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SAILING AHEAD

Will the renter pool keep up with the robust development pipeline?

by Beth Mattson-Teig

Multifamily has been riding a strong tailwind over the past several years thanks to a strong job market, household income growth, demographic shifts, and obstacles preventing renters from making a switch to homeownership. The question is how long the apartment industry will be able to sail along on that current, given the steady stream of new supply hitting the market.

Record levels of new construction have barely put a dent in national vacancy rates, which remained at a low of 4.4 percent at midyear, according to Reis. Some experts believe there could be softening ahead. But any weakness that does emerge may be confined to select pockets as the overall multifamily market, even moving at a slower pace, is still delivering solid performance numbers.

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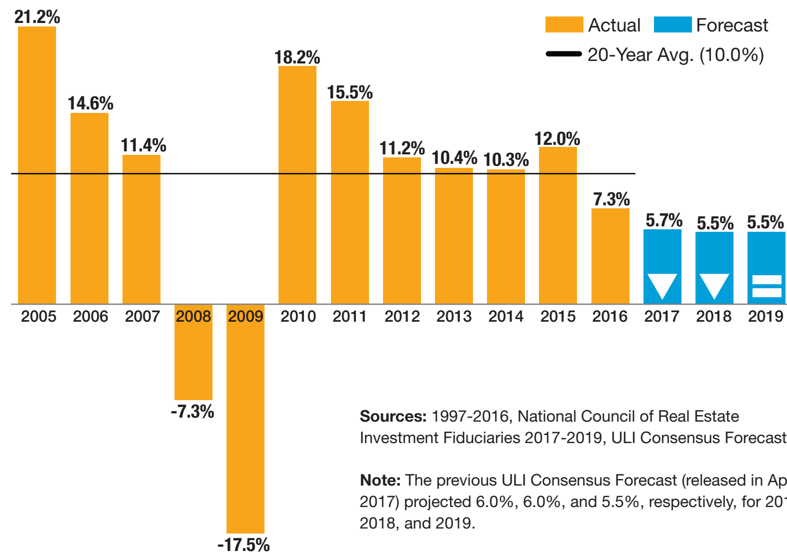
NCREIF Apartment Total Annual Returns



Sources: 1997-2016, National Council of Real Estate Investment Fiduciaries 2017-2019, ULI Consensus Forecast.

Note: The previous ULI Consensus Forecast (released in April 2017) projected 6.0%, 6.0%, and 5.5%, respectively, for 2017, 2018, and 2019.

Expectations of slower near-term growth is a safe bet considering there are about 300,000 units teed up for completion this year, according to Reis. Nationally, vacancies are expected to inch higher as rent growth decelerates.

According to the 2017 ULI Consensus Forecast, occupancies will increase 30 basis points this year to 5.2 percent by year-end, followed by slight increases to 5.3 percent in 2018 and 5.4 percent in 2019. The forecast also calls for slowing rent growth, with annual improvement expected to remain flat at 2 percent through 2019.

Varying Market Dynamics

Developers, investors, and lenders are keeping a close eye on those national forecasts and market trends, but market dynamics vary widely in different metros and various segments within the apartment sector. The surge in new supply has been heavily concentrated in high-end Class A properties, especially high-rise, urban projects. That activity has started to slow down over the past year, notes Daun St. Amand, senior vice president at CallisonRTKL in Los Angeles.

"Reading between the lines, the issue is that the price point has surpassed what the demand is or the ability of the demand to pay those rents," he says.

Development is shifting to suburban markets where building costs are lower, which is providing more affordable options for renters. Downtowns have expensive land and higher costs to support type one, concrete and steel construction.

"Those costs are skyrocketing, and, therefore, we are looking at a different kind of product," St. Amand says. Developers are shifting to a suburban, mixed-use product that feels urban and is close to rail or transit, but with low-rise design that can be built at a lower cost.

These more affordable options are pulling millennials out to the suburbs, but they seek the urban feel, according to St. Amand. That is fueling more mixed-use development, as well as an emergence of vibrant urban-like neighborhoods, in second tier or close-in suburbs.

"We see more and more trends toward these mixed-use projects where you have this blend of uses," he says. That includes access to leisure and conveniences ranging from proximity to grocery stores and restaurants, as well as a mix of housing types that appeal to millennials, mid-career professionals, and empty nesters that can fill the leasing pipeline.

