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Dollar volume of apartment transactions will rise as the economy gains momentum

January 20, 2011 - Connecticut

The U.S. economic recovery has unfolded in anything but a linear fashion, as tenuous, and occasionally erratic, economic growth has tested the durability of the recovery and sparked concerns of a double-dip recession. This scenario remains improbable, however, as today's low interest rate and minimal inflation environment differs from conditions 30 years ago, when the U.S. experienced its last double-dip recession. Furthermore, recent government actions, such as the extension of Bush-era tax cuts and the resumption of quantitative easing by the Fed, signal a willingness to take strong, albeit controversial, measures to reinforce economic recovery. Several trends suggest the recovery will gain more traction, including moderate private-sector job growth, improving consumption, lower initial unemployment claims, robust temporary hiring, strong and sustained corporate profitability, and easing bond spreads.

While overall employment growth disappointed through the latter half of 2010, job creation among the prime renter age cohort of 20 to 34-year-olds significantly outpaced the broader market. This trend helped jump-start a recovery in the apartment market, boosting absorption to levels unseen since 2000, when job growth and household formations boomed, a sharp contrast to current conditions. Both employment and household growth will accelerate in 2011, but the rate of gains depends on improving corporate confidencewhich is essential to increasing investment and hiring.

The Fed's ability to keep inflation at bay by recalibrating monetary policy in response to economic expansion may not be fully tested in 2011 but remains paramount to the recovery staying on course. The housing market, saddled with foreclosures, will not be a contributor to the expansion until 2012. Concerns about solvency and trade implications also loom as risks of sovereign debt defaults roll across the euro zone.

Apartments staged a strong recovery in 2010 well ahead of expectations, despite modest job creation and stubbornly high unemployment. Net absorption surged, with occupied stock rising by nearly 200,000 units, double the number of apartments constructed and the highest level on record since 2000. Several factors contributed to high levels of absorption, including the release of pent-up renter demand as households de-bundled in the wake of the recession. In addition, apartments benefited from private-sector job growth in the critical 20 to 34-year-old cohort, expiration of the homebuyer tax credit, displaced foreclosed homeowners entering the renter pool, immigration and lower unit turnover. Renting also became a lifestyle and economic choice for many households as the effects of the housing collapse and recession persisted. Continued recovery in 2011 depends more heavily on improvements in the job market which should gain momentum as the year progresses.

All 44 markets in the Marcus & Millichap National Apartment Index will post employment growth, vacancy declines and effective rent gains in 2011, confirming a sweeping recovery and expansion in the U.S. apartment sector above expectations. This year will mark the first across-the-board reduction in vacancy recorded since at least 1990; the strongest previous performance played out in 2005, when all but three apartment markets registered declining vacancy rates. The last time all markets exhibited positive employment trends occurred in 1999, and not since 2006 have all markets posted effective rent growth. Further, new apartment supply will decline in all but six markets in 2011, the first time such broad-based reductions have emerged in 20 years. At the national level, new supply dropped to extremely low levels last year and completions will slip further in 2011, as tight credit conditions stalled construction projects and delayed new starts through much of the past few years.

Moving into 2011, the dollar volume of apartment transactions will rise further as the economy gains momentum, fundamentals improve, debt markets loosen, and REITs and institutions increase acquisitions. During 2010, apartment sales volume totaled an estimated $40 billion, up nearly 65% from the cyclical low in 2009 but less than one-third of the 2006 peak. Institutional investors led the surge in sales in 2010, with dollar volume more than doubling in the $20 million-plus segment. Improving occupancy and rising rents, along with low-cost debt, will help assuage investors' and lenders' lingering trepidation about values. As the year progresses, investors will move down the quality chain in search of stronger yields, resulting in more sales in the Class B and B- categories. The average cap rate will decline in 2011 after slipping 20 basis points in 2010 to 7.2%, led by recompression of the most sought-after deals. Since peaking in 2009, cap rates for top-quality properties have fallen by as much as 100 basis points.

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