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Multifamily Media Frenzy

Apartment investments still rule the front page.

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Multifamily Media Frenzy

Apartment investments still rule the front page.

by Rich Rosfelder

We've all seen the headlines: "Apartments Shine as Beacon of Hope" and "Multifamily Sales Defy the Slump." National newspapers, industry blogs, and local business publications, among others, have joined in a chorus singing the praises of apartment investment opportunities throughout the country.

"Multifamily investments have received a lot of good press over the past several years, and this has attracted more money — and more investors — into the mix," says Jeff Siebold, CCIM, MAI, owner of Siebold Group Consulting in Caswell Beach, N.C.

Of course, this trend is the result of more than just the media frenzy. "The key [to multifamily's success] in today's market is net income or dividend to investors with upside potential, which is creating solid risk-adjusted returns," says Kenneth P. Riggs Jr., CCIM, CRE, MAI, CCIM Institute's chief real estate economist and president of Real Estate Research Corp.

And, compared with other sectors, apartments have shorter lease terms that allow for rent bumps as the economy grows. These factors, coupled with a large number of former homeowners entering the rental market, are making multifamily the go-to investment product right now, Riggs says.

For the last few years, apartment investment activity has mostly been concentrated in primary markets. And, in terms of volume and pricing, they're still leading the pack. New York, Los Angeles, Washington, D.C., Atlanta, and Dallas saw a combined 1H2011 transaction volume of more than $7.9 billion, according to Real Capital Analytics.

The increased competition has pushed average class A capitalization rates in primary markets down to the 4-percent-to-4.5-percent range, with some markets reporting cap rates below 4 percent, according to Marcus & Millichap.

The star sector's overexposure, manifested in the cap rate compression and the pricing rebound, has kept all but the largest institutional investors and real estate investment trusts from competing for assets in primary markets. And even these investors are now searching for alternatives.

"Some REITs are buying land to build apartments," says Ben Thypin, RCA's director of market analysis. "It would be more common if more land were available in markets like New York and San Francisco."

But since land is a limited resource — especially in densely populated primary markets — multifamily investors have been forced to look for opportunities elsewhere. This is the story behind the story. It might not be garnering a lot of headlines, but it is good news for CCIMs.

Small Markets See Influx

Siebold, whose company works in nine states in the Mid-South region, has seen

many regional markets bounce back relatively quickly after the downturn. "With many major cities strengthening and institutional investors paying premium prices for the best multifamily assets, there are a number of investors and developers looking at secondary and tertiary markets," he says. "Cities like Little Rock, Ark., Jackson, Miss., Mobile, Ala., Wilmington, N.C., and others have seen renewed interest over the past several years."

In 1H11, institutional investors accounted for a large share of purchases in secondary markets such as Charlotte, N.C., Orlando, Fla., Austin, Texas, and Seattle, as well as some tertiary markets in the Mid-Atlantic and West regions, according to RCA. REITs and equity fund managers looking for yield are also beginning to target secondary markets, Thypin says. "The general movement is a reaction toward competition in primary markets," he adds.

But even in secondary markets, it's becoming increasingly difficult to dodge the falling cap rates. "Oklahoma City has seen the trophy assets trading at 6 percent cap rates as more buyers are being priced out of the core markets," says Andrew Joseph Burnett, CCIM, investment adviser with Sperry Van Ness/Strange & Associates in Oklahoma City. "The solid class B properties are beginning to trade at cap rates approaching 2007 values, though C properties are still not trading as Fannie and Freddie have been reluctant to enter that asset class."

Capital is key. And for many small investors, which are more likely to consider class B and C properties, Fannie Mae and Freddie Mac have been the only source for the last few years. But other lenders are beginning to give them a run for their deals. Multifamily loan originations increased 47 percent from 1Q11 to 2Q11, according to the Mortgage Bankers Association, and a significant portion of those loans were from regional and local banks, as well as life insurance companies.

