Apartment Industry Hits the PAUSE Button

BY RANDYL DRUMMER

While still in high demand, the apartment investment cycle is in "pause" mode after an accelerated build-up.

Tightening competition among apartment investors will yield both winners and losers during this next supply-driven phase in the multifamily market. The winning developers will likely be those that offer novel products, capturing residents who have an expanding menu of housing options and amenities.

"We're past the point at which simply picking a market will lead to a successful strategy," says Luis Mejia, CoStar Group Director of U.S. Research, Multifamily, at CoStar's Midyear 2013 Multifamily Review and Outlook webinar. Mejia was joined in the presentation by real estate economist Francis Yuen and quantitative analyst Mark Hickey.

"Due to the impending supply wave and increased investor interest in apartments, investors need to go beyond that and be able to identify opportunities within each market—regardless of whether it's a mature, early recovery or late-recovery market—that put them in a position to compete.

"To avoid being swamped by the new offerings hitting the market, it's important for developers to position their projects as new, different and better from an operational, technological or locational perspective—especially for higher-end projects competing for well-heeled residents in such markets as Silicon Valley and the Boston seaport area," Mejia says.

Yuen says that clients often ask whether the multifamily housing investment cycle is over. "The simple answer is, 'No, we don't believe so,'" Yuen says. "However, it's clear that after two-and-a-half years of fundamentals improvement and a more than 200-basis-point decrease in the U.S. vacancy rate to around 6 percent, the apartment market has grown far more competitive. The market has hit the pause button and is now going in the reverse direction."

Chalk up a good part of the reversal to the feverish pace of new apartment construc-

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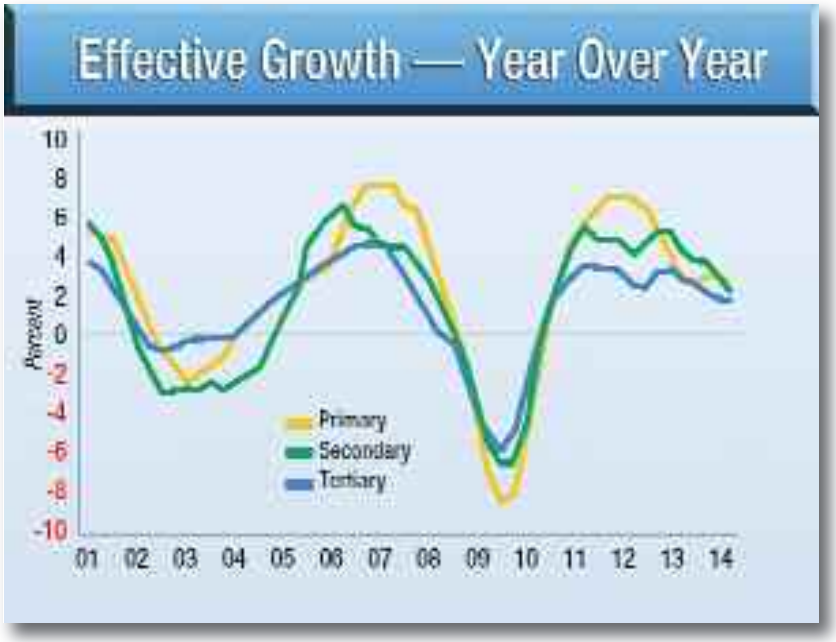
tion in many markets. The total number of units delivered is now outpacing net absorption by residents. Property & Portfolio Research Inc. (PPR), CoStar's analytics and economic forecasting company, expects about 170,000 units to be delivered in 2013 in the top 54 markets that PPR analyzes—on track to more than double the amount delivered the prior year.

Make no mistake—apartment demand is still very strong and U.S. demographics are clearly in the sector's favor. With more than 65 million Echo Boomers ages 20 to 34 now entering the prime renter cohort—more than at any time since the 1970s—savvy multifamily housing investors will continue to find opportunities despite a spate of new supply pressures.



The apartment market absorbed a net 130,000 units in 2012 and PPR is forecasting another 150,000 net units to be rented this year—highs that rival the peak of the previous up cycle. Even with the 40-basis-point rise in vacancy rates projected for this year, the market remains "exceptionally healthy," Yuen says.

Nearly three-quarters of the 75,000 properties of 50 or more units tracked by CoStar, ranging from institutional-quality 5 Star (CoStar's rating system) luxury communities to lesser-quality communities, have a vacancy rate of 5 percent or less. Another 15 percent have vacancies of between 5 percent and 10 percent.

"Even the properties rated by CoStar at 3 Star and below— the Class-C market—are tight," Yuen says. "This is certainly making it harder for value-add investors who are looking to pick off under-leased assets—there just aren't that many of them."

While these opportunities are harder to find, they're still out there, particularly in housing bust/boom and employment recovery markets such as Las Vegas, which may yet see additional vacancy compression.

Many Echo Boomers are still living in their parents' basement or with multiple roommates, but eventually they'll get decent jobs and leave the nest. Markets benefiting from the growing technology and energy sectors such as Seattle, Austin, Texas, Denver and Houston are all seeing continued increases in both demand and absorption.

In fact, recent history has been very kind to the apartment sector, with 40 of the top 54 markets tracked by PPR experiencing vacancy declines during the past year. Developers who have been able to get to the construction phase early are seeing many of their projects lease up quickly.

