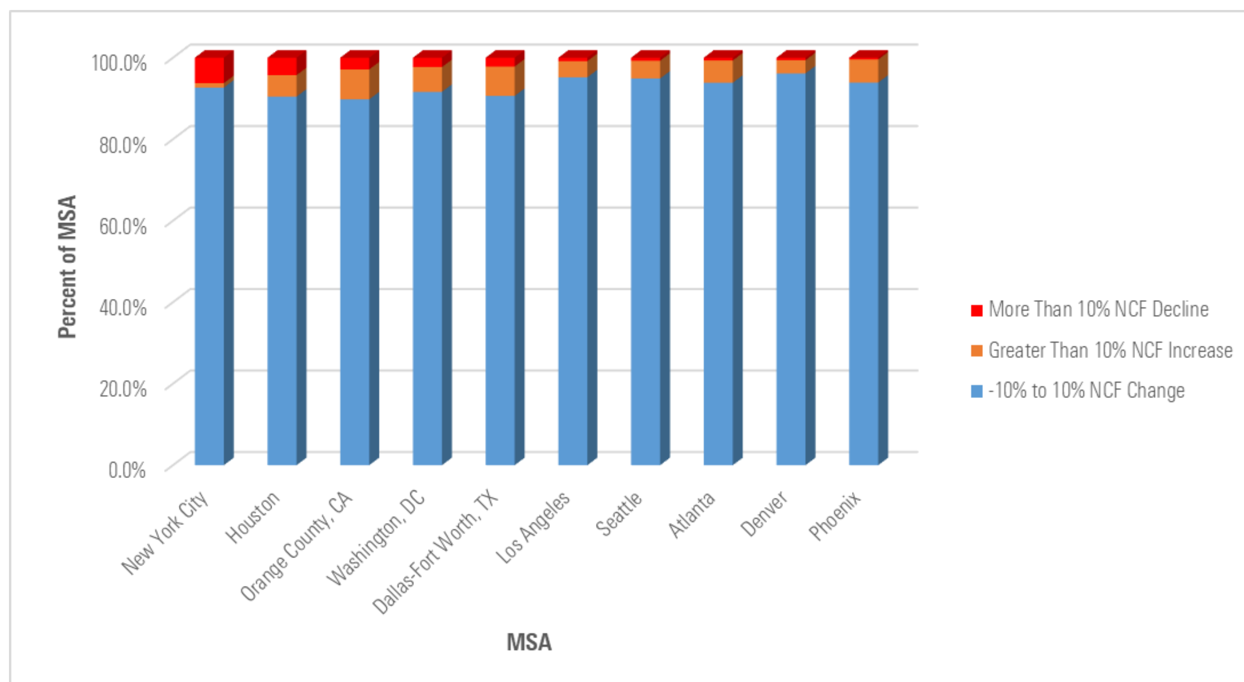
Off-campus student-housing is also feeling the pinch from declining international student enrollment because U.S. Citizenship and Immigration Services policy has become more restrictive, according to our research (What Happens to Student Housing When the U.S. Isn't First Choice Among International Students). This has contributed to rising vacancy rates, particularly at properties in noncoastal states.

Year of Issuance

Performance by vintage is stable, with no more than 4% of any vintage posting more than a 10% decline in net cash flow. Further, loans issued in 2013 and 2014 have outperformed, with more than 10% of these loans posting a greater than 10% increase in net cash flow (see Chart 3).

Chart 3 – Multifamily NCF Performance by Year Issued



Source: Morningstar Credit Ratings, LLC

Stable performance is only half the picture, though. As competition has intensified, loans issued more recently have become riskier, underwritten with even lower debt yields and higher leverage (see Chart 4). Following a rollercoaster ride from 2010 to 2014, during which the percentage of loans with an underwritten debt yield below 8% topped out at nearly 47% of 2013 originations, underwriting became more stringent in 2014 with just under one-third underwritten with a debt yield less than 8%. But underwriting became more aggressive in each of the past four years. More than 66% of multifamily loans were underwritten in

