REIT Research

Multifamily REITs Reduce Leverage and Development Pipelines as Fundamentals Downshift and Supply Peaks

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Key Takeaways

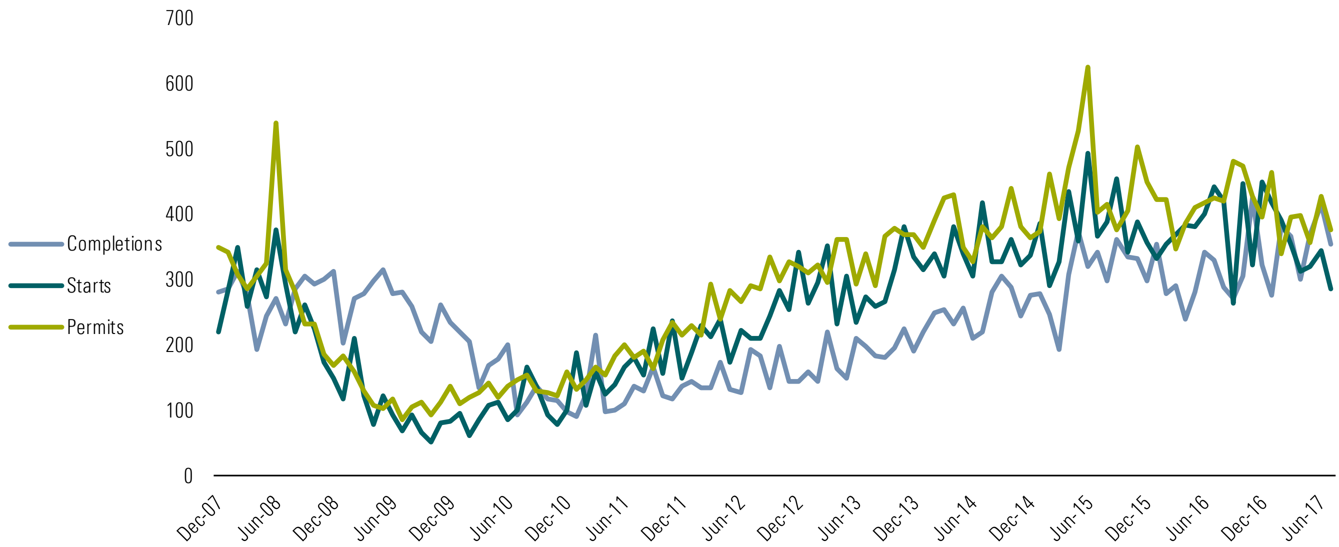
- Stronger credit profiles and balance sheets provide the multifamily REITs rated by Morningstar Credit Ratings, LLC with flexibility to withstand substantial market disruptions.
- New apartment supply is pressuring multifamily fundamentals, and REITs on average are lowering their exposure to new construction.

Morningstar Perspective

Morningstar expects net operating income among multifamily REITs to moderate after years of solid gains. Since 2016, NOI growth has slowed amid additional supply. As a result, multifamily REITs rated by Morningstar reduced their leverage and their exposure to new construction, positioning themselves for the impending completions and an environment where borrowing rates are expected to rise.

Rental growth among multifamily properties should be subdued for the next two years. While fundamentals remain sound, surplus inventory of new units likely will keep rent increases in check. New demand for apartments primarily comes from two groups: young people entering the workforce for the first time and others downsizing from owned homes, especially retirees. Generally, the retirees are more affluent than younger renters, as many have accumulated savings and proceeds from the sale of a home. An important factor supporting multifamily rental rates is the historically low level of homeownership. As of the second quarter, the U.S. homeownership rate stood at 63.7%, down from its prerecession peak of 69.2% set in 2004, according to the U.S. Census Bureau. Given the fundamentals, supply has burgeoned. Construction permits and starts of buildings containing at least five units appear to have peaked, as shown in Exhibit 1. Lenders and developers began to throttle back construction in 2015, and it will be at least two years before rent growth rates commence to accelerate again as completions have yet to peak.

Exhibit 1 – Permits, Starts, and Completions (Thousands of Units, Seasonally Adjusted Annual Rate)



Source: U.S. Census Bureau

Multifamily REIT Operating Income Expected to Moderate

Morningstar initiated ratings on six multifamily REITs: AvalonBay Communities Inc. (A-, Stable), Camden Property Trust (A-, Stable), Essex Property Trust, Inc. (BBB+, Stable), Equity Residential (A-, Stable), Mid-America Apartment Communities Inc. (BBB, Stable), and UDR, Inc. (BBB, Stable). These REITs experienced significant pressure on their fundamentals as a result of the last recession, similar to most other U.S. apartment landlords. Exhibit 2 illustrates the extent of the declines in property cash flows and same-property NOI (rental revenue less rental expenses for properties owned more than one year). Since bottoming in 2010, apartment REITs have seen increasing NOI averaging 6.2%, as conditions including low homeownership and solid employment conditions created a more favorable rental environment.

