Apartment Investments Look Great for AOA Members!

By David Baird

Although the multifamily sector often flies beneath the radar of many investors, its combination of stability and upside has made apartment properties one of the best and most tempting real estate investments. And today's combination of high single-family home prices, limited multifamily stock and burgeoning demand demographics points to improving multifamily fundamentals for many markets.

As an investment, apartment properties have outperformed the stock market for the last five years according to both the National Association of Real Estate Investment Trusts and the National Council of Real Estate Investment Fiduciaries. In 2005, the apartment sector achieved its best annual return since 1984 – 21.25 percent compared to the market's 20.06 percent. During that same year, $86.9 billion of apartments traded, a 72 percent increase compared to 2004, according to the National Association of Realtors.

Last year, apartment investors reaped returns at about 17 percent, which was similar to other property types according to NCREIF.

Although rental housing niches such as student and seniors housing continue to grow, few investors are pursuing them. Instead many traditional multifamily investors are focused on developing mixed-use projects in infill locations and will continue to do so throughout this year. Since some cities make affordable housing a conditional of the zoning approval, some of these properties will include an affordable-housing component.

The value-added strategy of acquiring and repositioning class B and class C apartment properties has been extremely popular for the past three years and is not expected to wane this year. However, the condominium conversions that ignited many markets, particularly in Florida, have slowed significantly and the absence of condo converters has made room for conventional apartment investors in markets such as Tampa, Orland and Miami, Florida.

While the conversion slowdown is returning some units to the market, cities with strong population growth will not be affected greatly, according to industry experts. In fact, most commercial real estate experts give multifamily a thumbs up for 2007 based on its all around improving fundamentals. As a result, investor interest in apartment assets should continue to grow stronger this year as the sector benefits from an expanding renter population, strong job growth and slowdowns in single-family housing.

Improving Fundamentals

Confidence in the current rental market is strong and expectations for this year are even higher, according to the National Association of Home Builders/Fannie Mae Multifamily Rental Market Index released in late November 2006.

More than 60 percent of MRMI respondents said that apartment demand rose during the third quarter of 2006 and 70% said that effective rental rates increased. Additionally, almost 70 percent of multifamily developers and owners said they felt good about continued demand due to a large volume of calls from prospective renters.

Strong fundamentals are evident in nearly every U.S. apartment market. Out of the 75 markets tracked by the New York-based research company Reis, 60 markets boasted positive absorbs ion and 55 noted falling vacancy rates. A whopping 73 markets recorded effective rent gains.

Vacancy during the third quarter of 2006 fell by 20 basis points to 5.4 percent – the lowest level since the first quarter of 2001, according to Reis. Vacancies are expected to continue to decrease despite the fact that development has strengthened and condo conversions have slowed.
During the third quarter of 2006, 16,300 rental units came online, but all of them and more were absorbed as net absorption reached nearly 22,000 units. During that same period, only 7,400 units were converted to condos, far blow the first and second quarter levels of 2006 of 29,800 units and 19,300 units, respectively. Further comparison shows that the third quarter of 2006 conversion rate was scant in comparison with the market's peak of 54,700 units in the third quarter of 2005, according to Reis.
The decrease in conversions, coupled with a muted development pipeline in comparison to previous development cycles is impacting acting rents and effective rents. Asking rents and effective rents grew at their fastest rates in 2006 since the national market's peak in 2000, according to Reis. Third quarter 2006 marked the sector's 18th consecutive quarter of asking rent gains, which rose 1.3 percent according to Reis, while effective rents climbed 1.4 percent as landlords reduced concessions. Asking rents will increase 3.4 percent and effective rents will grow by 3.6 percent this year, Reis forecasts.

