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As The Multifamily Recovery Accelerates The Smart Get Cycle Savvy

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The mood at last month's National Multi Housing Council Annual Meeting in Boca Raton was expectedly upbeat. The performance of the rental apartment sector is the envy of the real estate industry, and those who moved early have been amply rewarded. The sector is now operating in a mature, fully recovered, investment environment with a large and well informed investment and development community working closely with a robust and eager capital market.

While RCLCO believes that investment and development opportunities in the multifamily sector are significant—probably still the best in the industry—we have already passed through the early recovery stage of the real estate cycle in many markets, which means that the risk profile in the sector is changing. In response to this, investors should carefully analyze where risk exists in their markets and asset classes, adjust their strategy accordingly, and redouble due diligence efforts informing transaction activity (for both acquisition/disposition and development).

It's hard to quantify exactly how much of the recent performance surge in the sector is due to long-term structural shifts, which are permanent or, at least, long-lasting, and to what degree the surge is cyclical and thus more temporary in nature. In other words, it is very difficult to project how sustained the apartment market's strong performance is likely to be, or when the performance curve may begin to flatten.

Some of the risks that need to be considered in developing a multifamily investment strategy include the following:

1. Demographic Shifts Driving Demand for Multifamily. The confluence of three demographic patterns in the United States will increasingly drive demand for rental apartments: 1) Generation Y/Echo Boomers forming households and in many cases living in rental apartments; 2) the continued growth of single-person households of all ages, a relatively high percentage of whom rent; and 3) immigration, which has historically helped drive apartment demand. This swelling of the ranks of apartment renters will be long-lasting, but we may have already experienced the majority of the benefit from this structural shift in demand for apartments. On the other hand, strong and durable job growth in the United States would result in higher rates of household formation, a portion of whom will rent apartments.

2. Homeownership Will Eventually Rebound. The influence of the Echo Boomers on the rental market will begin to wane and then reverse over the coming decade, although it is challenging to know exactly when the shift will occur. Birth rate and immigration statistics suggest that the rate at which Americans are turning 22 will peak this year (2012) although we know that household formation has been delayed in many instances as recent college graduates return to their parent's homes or live with roommates. Probably there are several more years of structural demand growth, but the pendulum will inevitably swing back the other way.

Nor will this generation's pattern of homeownership be radically different than previous generations. We don't expect homeownership to surge back to 70% as it did in the last cycle, but we also don't believe that homeownership has permanently lost its luster. While there is strong reason to believe that a more robust renter-by-choice market exists today than it did 10 years ago, survey evidence also suggests that the long-term interest in owning a home is not meaningfully different for Generation Y than it was at the similar stage of life in previous generations. In other words, this phenomenon is partly structural but also partly cyclical, and subject to the unique economics in each market, including ownership costs, character and quality of the existing housing stock, and so forth.

3. Understanding the Impact of the Development Pipeline. At a macro level, multifamily rental production in the United States is at historically low levels. However, particularly relative to employment growth, there has been a significant increase in multifamily rental construction. This activity is concentrated in a handful of better performing metropolitan regions, and submarkets within these regions. So while the macro picture looks promising, there is a real risk that in some submarkets new supply will experience slower rental rate growth over the next 18 to 36 months. Rather than simply looking at the overall pipeline, there are micro-level conditions that bear scrutiny in fine tuning a multifamily strategy:

a. Most of the new product is oriented to the high-end renter, even in markets or submarkets where that group of renters as defined by income levels is relatively shallow; the character of pipeline in any given submarket needs to be considered in the context of the demonstrated market stratification by potential income/rent level.

b. Much of the new supply is concentrated in submarkets that are just open for development. These include untested neighborhoods that are urban or "urbanizing," but not particularly job nor transit rich.

c. The lack of product variation or market segmentation. The good news is that the markets for apartments today are more diverse than ever, which offers a range of development opportunity. But beware a positioning strategy that focuses exclusively on the young professional renter, which is targeted by the majority of new product in the pipeline today.

Given that the investment cycle is passing from recovery (in which a rebounding market ensures the strong performance of many investments) to a mature market (in which smart builds or buys will have solid long-term returns, but nearly every transaction will have the same level of near-term value growth), how should your strategy be adjusted?

1. Be Flexible and Open Minded About Exit Strategy and Timing. Given current cap rate conditions and threats to near- and mid-term rent growth, the window on short-term flips in the apartment space has probably closed. While capital will continue to like apartments (even if growth moderates) because they offer somewhat predictable yields, sponsors should be prepared for longer holds if their particular markets soften. It will also be increasingly important to identify multiple exit strategies, including repositioning and even condo conversion in some instances.

2. Is Your Market Really High Barrier to Entry? Many heretofore so-called "high-barrier-to-entry" markets and submarkets are experiencing a considerable amount of new construction. Yes, it often takes longer to secure approvals in these types of markets, but there is a pipeline. On the positive side, of course, these markets and submarkets tend to have deep pools of high-income renters with significant capacity for higher rents, the cost of for-sale housing is still comparatively high, the existing apartment stock is often outdated and undesirable, and the pressures of urbanization and transiency are fierce, making apartments a highly desirable housing solution for a wide array of household types. Supply is still a concern, however, especially at the submarket level.

Investors in these markets need to carefully consider where within these large metro areas the barrier-to-entry is actually high, and should consider being extremely submarket selective.

3. Consider Market and Asset Class Diversification. While some investors focus exclusively on core assets in core markets, many others have a more diversified strategy, including B and C apartments and value-add, albeit mostly in so-called preferred markets. The cap rate spread from A to B and C assets has narrowed to a level that makes non-core sectors equally exposed to the market dynamics discussed above. Be cautious in entering this space, which is subject to an entirely different but related set of risk factors, without seasoned and nimble partners who understand the operating dynamics and quirky submarket factors that drive pricing.

Some investors have decided not to compete in fully recovered cores and are instead focused on secondary markets that are still in recovery or are overlooked, where cap rates are still above a 7 or even an 8, and where values are still below replacement cost—these are markets that are still pricing risk.

Similarly, if you are rich in land in places where the development pipeline has become overheated, consider recycling capital into land in markets/submarkets that are still early in the development cycle to diversify your risk and potentially increase long-term returns.

4. Discipline Rests with All of Us, Not Just the Capital Markets. As an industry we should not rely on the capital markets alone to provide discipline, and we should not chase deals indiscriminately because it seems like money is eager to be placed. History tells us that lenders are no better than others in the industry at realizing when the cycle is changing. In fact, many capital sources are just entering the market now, when arguably the acquisition and development landscape has already become more challenging. Rather, be explicit in your strategy and extremely rigorous and transparent in your due diligence process. Capital will eventually gravitate to other sectors as desire for higher yield intensifies and the perceived level of relative risk normalizes. The developers and owner operators who have won the confidence that restraint and market savvy rests with them and not the capital provider will have earned a strong commitment and significant discretion.

A broad array of apartment strategies can yield favorable results, and there are probably more such opportunities in the apartment sector than in other types of real estate. But this cycle, at least in the multifamily space, appears to be decidedly different than the last one. In the late 1990s and early 2000s, the real estate cycle was a slowly but continuously accelerating up-cycle, followed a devastating slow motion crash. This apartment cycle so far, driven by eager capital desperate for yield and with few compelling alternatives, appears to have gone from recovery to mature within the span of 24 months, and smart players should prepare for more challenging market conditions in the years ahead by planning wisely, buying and building smartly.

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