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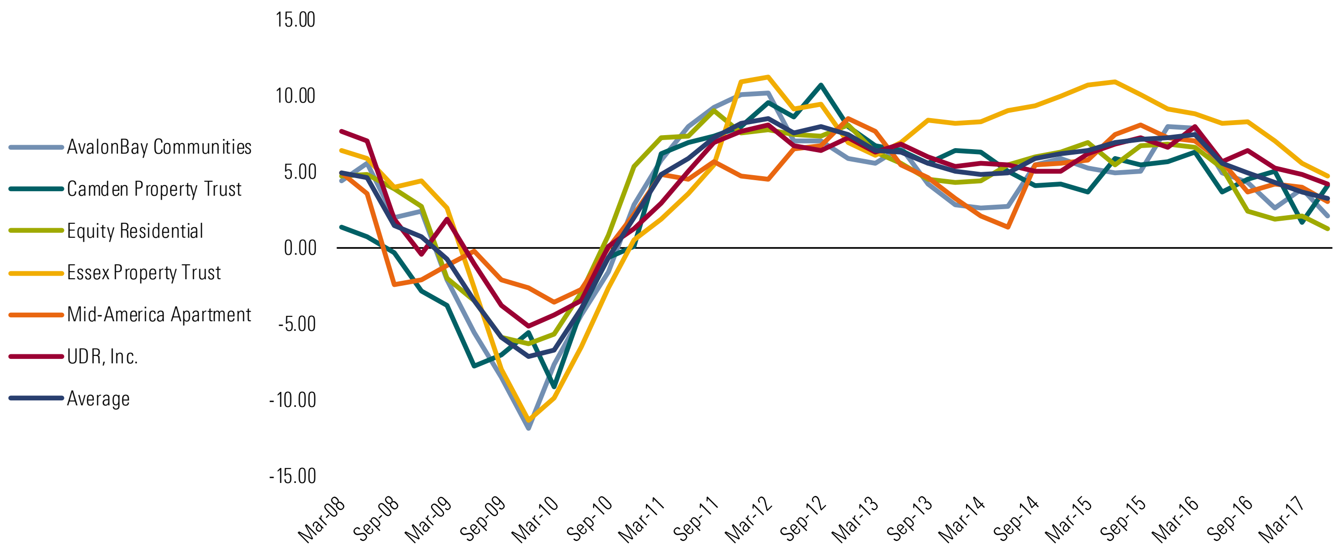
Exhibit 2 – Quarterly Year-Over-Year Percentage Change in Same-Property Net Operating Income (%)



Source: SNL, the companies, Morningstar Credit Ratings, LLC

As NOI growth slowed, the multifamily REITs covered by Morningstar trimmed their pipelines. As of the second quarter, development pipelines accounted for 10.2% of the Morningstar-rated REITs' gross assets, down from the peak of 13.0% two years ago. Similar to the majority of residential developers nationwide, these multifamily REITs reduced their exposure to new construction, given the economic and financial uncertainty at the time. This is evident for the years 2008 through 2010 in Exhibit 3 below.

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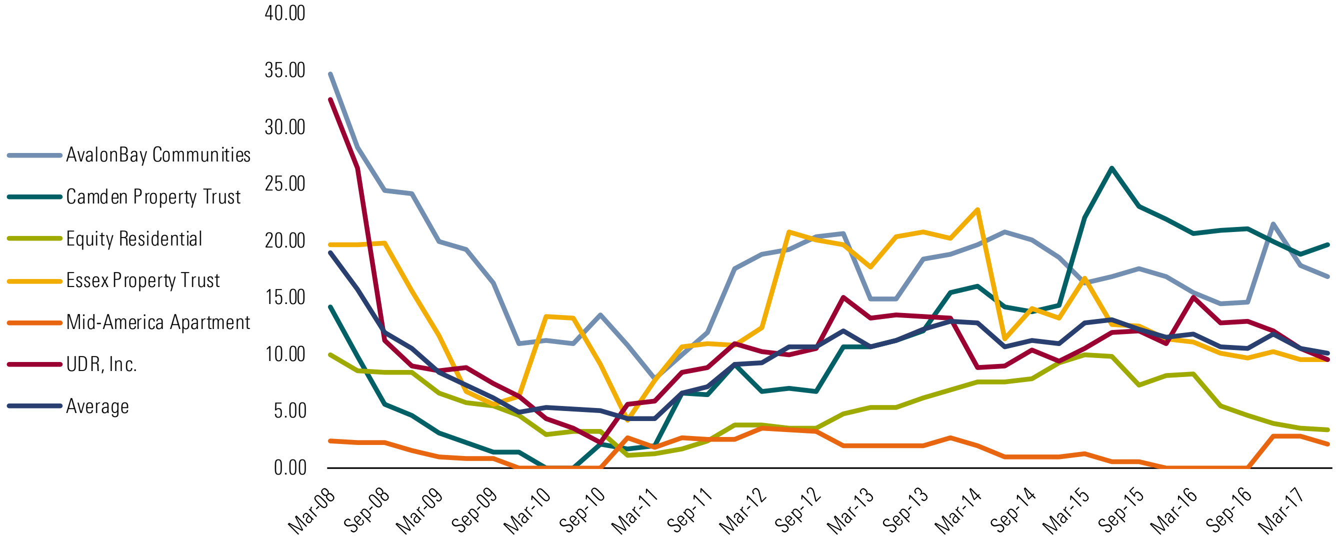
Exhibit 3 – Development as a Percentage of Gross Assets (%)