California Apartment Market – Cap Rates
Having four of RREEF's top high-barrier markets located in California provides a reason why the stat's cap rates among the lowest in the country, according to Real Capital Analytics. Apartment transactions that closed during the third quarter of 2006 in ***Orange County,*** for example had an average cap rate of 4.9% and sold for an average of $195,882 per unit. Farther east toward the desert, the ***Inland Empire*** has had an average cap rate of 5.4 percent and an average price per unit of $147,151.
Despite the low cap rates and high unit prices, there's still a lot of upside to be found in Southern California. For example, the Inland empire's apartment market is expected to see occupancy and rental rate growth increases in 2007 as the population expands by 3.2 percent – the largest amount of all markets evaluated. Vacancy is predicted to drop to 4.2 percent as rents grow 4.7 percent to reach an average of $1,053 per month.
Orange County's vacancy rate is expected to drop to a countrywide low of 3.2 percent and effective rents are forecast to grow 5.1 percent to $1,481, which is the biggest increase for all markets evaluated in reports. Like the Inland Empire, Orange County will add more than 22,000 jobs and 22,000 new residents. Investors should look to Fullerton, California for significant upside as renters in Buena Park and North Anaheim are priced out of the market and move to Fullerton.
Northern California's apartment market also has strong momentum. For example, ***cap rates in both San Francisco and San Jose averaged 5 percent*** at the end of the third quarter of 2006, according to Real Capital Analytics, with an average price per unit of $286,867 and $183,715 respectively.
San Jose and San Francisco posted the strongest gains in asking and effective rents for most of 2006, according to Reis. And in terms of asking rents during the third quarter of 2006, **San Jose led the nation with an increase of 2.6 percent**.
Both San Jose and San Francisco's downtowns are undergoing significant revitalization and a number of mixed-use infill projects are under construction. At the same time, job growth has returned to the region. San Jose will add 10,000 new jobs – most of them in the service and professional sectors – and welcome 8,500 new residents. The high cost of living in the Bay Area bodes well for apartment owners. A decreased vacancy of 3.7 percent over the coming months will allow owners to boost asking rents by 4.9%, bringing the average rent to $1,380 per month.

San Francisco also has rebounded from the dot-com bust and many people have returned to jobs in the city, seeking homes near transit lines or close to downtown. Rental signs are coming down as are vacancies and concessions. The city's marketwide occupancy is expected to reach 3.8 percent by mid-2007, while effective rents will jump 5.4 percent to $1,668 per month according to a recent report.

What's Driving the Apartment Sector?

Demand for rental housing is showing no signs of slowing. The United States is projected to add 11.6 million new households between 2007 and 2015, an average of roughly 1.5 million new households each year. This rate is 15 percent higher than the 1.3 million new households created each year since 2001. According to a RREEF report, most of the growth can be attributed to the echo-boomer generation, who range in age from 20 to 24 years and strong immigration, which both positively impact the apartment sector.

Echo boomers account for around 30 percent of the U.S. population or 76.3 million. This group is critically important to the apartment market – roughly 75 percent of this age group calls an apartment home and historically has lived in apartments.

Similarly, immigrants make up a large portion of the renter population. Roughly 4 million immigrants households live in apartments today and immigrant households are expected to contribute a greater proportion to future apartment demand, according to the National Multi-Housing Council (NMHC). By 2010, another 500,000 immigrant households are expected to live in rental units.

In addition to the echo boomers and immigrants, many Americans may end up in apartments as the cost of homeownership increases. Homeownership costs about 30 percent more a month than renting, according to the NMHC. That affordability gap plus high housing prices are causing fewer apartment residents to become homeowners.

In addition, many existing homeowners have mortgage payments that grow as short-term interest rates increase. The impact of the interest rate hikes already is apparent; the number of foreclosures during the first 10 months of 2006 (766,058 properties) was 19.6 percent more than the number of foreclosures for all of 2005, according to Foreclosures.com, a California-based advisory firm and publisher of property foreclosure information.

While foreclosures and weak home sales aren't anything to cheer about from an economic perspective, the multifamily sector certainly will benefit and those rewards will be passed on to investors – (and mostly AOA members).

Conclusion

Even the amount of new development that is planned nationwide for 2007 can't cast too large a shadow on the apartment market's future. About 92,000 units are expected to be completed this year, 2,000 more than last year. Although condo conversions reverting to rentals may add to that total, completions still will fall short of the 1990s' levels.

All in all, the economic indicators paint a pretty picture for apartment performance and will tempt investors throughout the year. Opportunities for strong returns exist in several markets. Investors just have to be willing to look hard and move quickly.

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