

# Playing Defense And Preparing for Opportunity

## Why the Multifamily Recovery Cycle Requires Patience, Discipline and Liquidity

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### 1. Executive Summary

There has been an interesting disconnect developing in the multifamily market over the last few months. After several difficult years, apartment fundamentals are finally beginning to improve. National occupancy has recovered to 95.5%, annual rent growth has turned positive again, and the enormous wave of new apartment deliveries that pressured rents and occupancy in many markets is finally beginning to subside. Those are all encouraging signs.

Unfortunately, improving fundamentals don't immediately translate into improving cash flow or investor returns. Operating expenses remain elevated, concessions are still significant in many markets, workforce renters continue to face affordability pressure, and interest rates remain high. Property values also remain well below their peak in many markets, while refinancing proceeds are often significantly below the debt they are replacing.

At the same time, financial distress is increasing, particularly among properties acquired near the peak with short term or floating rate debt. This creates an unusual environment where we may be approaching one of the more attractive multifamily acquisition periods we've seen in years while simultaneously working through one of the more challenging operating environments we've also seen in years.

At CALCAP, that means we have to be prepared to do two things at once. Our first priority remains protecting the portfolio we currently own, aka "The Golden Goose," and the capital our investors have already entrusted to us. That means protecting cash flow, improving economic occupancy, reducing bad debt, controlling expenses and creating liquidity wherever possible. At the same time, we need to prepare for opportunities that may emerge as overleveraged capital structures finally force good assets to come to market.

We aren't declaring victory on the existing portfolio, and we're not going to manufacture acquisitions simply because we believe the cycle is turning. The next phase will require patience, liquidity and the discipline to recognize when the right opportunity actually arrives.

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### 2. The Recovery Is Real, But It Is Still Early

For the last several years, the multifamily industry has been waiting for "the recovery," and I think we're finally beginning to see it. National apartment occupancy reached 95.5% in the second quarter and remained there in August. Same store effective asking rents increased 0.9% from a year earlier in August after annual rent growth turned positive in July. Perhaps more importantly, annual apartment deliveries have declined dramatically from their late 2024 peak as the historic construction pipeline finally begins to clear. Census data reinforces

that trend, with multifamily completions slowing to a seasonally adjusted annual rate of approximately 302,000 units in August.

For owners who spent the last several years competing against thousands of brand new apartments offering significant concessions, this is welcome news. But the recovery isn't occurring evenly. Some markets are recovering quickly while others are still absorbing excess supply. Concessions remain elevated, particularly across some of the Sunbelt markets where much of the construction boom was concentrated, and modest rent growth doesn't immediately repair several years of increasing operating expenses.

The industry tends to focus heavily on headline rent growth and physical occupancy, but as an owner I care much more about what ultimately makes its way to the bottom line. A property can be 95% physically occupied and still struggle if collections are weak, concessions are high and operating expenses continue to rise. That is why we remain intensely focused on "economic occupancy," not simply whether a unit is occupied, but whether the rent is actually being collected.

The fundamentals are improving, but there is still a lot of blocking and tackling required before that improvement fully translates into cash flow.

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### 3. The Hard Part of the Recovery

One of the lessons of this cycle is that revenue can recover much faster than NOI. Over the last several years, insurance, property taxes, payroll, repairs and maintenance, utilities and other operating costs have all increased. At the same time, many workforce housing residents have been dealing with their own inflation problem as food, insurance, gas, utilities and virtually everything else has become more expensive.

That creates what I think of as an affordability ceiling. The traditional value-add multifamily model was relatively straightforward: buy an older apartment community, renovate the units, improve the amenities and increase rents. For many years, strong rent growth and inexpensive debt made that strategy extremely profitable. I don't think the value-add model is dead, but I do think it has changed and is much more market dependent. At some point, it doesn't matter how nice the flooring and countertops are. The resident still has to be able to afford another \$150 or \$200 per month (although the rent control folks will have you believe landlords can charge whatever they want--but that's another story).

In today's workforce housing market, value creation is increasingly about basis, disciplined underwriting, resident retention and operations, and less about assuming every renovation will generate an outsized rent increase. Sometimes the best investment in a property isn't another quartz countertop, but rather reducing turnover, improving collections, renegotiating an insurance policy, reducing water consumption, keeping a good resident for another year or simply making sure the property team executes the business plan every single day.

None of this is particularly exciting, but neither was apartment investing for most of its history. As we wrote last quarter, multifamily has returned to its "get rich slow" roots. Value has to be earned again.

## 4. Protecting the Golden Goose

At the beginning of this year, we described our strategy as Protect, Prune and Position, and Protect remains first for a reason. Investor distributions across much of the multifamily industry remain below the levels investors became accustomed to during the previous cycle, and our portfolio is not immune from the operating pressures affecting the broader market. Our job isn't to pretend otherwise. Our job is to constantly work to improve it.

That means focusing relentlessly on sustainable cash flow. We are targeting economic occupancy above 90% across the portfolio, with particular attention to delinquency, bad debt and resident retention. Retention is key because the cost of a resident leaving gets very expensive. Between lost revenue, marketing and turnover costs, a vacant unit can cost \$3,000 to \$5,000, and potentially much more if the vacancy involves a lengthy and costly eviction.