Full Steam Ahead

Many metros are continuing to see development roll along at an ambitious pace. Downtown Los Angeles is one market that is experiencing explosive growth in residential development among both apartments and condos. At midyear, there were nearly 9,000 market-rate apartments and 1,700 condos under construction, according to the Downtown Center Business Improvement District.

Although occupancies have dipped slightly due to new inventory, rental rates continue to rise and are now averaging $2.92 per square foot, according to the Downtown Center BID. "The new units being built in L.A., although generally considered expensive, still lease up extremely fast regardless of the price," says Sharon Carz, CCIM, a senior adviser at Sperry Van Ness | SVN Rich Investment Real Estate Partners in Los Angeles.

A shortage of building sites has developers considering alternatives to move projects forward. Currently, Carz is working with an investment group that wants to purchase an office building to reposition for another use, such as housing or a boutique hotel.

"We are looking at different creative ways to reposition older buildings," Carz says. Another

CO-LIVING TREND DIGS DEEPER

by Beth Mattson-Teig

The sharing economy is taking off in multiple industries — from bicycles and cars to hotels and workspace. So, why not apartments? Co-living models already have a long history in the housing market, with examples such as hostels, college dorms, and group homes, among other venues. Developers are putting a new twist on co-living concepts with an eye on providing a lifestyle alternative and a more affordable housing option, particularly in urban areas where housing costs are soaring.

In Los Angeles, co-living has become not only popular, but necessary to manage the high rental costs, according to Sharon Carz, CCIM, a senior adviser at Sperry Van Ness | SVN Rich Investment Real Estate Partners in Los Angeles. “Most developers have taken this into consideration with regard to the unit mix and design choices,” she says.

The co-living spaces that are emerging come in many shapes and sizes. “There are several different variants depending on the socio-economic status of the specific neighborhood, but this has been going on in the northeast market for two decades,” says Chris Cervelli, CCIM, owner of Cervelli Real Estate and Property Management in North Bergen, N.J.

Ollie is one branded co-living concept where residents enjoy hotel-style conveniences, such as high-speed Wi-Fi, premium television programming, and weekly cleaning and fresh linens. The company opened its first location, Ollie at Carmel Place, in Manhattan in 2016. The property contains 55 studio apartments that range in size from 260 to 360 square feet, with shared spaces such as laundry facilities, a gym, a lounge, and a rooftop terrace, along with organized social events aimed at creating a greater sense of community among building residents.

Ollie has since opened a second location in Pittsburgh and has more projects underway or planned for Queens, N.Y.; Jersey City, N.J.; and Los Angeles.

Co-working innovator WeWork also has introduced its own co-living concept. WeLive currently offers flexible, fully furnished dorm-style rental apartments in New York City and Washington, D.C.

For some renters, the market rate co-living properties being developed are a more affordable option that bridges the gap between student housing and a traditional apartment, says Daun St. Amand, senior vice president at CallisonRTKL in Los Angeles. The questions are how deep is that market? And how long will millennials be willing to continue in that shared lifestyle before they want or need more independent space?

“Group living may be a temporary bridge between graduating from college and entering the workforce and being able to afford your own place, whether renting an apartment or buying a home,” he says.

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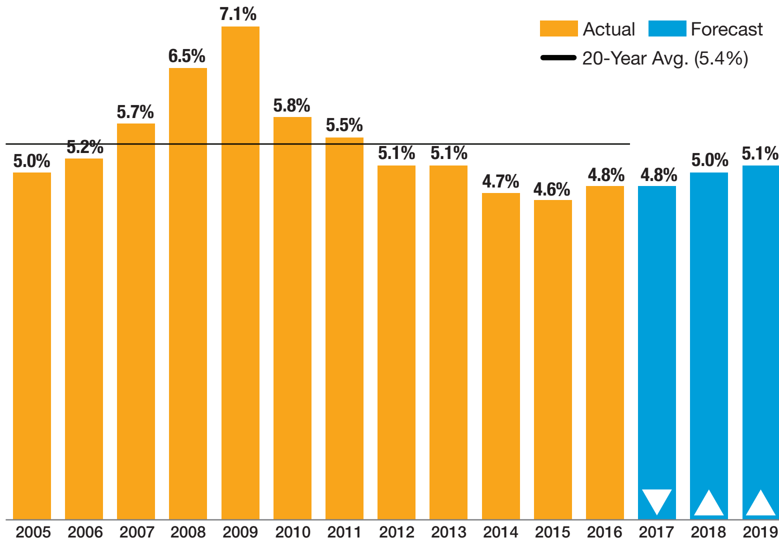
Apartment Vacancy Rates



Sources: 1997-2016 (Q4), CBRE; 2017-2019 (Q4), ULI Consensus Forecast.

