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CELEBRATING 55 YEARS

Witten explains how the strengthening multifamily market provides a lift to the economy

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In spite of current headwinds that are slowing economic growth, the U.S. and state economies are expected to improve on a long-term basis, albeit at a slow pace. Recent concerns include the softening for-sale housing market and sovereign debt issues abroad. Moving into the third quarter, many analysts have also expressed concerns over the impact of the expiration of the second round of quantitative easing (QE2). These issues, however, are expected to place only a short-term drag on the economy. Improved momentum over the past year in private sector job growth, GDP and retail sales, in addition to the passage of Greek austerity measures, are providing the economy with the stability it needs to overcome these short-term challenges.

In the commercial real estate market, the multifamily sector has clearly led the recovery, outperforming the retail, office and industrial sectors. U.S. multifamily fundamentals will remain positive over the next five to 10 years. The national vacancy rate edged down to 5.6%, only 60 basis points away from being defined as a tight market. Rent growth nationwide is expected to increase a healthy 5% to 6% by year's end. New apartment construction is under way across the U.S., with publicly traded REITs leading the charge due to available capital and low-cost debt. The outlook for 2011 calls for demand of approximately 150,000 units, three times the number of new units slated for delivery. The recent uptick in multifamily permit issuance will require another 12 to 18 months before new units come to market, creating another three- to four-year window before supply reaches a level considered risky, at least at the national level. Should interest rates rise, escalating all-in construction costs will require sustainable rent levels high enough to justify construction risk, which may naturally curb financing and development.

New Haven-Fairfield Market Strengthens

Apartment vacancy dropped 20 basis points on a year-over-year basis to 4.5% in the first quarter of 2011 in the New Haven-Fairfield market. Meanwhile, rent growth has been extremely strong, surpassing levels achieved in the boom year of 2006-2007. Asking rents increased 5.6% in the first quarter of 2011 to $1,571 a month on a year-over-year basis. Effective rents increased 4.2% during the same time frame to $1,504. There was a 3.6% addition to the existing inventory of apartment units on a year-over-year basis in the region. Inventory jumped from 45,924 units in the first quarter of 2010 to 47,572 in the first quarter of 2011.

Fannie Mae and Freddie Mac remained the most active lenders in the national multifamily sector. While agency lending accounted for 52% of mortgage originations, this figure reflects a downward trend in market share over the past year as regional and local banks, and life insurance companies expanded competitive lending efforts in the multifamily arena, which is a positive trend for multifamily developers nationwide and in Connecticut. Access to low-cost agency debt has long been a competitive advantage for the sector, but the possibility of privatizing or dissolving Fannie

Mae and Freddie Mac places this benefit at risk. The withdrawal of this government support, though unlikely, could result in higher borrowing costs and inflate cap rates over the forecast period. Any action may be years out but could occur within a five to 10-year horizon.

The expanding economy, growing deficit and the end of government initiatives and subsidies will exert upward pressure on interest rates. As cap rates fall, higher leverage will become somewhat more challenging as loan-to-value ratios become constrained by debt service coverage ratios. Average cap rates for Class A multifamily properties in the U.S. dropped 30 basis points to 6.4% in the past 15 months.

Stronger operational performance and low-cost debt have broadened investor demand for Connecticut multifamily real estate, leading to more sales of Class B and B- properties. Greater sales velocity in a broader spectrum of asset quality and markets in 2011 will create greater transparency and lend support to market pricing in the lower tiers, and secondary and tertiary markets. By year's end and moving into 2012, more value-added transactions are expected to close throughout the region.

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