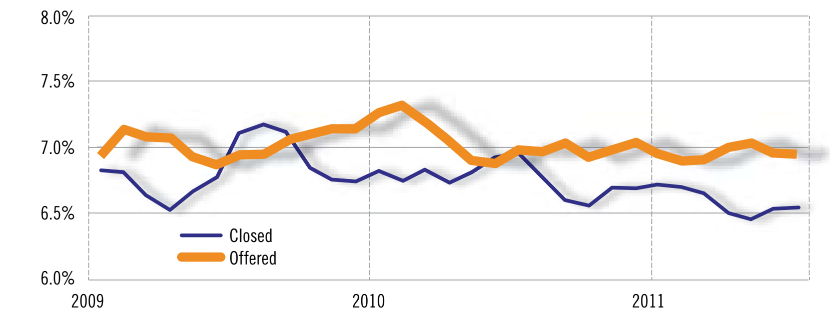
"Financing is very competitive," says Shahid Abdulla, CCIM, vice president of Broadway National Bank in San Antonio. In Abdulla's market, which is attracting out-of-state investors searching for relatively high yields, it's not uncommon to see pricing at 200 basis points over the London interbank offered rate, or LIBOR, with burn-off guarantees. "Strong banks and life companies all have issues with placement of their cash, so the spreads of have come down significantly and will continue to be trimmed until development picks up," he says. "We're also seeing life companies get pretty skinny on pricing and gain traction in replacing the GSEs for pricing and structure."

Credit unions, which all but vanished during the downturn, are also re-emerging as a potential funding source. "At least two of our largest credit unions have been extremely aggressive in their attempt to expand their lending portfolios," says Erik Olson, CCIM, senior adviser with NAI Maestas & Ward in Albuquerque, N.M. "We are seeing 70/30 LTVs and 4.75 percent fixed rates for five-year loans for multifamily and commercial assets."

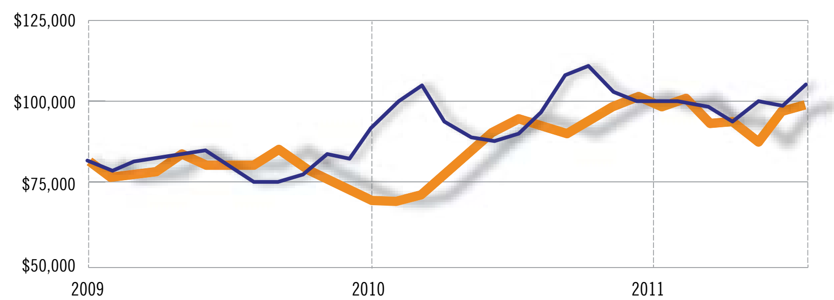
Olson is working with an investment group that's considering 75-plus-unit, class B and C apartment properties with a 7.5 percent cap rate return for purchase. "The interesting component is that a 7.5 percent cap rate has generally been the trading rate for institutional, class A properties," he says. "The lowering of investor expectations on the

MULTIFAMILY BY THE NUMBERS

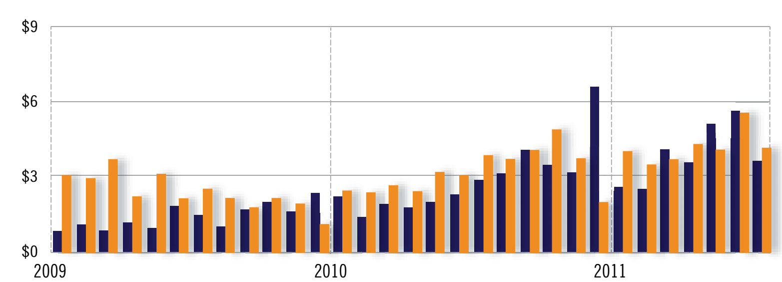
Average Cap Rate



Average Price per Unit



Volume (in billions)



Source: Real Capital Analytics

DEVELOPMENT ON THE HORIZON

At first glance, the multifamily market doesn't seem to be experiencing a building boom. CoStar forecasts that only 30,000 units will come online this year in the 54 largest U.S. markets, which amounts to approximately one-third of the average annual apartment unit deliveries from 2003 to 2008.

But in markets with sustained household growth and dwindling supply, multifamily development is coming back in a big way. The proof is in the permit data. There were more than 70,000 construction starts in 1H11, according to CoStar. And if owners and developers are going to avoid the fallout from the glut of new apartments set to come online in many markets from 2013 to 2015, they should act fast.