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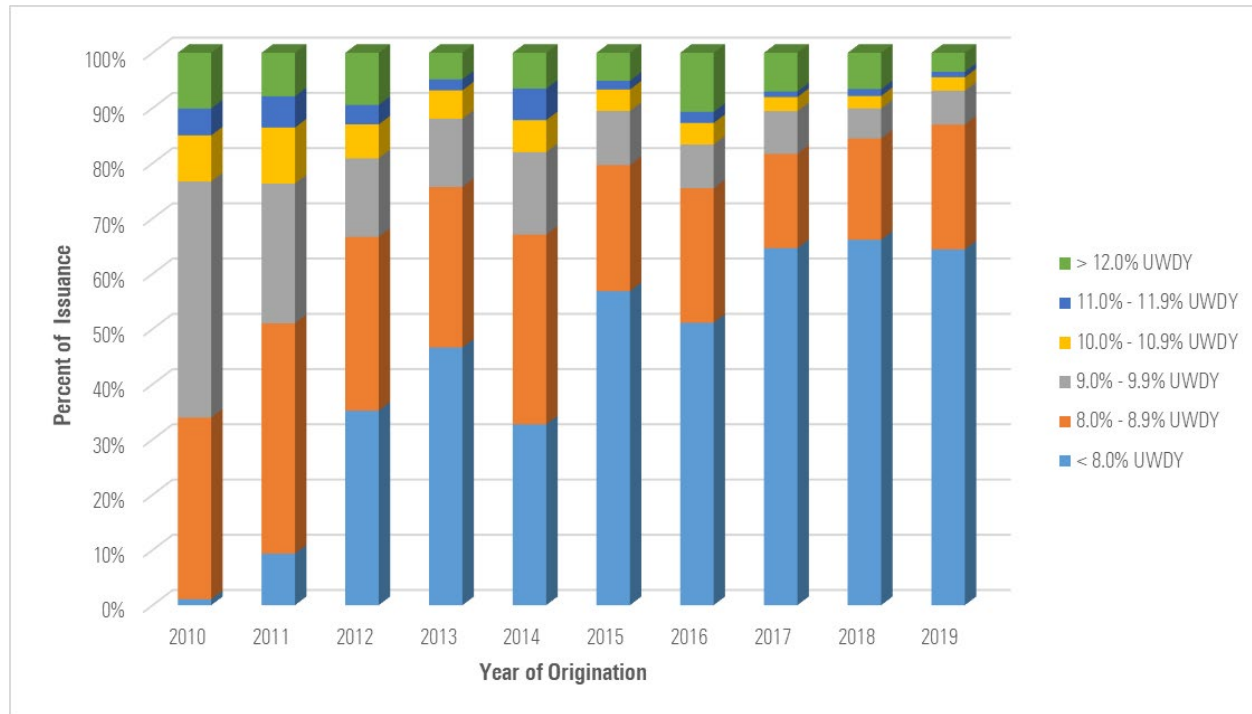
2018 with a debt yield less than 8% as lenders and issuers ramped up their competition for deals. While multifamily isn't typically considered a risky property type, lower debt yields are a concern because an economic slowdown is likely to hamper refinancing of loans in weaker markets.

Chart 4 – Multifamily Underwritten Debt Yield by Year of Origination



Source: Morningstar Credit Ratings, LLC

Metropolitan Statistical Area

While New York City is one of the most stable apartment markets in the nation with rent growth in 2018 reaching a three-year high of about 2.5%, along with a 2.0% vacancy rate as of June, according to CoStar Group, Inc., we found that 6.2% of New York City apartment loans reported a net cash flow decline of more than 10% (see Chart 5). But that decline may be more the result of an increased supply as more than 60,000 units have been delivered since the start of 2016. Further, its delinquency rate of 0.58% ranks lowest among the top 10 MSAs, leading us to believe that the 6.2% net cash flow decline is having little effect on New York City multifamily CMBS performance. The $212.2 million The Aire loan with pieces in JPMBB 2013-C17 and JPMCC 2013-C16, is the largest New York City loan of concern. The loan, which remains current, has been on our Watchlist since May 2018. Net cash flow dropped 22.6% from underwriting because the property's tax abatement expired, pushing the debt service coverage ratio below 1.00x.

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Among MSAs outside of the ten largest with $1 billion or more in multifamily exposure, Cleveland is the weakest, with about 10% of its $1.13 billion multifamily loan balance experiencing an NCF decline of 10% or more. Total net absorption is forecast to be a negative 2,565 units, lagging supply during the same period, which will hamper multifamily growth.