Source: SNL, the companies, Morningstar Credit Ratings, LLC

Shoring Up Balance Sheets

We anticipate the REITs rated by Morningstar to maintain leverage below recent years as protection against new supply, potentially peaking employment, and increasing interest rates. These REITs, which have been improving their balance sheets, are better insulated against weakness related to elevated supply levels. Debt relative to earnings before interest, taxes, depreciation, and amortization has declined, as shown in Exhibit 4. The average for these REITs decreased to 5.4 times as of June 30, from 6.7 times in 2012. In addition, average interest expense coverage rose to 5.3 times from 3.6 times over the same period, as seen in Exhibit 5. Another measure of leverage, debt as a percent of gross real estate, also dipped, as shown in Exhibit 6, with the average for the REITs rated by Morningstar declining to 36.8% as of June 30, from 45.2% at year-end 2012. We expect leverage metrics to stay near current levels, or possibly decline, until it is evident that new supply has peaked and NOI growth is poised to accelerate. We anticipate higher interest coverage as a result of lower leverage, which has been the case recently.

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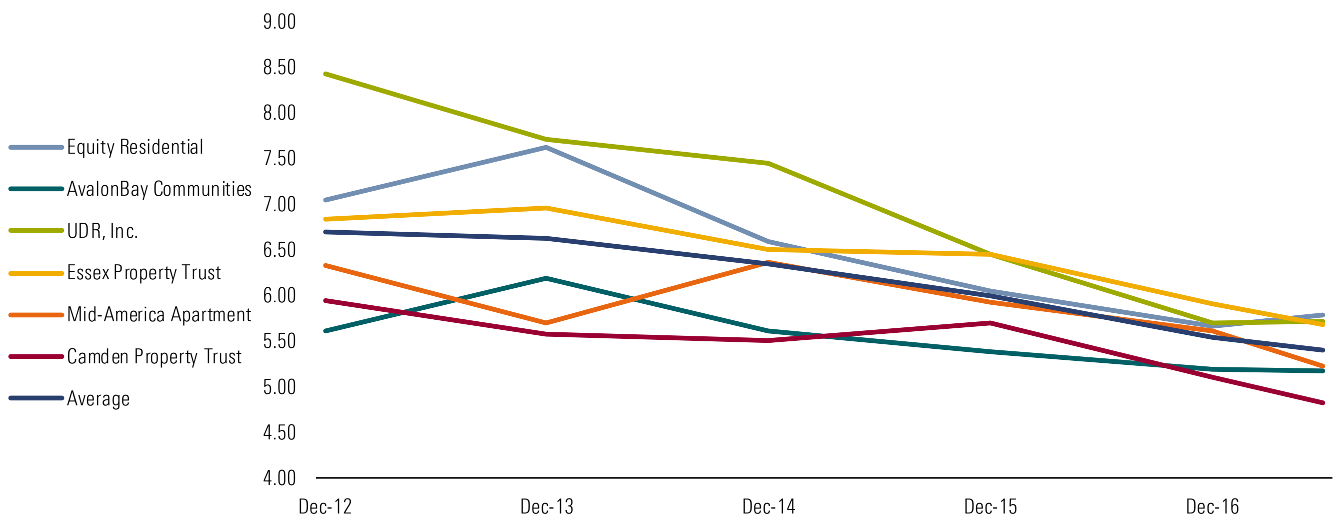
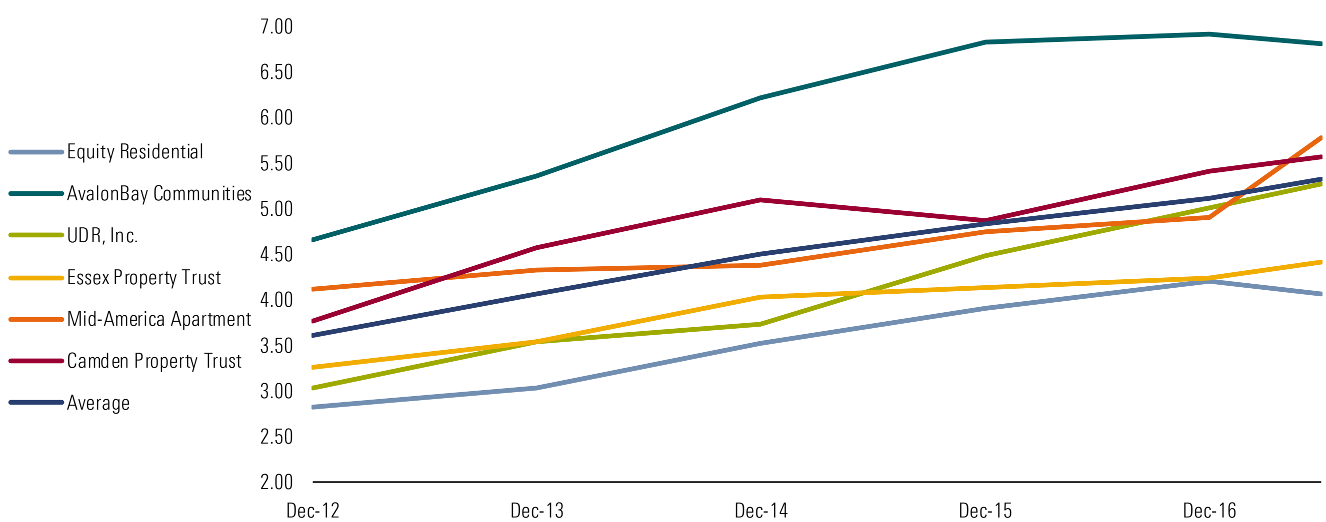
Exhibit 4 – Debt/EBITDA (x)