"We closed on two multifamily development sites in the previous six months and have three more under contract," says T. Sean Lance, CCIM, managing director with NAI Tampa Bay in Tampa, Fla. "Apartment developers have been shut out of the game for the last several years and it will take 24 to 36 months for these properties to come out of the ground, so the time is now to fill the void in the market."

Niche multifamily properties are also seeing new construction starts. For example, in Albuquerque, most recent multifamily developments have been University of New Mexico student-housing projects, says Erik Olson, CCIM, senior adviser with NAI Maestas & Ward in Albuquerque. However, given the MSA's shortage of entitled multifamily land sites, 97 percent apartment occupancy rate, and steadily rising rents, Olson expects multifamily development to ramp up across the board soon.

Who's funding all of these projects? For now, the government is still carrying the bulk of them. "Almost every new multifamily development we've seen in the past four years has been financed through the HUD 221(d)(4) program," says Jeff Siebold, CCIM, MAI, owner of Siebold Group Consulting in Caswell Beach, N.C. Last year, HUD insured $11.5 billion in loans for new development and refinancing, up from about $5.5 billion in 2009, Siebold notes. HUD expects to match or surpass the 2010 mark this year. "The trick," Siebold says, "is to identify markets with the demand components that match up with the HUD financing criteria."

For some types of multifamily development, HUD financing needs to be supplemented. In West Texas, for example, HUD is financing some affordable-housing developments, in addition to market rent and rehab projects, explains Tim Treadway, CCIM, managing director of multifamily for The Gerald A. Teel Co. in Houston. "However, the tax credit deals often require a mezzanine lender to fund the construction, as HUD takes too long and developers chance losing their tax credits," he adds.

In other markets, alternatives to HUD are beginning to surface. "New Mexico's credit unions have provided a welcome breath of fresh air with multifamily and commercial financing," Olson says. "And I envision that they will continue to be a strong lending source in the ground-up construction area."

Limited construction is even driving competition among lenders in healthier markets. Development starts in San Antonio's CBD, western corridor, and military base areas are all attracting attention, according to Shahid Abdulla, CCIM, vice president of Broadway National Bank in San Antonio. "We recently competed with five other lenders on a 300-plus-unit development in the western portion of the city with an institutional equity partner and a long-term successful developer," Abdulla says. "The final terms came down to pricing, which was committed to at 2 percent with only a completion guarantee."

As lenders and investors clamor for these projects, however, overbuilding will become more of a danger. It's up to developers to watch the market and pursue projects accordingly.

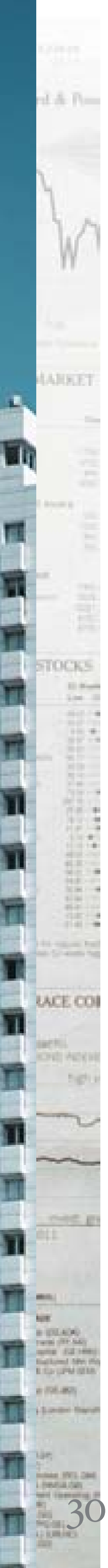
"Historically, we have typically developed new product unabated, overbuilt, and waited for the market to catch up," Treadway says. His market currently has proposals totaling 13,000 units, but he expects that the tight credit markets will help stagger the flow of new product. "As long as we don't start developing ahead of our absorption horizon, we will be OK," he adds.

class B and C assets is pushing up returns for sellers, and higher demand is setting in."

The Niche Is Back

Danny Zelonker, CCIM, SIOR, broker associate with Mizrach Realty Associates in Miami, markets himself as an industrial specialist, but lately he's spending a lot of time at community banks looking for real estate-owned apartments. "All of the South American buyers want multifamily," he explains. "It gives immediate returns, and, because many of the rental properties were converted into condos in our market, there's a shortage of affordable rentals."

Zelonker recently listed a 27-unit apartment property in Miami's central business district that was in foreclosure. With the heightened competition among South American buyers, who tend to pay cash, he expects this class B property to transact at a cap rate near zero. "The purchaser would have to buy on the per-square-foot price going up and probably rent at a break-even or a loss," Zelonker says.



"We believe the homeownership picture in the U.S. has changed," Burnett says. "More people will choose to rent than buy in the near future due to the difficulty in obtaining a new mortgage for most prospective home buyers."

