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Investors flee to safety of multifamily properties with no shortage of capital

October 18, 2011 - Connecticut

Volatility in the stock market and turmoil abroad has sent investors back to the safety of commercial real estate. Investors throughout the Northeast - both private and institutional - are motivated by this uncertainty, as well as remarkably low interest rates. Moderate improvement in financing sources has accompanied low interest rates, as many commercial banks and life companies are willing to lend again, notwithstanding tight underwriting criteria and the risk of low appraisal values.

Investor appetite for commercial property, particularly apartments, has rebounded strongly with no shortage of capital looking to re-enter the market. Growth in both GDP and private-sector jobs provided enough impetus to stem occupancy and rent declines in recent quarters across virtually all product types, resulting in improved operations and asset values. Apartments moved full tilt into expansion in the Northeast thanks to a high employment capture rate among young adults, the release of pent-up demand, and consumers' disdain for and limitations on (at least for now) home buying.

Capital migration to Class B multifamily assets, secondary markets and value-added investments has begun, but may lose steam as risk aversion re-emerges in response to a stalled recovery. Investors must fully weigh new pressures on tenants and the possibility that the soft patch could last longer than expected or become more serious if companies and consumers become overly cautious. Assuming the current phase is short-term stagnation or a minor contraction, commercial real estate operations should continue to inch upward.

The markedly slower pace of net absorption in the first two quarters of this year, relative to the highs achieved in the prior two quarters, raises a cautionary flag. Apartment operations benefited from numerous demand drivers, including pent-up demand from the recession, the ongoing significant transition from home ownership to rental housing, and remarkable demographic strength among the 20-to-34-year old age cohort that demonstrate the strongest propensity to rent. Apartments may offer a good defensive hedge against economic slowdowns, but the sector is not immune to the knock-on effects of periods of stagnation in productivity and jobs. With pent-up demand satiated to some degree and job growth waning, demand for apartments will slow until payroll growth regains momentum.

The apartment sector is the only commercial real estate segment simultaneously benefiting from favorable dynamics in both supply and demand. The national vacancy rate peaked in 2009 at 8%, before reversing course one year ago, well ahead of all other property types. Surging demand and tight supply conditions drove stellar apartment performance across most primary and secondary markets over the past 12 months. Net absorption totaling 225,000 units generated a precipitous 190-basis-point decline in vacancies over the last year to 5.9% as of the second quarter. Class A properties, which recovered quicker and with more strength, reported vacancy at 5.6%; Class B/C properties posted a combined 6.1% vacancy rate.

Strong leasing demand is expected to persist through 2011, albeit at a slower pace, with apartment absorption forecast to total nearly 147,000 units compared with scant deliveries of 53,000 units. This will reduce the vacancy rate another 30 basis points to 5.6% at year end. Permitting activity, up 26% to 185,000 multifamily units, appears strong, but is rising off a low base. Nonetheless, starts will accelerate meaningfully by mid-2012, ramping up in 2013. Diminished concessions resulted in surging effective rent growth and modest asking rent gains in most markets. As of the second quarter of 2011, national asking rents and effective rents grew 2.1 and 2.3%, respectively, measured on an annual basis.

Still, the strengthening performance in the apartment sector supports values and helps clear underwriting hurdles for refinancing and new development loans. Funding for apartment investments is readily available along the entire capital stack.

In Connecticut, strengthening operations have resulted in strong sales results so far in 2011. Through the third quarter of the year, we are ahead of 2010 in statewide apartment sales by more than 44%. Transaction velocity continues to heat up and we anticipate surpassing both 2009 and 2010 in total sales. Average per unit values have also increased in all Connecticut municipalities, and with the 10-year Treasury rate dipping well below 2%, we expect this trend to continue into 2012.

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