Those later to the game may not see their leasing efforts go as smooth, however, with the total number of multifamily starts and building permits reaching mid-2000s highs. The new inventory is following renters into the fast-growing Sunbelt metros. Year-over-year supply additions in Dallas and Houston lead all comers, with nearly 12,000 and 10,000 new units, respectively.

With costs to acquire existing properties in top coastal markets such as New York, Boston and Washington, D.C., reaching the stratosphere, investors and their developers are finding it much more attractive to build than buy.

Vacancy Rates Rising

During the next 12 months, 40 markets will see elevated vacancies, with 20 of those seeing rises of 50 basis points or more. Active supply markets like Austin, San Jose, Calif., and Charlotte, N.C., will see vacancies rise by 200 basis points or more, CoStar projects.

"It doesn't mean projects in these markets are doomed. Vacancies are still very tight. But it does mean investors and lenders will need to be even more cautious," Yuen says.

Developers are building projects in the best locations and, in most cases, that means close to rail or other mass transit.

Nationally, 40 percent of the total units under construction are walkable to transit stops or stations. Leaving aside markets without transit systems, 60 percent of units under construction are transit-oriented developments (TOD), compared with less than 20 percent of the units delivered from 2000 to 2010.

"With many of the best development sites already spoken for, it's even more important for developers and investors to build in a location that won't be a resident's third or fourth choice," Yuen says.

During the past few quarters, secondary markets have begun to outshine primary markets in terms of effective rent growth, a

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trend likely to continue for the next year.

Rents can only get so expensive in the face of double-digit gains in New York, San Francisco and Boston before residents seek less pricey alternatives. Consequently, CoStar is now seeing a run up in rent growth this year in some housing boom/bust markets such as Phoenix, Palm Beach, Fla., and Orlando, Fla.

With 45 of the 54 top markets more expensive than at any time during the past decade, average rent growth isn't likely to remain as stellar for owners going forward. That said, markets such as Las Vegas or Sacramento, Calif., which still have slightly lower average rents compared to history, have a somewhat longer runway for growth.

Homes/Apartments: Living Together

Economists are still spending a lot of time studying the question of how the improving market for single-family homes is affecting apartment demand.

Some markets that were hit the hardest when the bottom fell out of housing between 2007 to 2010 and have experienced robust single-family recoveries during the past couple of years, including Phoenix, Las Vegas and Detroit, have experienced somewhat slower apartment demand but could attract additional renters as their economies improve, Mejia notes.

More stable metros such as Washington, D.C., New York and Boston, however, continue to enjoy both solid demand for apartments and rising home prices because of factors such as strong employment growth.

"We should not be afraid of rising home prices. The factors that drive home price growth will eventually also be favorable to the apartment market," Mejia says.

Those factors include employment growth that's leading to more household formation. Since 2011, young people have launched nearly 300,000 new households each year, which will help absorb the mounting new apartment supply, Mejia says. Meanwhile, the U.S. homeownership rate is still trending slightly down or flat around its recent low of 65 percent, with new renter households largely offsetting those transitioning from renting to owning.

Apartment Transaction Volume Impressive

The closing of the $15 billion purchase of Archstone by AvalonBay Communities and Equity Residential resulted in near record volume of $15 billion in the first quarter. Volume decreased in the second quarter amid seasonal factors for apartments and other CRE product types, according to preliminary CoStar data.

However, total multifamily sales volume should accelerate in the third quarter and jump even higher in the fourth quarter, Hickey says. And that investor capital will continue to flow everywhere at once, into both CBD and suburban properties, and into primary as well as secondary and tertiary markets, into all U.S. regions and across the building quality spectrum, from 5 Star or Class A properties to 2 Star (Class C).

Interestingly, the common perception that investors have traded down to lesser-quality properties in superheated markets such as New York and San Francisco because the best properties have become too expensive is not supported by the data. Investor interest across all parts of the quality spectrum has remained unchanged since at least 2009.

"Other than in the first quarter due to the Archstone deal, which included a lot of high-quality, we are not seeing investors trade down in the primary markets," Hickey says.

Because of the Archstone deal, REITs have been the largest net buyers of apartments in 2013 by a wide margin. REITs were large net sellers in 2008 to 2009, disposing of their underperforming assets to maintain required leverage levels and emerging from the recession stronger than many other investor classes.

CBD Asset Pricing Passes Peak

Suburban apartment communities didn't see much decline in the average price per unit during the downturn, and haven't had a large pop during the recovery. CBD assets, however, which had a clearly defined pricing peak in 2006 and a trough in 2009, have seen prices edge past their 2006 highs.

Capitalization rates on both suburban and urban properties, while ebbing, haven't reached their pre-recession lows. While cap rates may fall a bit further, especially for urban properties, CoStar and PPR say cap rates will begin to rise across virtually the entire CRE spectrum by the end of 2014, because of several factors, including the projected increase in the 10-year Treasury rate to 4 percent or higher during the next few years.

Another factor driving up cap rates will be the massive new inventory wave, which will surpass 2008 and possibly 2000 levels as a large amount of property will come up to bid at a time when fewer buyers are in the apartment market.

With returns weaker in 2013, REITs likely won't be willing to further dilute their shares by raising as much equity as in the past. Buyers who specialize in other product types such as office and industrial moved into apartments because it was the only game in town for several years. But as yields shrink in the apartment space, some will probably return to their core specialties as warehouse and office fundamentals continue to improve in 2014 and 2015.

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