Separately, four markets in particular are facing significant supply risk: Boston; Charlotte, North Carolina; Miami; and Salt Lake City. Each of these markets has at least 8% of current inventory under construction, but they face contrasting outlooks. Boston has some of the most expensive housing stock in the nation, which is a positive for multifamily performance. Salt Lake City and Charlotte, on the other hand, have traditionally offered affordable homeownership, which is a negative for apartments. Of the four, Charlotte is performing the best with 12.7% of its multifamily loans by balance experiencing a 10% or more increase in net cash flow. Rent affordability is a plus for Charlotte, which reports median household income substantially above that recommended to afford a one-bedroom apartment, while Boston has a negative income gap of more than $3,000 that will likely squeeze renters out of an already tight market. Miami's strong employment growth, which, at 2.4%, exceeds the national average of 1.5% over the last five years, will continue to buoy apartment demand, which has lagged supply. But slowing construction will curb supply growth and hold the vacancy rate below 4%.

We expect high population growth markets like Albuquerque, New Mexico; Atlanta; Austin, Texas; Las Vegas; Phoenix; and Raleigh, North Carolina, to continue to perform well as they grapple with a shortage of affordable single-family housing.

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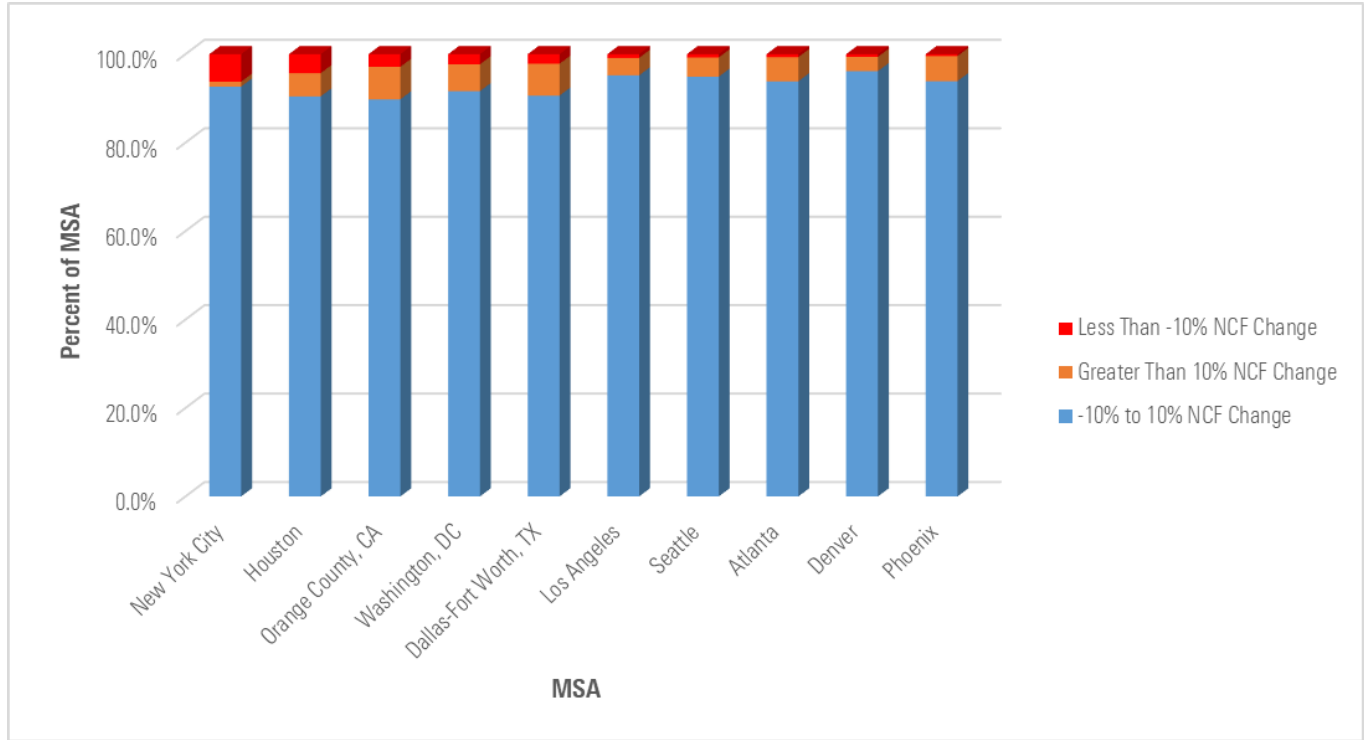
Chart 5 – 10 Largest MSAs Net Cash Flow Change



