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Strong demographics: Weak for-sale housing market driving apartment sector

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Ongoing weakness in the for-sale housing market and beneficial shifts in demographic trends and societal patterns are sustaining a thriving rental market. The closing months of 2011 manifested meaningful increases in productivity, monthly job creation, wage and income growth, consumer confidence, and household formations, forming a powerful alliance of demand drivers. The dearth of apartment supply and continuous retreat from homeownership boosted apartment performance as well. The apartment sector has fully moved into an expansion cycle as defined by a broad-based recovery in vacancy rates, rising rents, downward migration by residents to less-expensive units, improved operations for class B and C properties, and the start of a new construction cycle.

Effective rents grew 4% on average across the U.S. but gateway and supply constrained markets achieved double-digit increases for the second year. Aggressive rent increases more recently resulted in mild revenue loss in a few markets, which will quickly correct, but most markets continue to record steady rent growth. As a result, effective rents now meet or exceed their prior 2008 peaks in many markets, including New Haven. Improvement in class A operations last year filtered to class B properties throughout the state of Connecticut, which in turn have progressed to a point that positions class C properties for stronger revenue growth over the next year.

As rents continue to rise, alternative housing, including foreclosed homes and government-sponsored REO-to-Rental program, could pose a threat to multifamily owners. Depending on the location and quality of the assets, this trend could compete with apartments on a cost basis if rents should continue to climb and roommate scenarios reemerge. The national homeownership rate lost another 50 basis points over the past year, declining to 66% and contributing to a commensurate increase of 1.35 million renter households, many of whom moved into rental homes rather than apartments. Sales of existing single-family homes have recovered to the 30-year annual average of 3.8 million units. However, despite record-low mortgage rates and home prices, issues of price instability, down-payment hurdles, low appraisals and credit application declines and a preference to stay mobile continues to sideline many prospective buyers. In fact, apartment unit turnover rates due to residents becoming first-time homeowners have diverged from the long-term average of 25% by nearly half. Foreclosures and short sales account for nearly 30% of existing single-family sales, and investors now comprise about one-third of sales. As part of the FHFA plan to shrink the GSE's single-family portfolio, the recently initiated REO-to-Rental program will market portfolios of distressed homes in select markets to pre-qualified investors who must rent the properties for a specified number of years before selling. The intention is to keep homes off the for-sale market to avert price depreciation with distressed asset sales and unloading more inventory on the market than can be absorbed in a reasonable amount of time.

The multifamily investment sales market continues to strengthen, and outperform every other major

property sector. Total sales volume for 2011 increased 39% above year-ago levels to \$64.9 billion, dominated by sales in the \$40 million plus and \$10 million to \$20 million price tiers, up 52 and 42%, respectively. The average overall cap rate fell 70 basis points to 6.5% from one year ago. Equity funds remain active buyers of portfolios and distressed properties; international investors remain committed to coastal markets, such as Washington, D.C., and San Francisco; REITS and institutional investors prefer high-density product in 24-hour cities, but also expanded to class A assets in secondary Texas, Connecticut and North Carolina markets. Private buyers comprised a shrinking, but still high, 42% of transactions in primary metros and 69% of sales in tertiary markets in 2011, migrating to higher risk/higher return strategies. The cap rate arbitrage between asset classes, market tiers, and spreads relative to the 10-year Treasury, along with evidence of stabilizing operations in class B assets and improvements in class C, create a compelling investment thesis for diligently vetted value-add strategies.

Approximately 85,000 units that are under construction nationwide should deliver in 2012, still short of fairly conservative demand projections for 120,000 units. This dynamic will drive the national vacancy rate close to a 10-year low of 4.8% and push effective rent gains close to 5%. The increase in permitting, starts and deliveries, and abundance of capital for construction loans signal the start of a new development cycle. Permits increased to an annualized rate of 208,300, a 53% rise over last year, while starts doubled year-ago levels increased to an annualized 188,700 units.

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