Source: SNL, the companies, Morningstar Credit Ratings, LLC

Exhibit 5 – EBITDA/Interest Expense (x)



Source: SNL, the companies, Morningstar Credit Ratings, LLC

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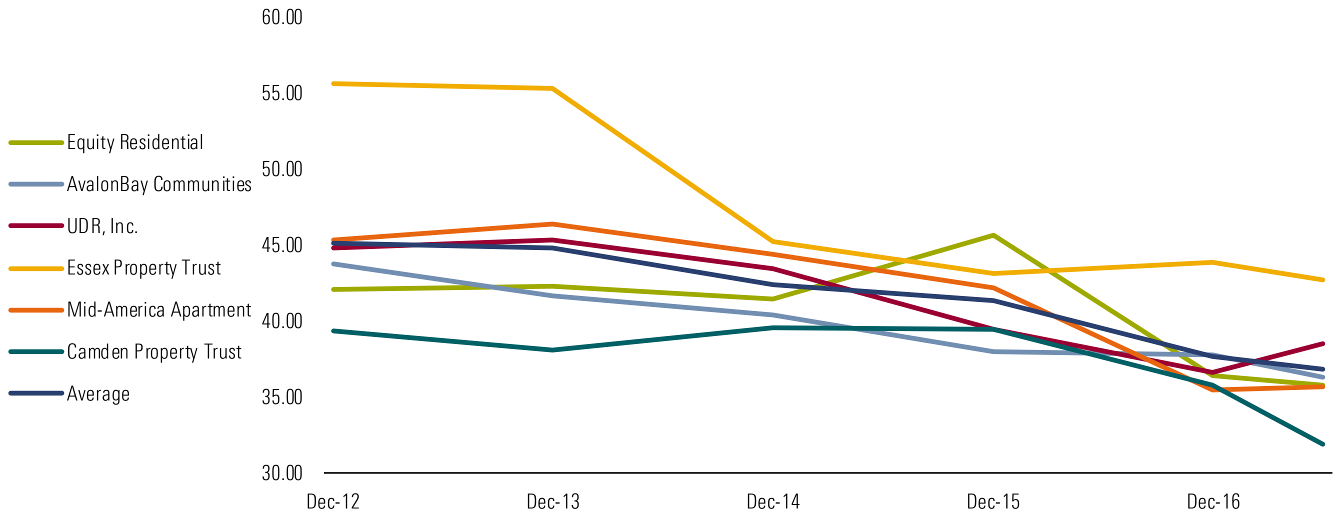
Exhibit 6 – Debt/Gross Properties (%)



Source: SNL, the companies, Morningstar Credit Ratings, LLC

Risks for apartment owners are at higher levels, as delivery of new units reaches cyclical peaks, fundamentals moderate and U.S. borrowing rates are expected to climb. With healther balance sheets and lower construction pipelines, the multifamily REITs rated by Morningstar are prepared for these potential difficulties.

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