Source: Morningstar Credit Ratings, LLC

Nonagency Underperforms

Government-sponsored enterprises including Freddie Mac issue the majority of multifamily loans, about 84.1% of all CMBS mortgages on multifamily properties. With more attractive terms--including higher leverage, lower interest rates, and smoother execution--compared with conduit lenders, agencies can pick the best loans. The numbers confirm it, with just 1.7% of agency loans by balance seeing NCF decline by 10% or more, compared with about 7.0% of nonagency loans showing a similar decline (see Chart 6).

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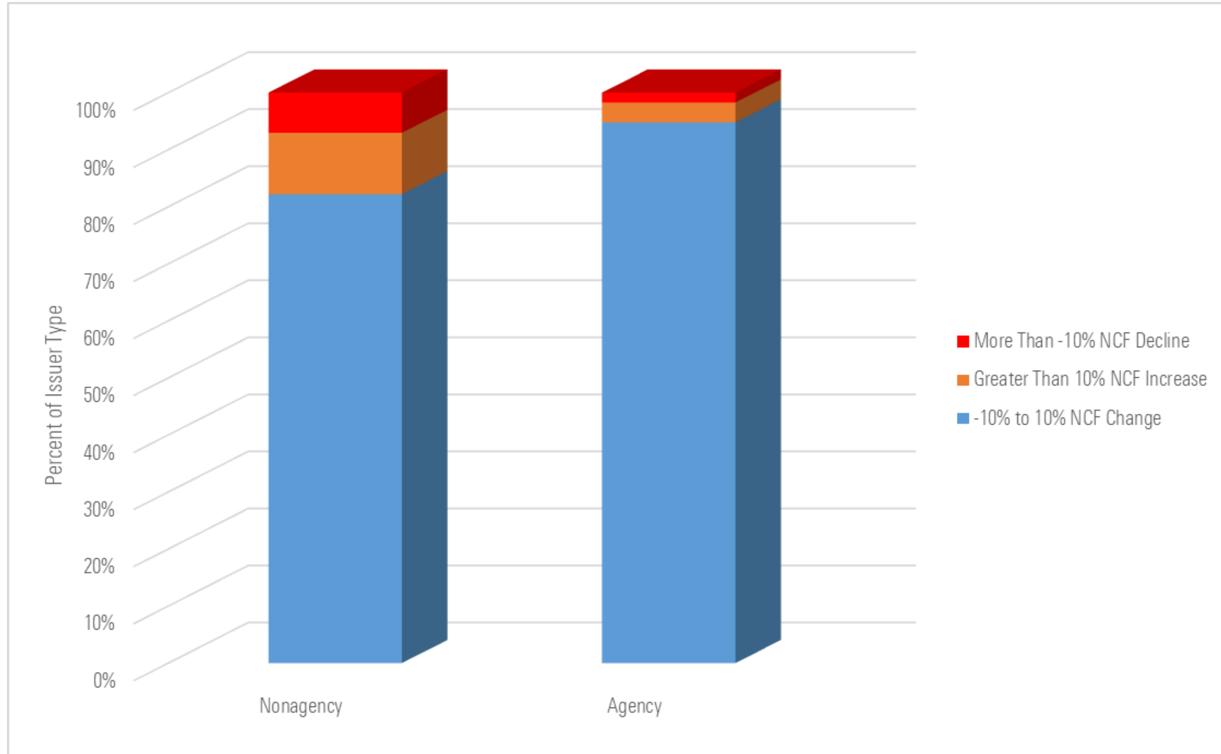
Chart 6 – Change in Multifamily Net Cash Flow: Nonagency vs. Agency



Source: Morningstar Credit Ratings, LLC

Continuing Demand Will Partly Offset Slowing Growth

Morningstar expects the multifamily CMBS delinquency rate to continue to inch higher resulting from a slowing economy and overbuilding. However, a shortage of other affordable housing options will buoy apartment demand even as job growth slows, which we believe will temper the rising delinquency rate.

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