Nationally, inbound foreign investors doubled their share of multifamily acquisitions in 1H11 from 3 percent to 6 percent, according to RCA. Canadians, Germans, and other Europeans led the pack. While they tend to focus on primary markets, cross-border buyers are also active in smaller Southeastern markets, accounting for 51 percent of the acquisitions in Palm Beach, Fla., in 1H11, for example.

In markets that aren't seeing an increase in foreclosures, other high-yield niches are leading the way. Garden apartments accounted for two-thirds of total multifamily investment activity in July, according to RCA, capping a strong run through the first half of the year. MPF Research notes that the niche saw a 165 percent year-over-year increase in sales volume in May.

"We're seeing recently built garden-style apartments go with a flair toward very low percentage costs," says Skip Duemeland, CCIM, chief executive officer of Duemelands Commercial in Bismarck, N.D. Tax deferrals, garden-style construction, and tenant utility payments help many investors realize costs of 14 percent to 21 percent on these assets in Duemeland's market, compared with the sector average of 35 percent to 39 percent.

Expiring tax-credit properties are also beginning to surface as investor targets. "From a buyer perspective, these assets are typically in good condition with low vacancies and don't require a high level of experience in affordable housing," says Thomas J. Cooper, CCIM, founder of Minnesota Brokerage Group in Minneapolis. "At this stage, compliance is less restrictive and can be managed in-house or through an outside resource."

Trouble Ahead?

With investor interest spreading to smaller markets and riskier niche product, the multifamily sector seems poised to continue generating glowing headlines. But several potential roadblocks loom.

The first is job growth — or the lack thereof. Apartment absorption is still closely tied to employment. Nonfarm payrolls saw no monthly change in August, and July and June numbers were revised down by 58,000, according to the Bureau of Labor Statistics. Additional contraction in the labor markets could have a significant impact on multifamily occupancy.

At the same time, healthy markets tend to have more homeowners. "Areas with stronger housing markets or lower unemployment rates should generally see higher vacancy and lower rents for multifamily," Riggs notes.

But Riggs, for his part, sees overpricing as the greatest potential detriment to investor enthusiasm. "Forecasts for supply additions are low, suggesting that competition for multifamily properties will remain intense," he explains.

A flood of single-family rentals could also cut into multifamily absorption in foreclosure-ridden markets. In August, the Federal Housing Finance Agency announced that it was considering renting out homes owned by Fannie, Freddie, and the Federal Housing Administration. The government's single-family portfolio totaled approximately 250,000 properties at the time of the announcement, but hundreds of thousands of more homes could be added in the coming years. This effort to bolster property values, then, might end up creating vacancies and dampening rent growth in certain multifamily markets.

"The impact will be felt in commodity markets and submarkets, especially on class B and C assets," notes Karsang Sherpa, senior vice president with Caldera Asset Management in Denver, referring to rentals of foreclosed single-family homes controlled by any investor, including the government. Unless significant employment growth returns, he adds, Atlanta, Dallas, Houston, and other commodity markets could see the fallout from this trend soon — perhaps before the end of the year.

The GSEs might also pose a problem from a financing angle. Fannie and Freddie have been a source of cheap capital for many multifamily investors during the market downturn. "Thirty-year fixed-rate mortgages wouldn't exist if it weren't for these lenders," Thypin says. If the GSEs were modified or shut down, the cheap capital that investors have come to rely on might become extremely difficult to find.

Could other lenders fill that void? Perhaps, Abdulla says. "The life companies will need to significantly pick up their volumes and HUD will need much larger allocations," he explains. "Regional and national banks may play a larger role; however, they will keep maturities short and may not have the stomach for nonrecourse structures."

But changes to Fannie and Freddie are not expected to materialize before 2013. In the meantime, multifamily investors can take solace in what seems to be a fundamental shift in Americans' attitudes. "We believe the homeownership picture in the U.S. has changed," Burnett says. "More people will choose to rent than buy in the near future due to the difficulty in obtaining a new mortgage for most prospective home buyers."

The numbers — and the headlines — bear this out. According to a survey conducted by Fannie Mae in July, fewer Americans said they would buy their next home (down 5 percentage points from June) and more expected to rent (up 3 percentage points from June).

A home, it seems, no longer requires a house.

Rich Rosfelder is associate editor of *Commercial Investment Real Estate.*