We continue to scrutinize every controllable expense while recognizing that some costs, particularly insurance, taxes and utilities, have structurally reset higher. On the positive side, we have begun to see insurance costs come down. We have also seen lenders, including the Agencies, become much more assertive in examining a property's condition and mandating expensive capital repairs.

We continue to evaluate every asset individually. Some properties deserve additional capital and time, while others may have reached a point where selling or refinancing creates greater value by unlocking liquidity and reducing risk across the broader portfolio. That is the "Prune" part of the strategy, and it is every bit as important as finding the next acquisition, although admittedly more difficult to execute given current market conditions.

There is always a temptation at this point in a cycle to focus on "the next deal." New acquisitions are exciting; working through an existing portfolio isn't. But protecting the assets you already own is what ultimately gives you the ability to take advantage of the next opportunity. You don't get to play offense later if you exhaust your balance sheet playing defense today.

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## 5. The Other Side of the Market: Capital Structure Distress

While apartment fundamentals are beginning to improve, financial distress is moving in the opposite direction. The distress rate among CRE CLO loans jumped from 19% in July to 28% in August, with much of the stress concentrated in loans originated during 2021 and 2022.

Those were peak acquisition years when values were high, rent growth assumptions were aggressive and bridge debt was readily available. For several years, borrowers and lenders found ways to postpone the inevitable. Owners contributed additional equity, purchased new rate caps and modified business plans, while lenders extended loans. Everyone essentially had the same hope: buy enough time for interest rates to decline and property fundamentals to recover.

The property fundamentals are finally beginning to cooperate. Interest rates haven't.

That matters because a recovering property doesn't necessarily fix an overleveraged capital structure. A property may be 94% occupied with rents beginning to grow again, but if it was purchased at the peak with highly leveraged short-term debt, today's NOI may still not support the amount required to refinance the existing loan. The Mortgage Bankers Association estimates that \$875 billion of commercial mortgage balances

are scheduled to mature in 2026. Within multifamily specifically, approximately 13% of outstanding mortgage balances are scheduled to mature this year.

This is where the next phase of distress will increasingly occur. Not necessarily because the apartment property is bad, but because the capital structure can no longer be supported.

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## 6. Good Real Estate, Bad Capital Structures

When I started CALCAP in 2008, we were in the middle of the Global Financial Crisis. Properties were distressed, lenders were distressed and credit markets were effectively frozen. Eventually, that combination created some extraordinary buying opportunities.

This cycle has been different because the distress has developed much more slowly. First came valuation distress, as the interest rate shock pushed cap rates and borrowing costs higher and caused property values to fall. Then came operational distress, as record new supply in many markets brought concessions, pressure on rents and higher vacancy while operating expenses continued to rise. NOI was being pressured at exactly the same time cap rates were expanding. Not good.

Now we're increasingly seeing the third stage: capital structure distress. The distinction is important because I've said for a while that the next great multifamily buying opportunity wouldn't necessarily come because apartments became a bad business. It would come because falling values, several years of difficult operations and overleveraged capital structures eventually forced fundamentally good assets to change hands.

For us, that creates a very different underwriting question. We aren't simply looking for "distressed real estate." We are looking for good real estate where the seller's capital structure has created an attractive basis for the next owner. That means properties in markets we understand, with sustainable resident demand, realistic rents, manageable capital needs and debt that works based on today's cost of capital, not the hope for a future rate cut.

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## 7. Positioning With Patience

We believe attractive acquisition opportunities are developing, but that doesn't mean we know exactly when they will arrive, how many there will be or whether every distressed situation will represent a good investment. There is an important difference between seeing an opportunity developing and feeling compelled to act immediately.

Distressed deal flow will determine one side of the equation, while the availability and cost of equity capital will determine the other. Both have to work. We aren't interested in raising capital simply so we can say we're deploying it, and we aren't interested in buying assets simply because they trade at a discount to 2021 values.

The basis has to make sense. The debt has to produce positive leverage. The property has to generate sustainable cash flow under realistic assumptions, and the return has to justify the risk without relying on aggressive rent growth, cap rate compression or a dramatic decline in interest rates. When those opportunities arrive, we want to be positioned to act on them. If they don't, patience is also a strategy.

One lesson I've learned over three decades in the apartment business is that you do not have to catch the exact bottom of a cycle to make a good investment (and it is very difficult to do). You need to buy at a basis that makes sense, finance it appropriately and conservatively, operate it well and give the investment enough time to work. Owning apartments has always been a fantastic creator and protector of wealth.

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## **8. Conclusion: Doing Both at Once**

The multifamily market is entering an unusual phase. The supply picture is improving, occupancy is recovering and rent growth has turned positive, so the operating environment finally appears to be moving in the right direction. At the same time, the financial consequences of the last cycle are still working their way through the system.

That means the next 12 to 24 months will require disciplined operators to do two things simultaneously: protect the portfolio they already own while preparing for opportunities created by owners who have run out of time and capital. When I started CALCAP in 2008, we didn't have an existing portfolio to protect and could focus entirely on the opportunities the distress created. This time we have to do both.

At CALCAP, our first responsibility remains clear. Protect the portfolio, improve cash flow, preserve liquidity and make thoughtful decisions about every asset and every dollar of capital. At the same time, we have to prepare for fundamentally good opportunities as properties begin trading because their existing capital structures no longer work. We want relationships, liquidity, operating infrastructure and capital partners in place to act when the right opportunity presents itself.

The recovery is beginning, but the work isn't finished.