Six Signs the Multifamily Investment Market is Peaking

Higher Rates, Lower Returns Coming Soon?

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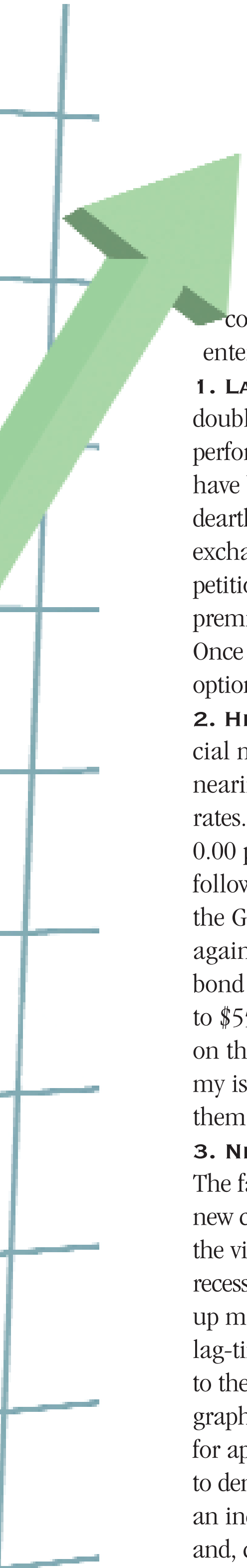

Investors frequently ask how they can tell when the market has reached its peak. As we know, such assessments are more accurately made in retrospect or, as the saying goes, "Hindsight is 20/20."

But absent any crystal ball, certain market conditions may act as indicators of things to come. Below are six signs that the apartment market is entering the apex of the current investment cycle.

1. Lack of Inventory. With continued year-over-year double-digit rent increases, many apartment communities are performing better than ever. Consequently, many investors have been unwilling to sell, citing both record returns and a dearth of properties in which to reinvest through a 1031 exchange. A side effect of this lack of supply is increased competition among buyers, many of whom are willing to pay a premium to secure a property, thereby compressing cap rates. Once more inventory hits the market, buyers will have more options and these premiums will likely disappear.

2. Higher Interest Rates Coming Soon. The financial markets widely speculate that the Federal Reserve is nearing the end of its five-year run of near-zero interest rates. The Federal Funds Target Rate has hovered between 0.00 percent and 0.25 percent since the beginning of 2009, following the collapse of financial markets and the advent of the Great Recession. But with the economy in full-swing again—at least for the time being—the Fed has reduced its bond purchase rate from its peak of $85 million per month to $55 million per month (as of June). More reductions are on the way. The next step in tempering growth in the economy is to gradually raise interest rates, which most expect them to do in 2015.

3. New Construction Permits at Record Highs. The favorable market conditions noted above have spurred new construction permit applications to record levels. With the virtual disappearance of new construction during the recession, developers have been scrambling to meet the pent-up market demand. But as with every real estate cycle, the lag-time between concept and occupancy creates latecomers to the market, and eventual oversupply. Although the demographics in the United States favor apartment owners, demand for apartments is still finite, and as soon as supply catches up to demand, vacancies will increase. The result of this will be an increase in competition for residents, more concessions and, consequently, reduced growth in net income.

4. Rents Leveling Out. Multifamily real estate has outperformed all other real estate sectors for almost a decade, primarily because of increased rents and a growing number of owners passing utility expenses on to residents. However, rent levels have outpaced residents' income growth at a rate that is unsustainable, and the ceiling is finally within sight. In many top markets, double-digit rent increases of the past have given way to predictions of a more sustainable 3 percent through 2018. Additionally, recent surveys of owners and property managers reveal that many communities have fully realized the rent increases the market will bear and, for the first time in years, owners are scaling back their projections and offering concessions to attract renters.

5. Higher Rates Mean Lower Returns. As the table below shows, a property producing $300,000 in net operating income will sell for $5 million at a 6 percent cap rate. If a buyer is able to secure 75 percent financing at today's 3.5 percent interest rates, annual debt-service would be about $202,000 and net cash flow after debt service $98,000—providing a cash-on-cash return of 7.8 percent.

When market rates for the same loan increase to 5.5 percent, for example, annual debt service on that same loan would be $255,505—yielding a net cash flow of $44,495 and a cash-on-cash return of just 3.6 percent. As happens with every real estate cycle, investors will likely be unwilling to settle for such low returns, consequently driving cap rates up and prices down.

Cap Rate Analysis

Net Operating Income	*$300,000*	*$300,000*
Cap Rate	*6.0%*	*6.0%*
Property Value	*$5,000,000*	*$5,000,000*
Equity Investment @ 25%	*$1,250,000*	*$1,250,000*
Loan Amount @ 75%	*$3,750,000*	*$3,750,000*
Interest Rate	*3.5%*	*5.5%*
Annual Debt Service	*($202,070)*	*($255,505)*
Net Cash Flow	*$97,930*	*$44,495*
Cash-on-Cash Return	*7.8%*	*3.6%*

6. Buy Low, Sell High. Once investors begin to see that their investments are performing at peak levels, many will choose to sell and realize their equity gains. As this happens, the momentum in the market will begin to shift. With increased supply, buyers will have more options and the "sellers' market" that owners currently enjoy will begin to rebalance in favor of those buyers.

Savvy owners and asset managers will take time in the second half of 2014 to analyze their portfolios and identify opportunities to sell certain assets at the top of the market, capitalizing on favorable market conditions and realizing extraordinary returns. Although some of the indicators listed above may be slower to materialize than others, one thing is certain: This gravy-train will not continue forever. For many assets, now may be the perfect time to sell. ■

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