Note: The previous ULI Consensus Forecast (released in April 2017) projected 5.2%, 5.3%, and 5.4%, respectively, for 2017, 2018, and 2019.

trend in downtown Los Angeles is that developers are building apartments with some of the framework in place, such as condo subdivision maps, which allows the developer to shift from apartments to condo sales depending on what the market dictates, she adds.

Baton Rouge, La., also has an ample pipeline of projects underway, mainly focused on luxury, Class A apartments, and student housing markets. In 2016, about 770 market-rate apartments and 380 student apartments were delivered.

The pipeline for 2017 and 2018 includes 1,800 market-rate apartments and about 1,000 student units, according to Chris Gremillion, CCIM, an investment sales specialist at NAI Latter & Blum in Baton Rouge. There is a lot of money chasing the student deals, but those owners and developers could face a tough market in the next few years due to concerns about oversupply, he adds.

On the market rate side, developments that have timed the market right and have Class A locations are leasing very well. "Baton Rouge is becoming more pedestrian and biker-friendly," Gremillion says. "Projects that are located in areas where people can walk to bars, restaurants, and other conveniences are in favor. Looking ahead to first and second quarter of 2018 when more supply is due to hit the market, it will be interesting to see how those units are absorbed."

Narrower Window of Opportunity

In some markets, the low hanging fruit and best development opportunities have already been snapped up. Some developers are looking to get in — and out — of the market before the cycle winds down. Lenders are already starting to pull back on financing for new construction.

"We have seen nearly a dozen projects drop this year throughout Florida, and financing is a key component of the projects not being able to move forward," says T. Sean Lance, CCIM, ALC, founding partner of Vertica Partners in Tampa, Fla.

Some lenders have stopped lending altogether, while others are requiring bigger equity commitments. In Florida, loan-to-cost ratios on construction loans have dropped from about 65 percent to 55 percent, according to Lance. "Lenders also are very concerned about the pipeline in virtually every market," he says. "As a result, they are being much more selective on deals."

There are multiple new projects in the northern New Jersey market that are proposed and are working toward approvals, and some that are being built, says Chris Cervelli, CCIM, owner of Cervelli Real Estate and Property Management in North Bergen, N.J. There is a push to get those projects sold early, because there is a lot of new product that has been built and is coming online.

Developers are starting to put projects on hold. "Even though there are a lot of projects that are entitled, they are not all being built," he says.

In Florida, the first wave of development was focused on urban infill and the downtown core markets. Once those areas became more saturated, construction shifted more to the suburbs. That second wave of suburban development is just starting to deliver completed projects.

"There is a last wave now as people are backfilling space and scrambling to find projects to get going," Lance says. Some proposed developments have started to drop out for a multitude of reasons. Lenders have tightened the access to capital for new construction, which has provided a headwind to new projects getting off the ground.

Absorption has gone well for those projects that have been delivered to date. That said, projects that are coming online in the second half of the year and into 2018 will start to test how deep the market is, especially at the high end, according to Lance.

For example, how many renters in Tampa can

afford to live in a $2,500-per-month unit? “That question hasn’t been answered yet, but it certainly will be with the projects that are set to deliver over the course of this year and into 2018,” Lance says. Each new project seems to be setting a new high watermark for rent, but people are looking at the market more cautiously to see if concessions start to be introduced and rents level off, he adds.

Proceed with Caution

Properties on the high end are going to feel the brunt of the softening, because that is where most of the new supply has been focused. However, that softening will cause rents to come down, which will create a trickle-down effect and create more pressure on the broader market, Cervelli notes.

“We are seeing softening, but it is not as public as it really should be,” he says. “There are cracks in the foundation that aren’t really showing.” For example, projects are starting to offer concessions, such as several months of free rent, to speed lease-up, he adds.

Other cracks are emerging in investment sales in some areas of the country. Apartment sales dropped 17 percent during the first half of the year compared to the same period in 2016, according to Real Capital Analytics. People are taking some risks right now. Buyers may be relying too much on underwriting, with low expenses, low interest rates, and high rents, according to Cervelli.

“I think if you’re doing that, you’re going into that with all of the headwinds and nothing behind you,” Cervelli says.

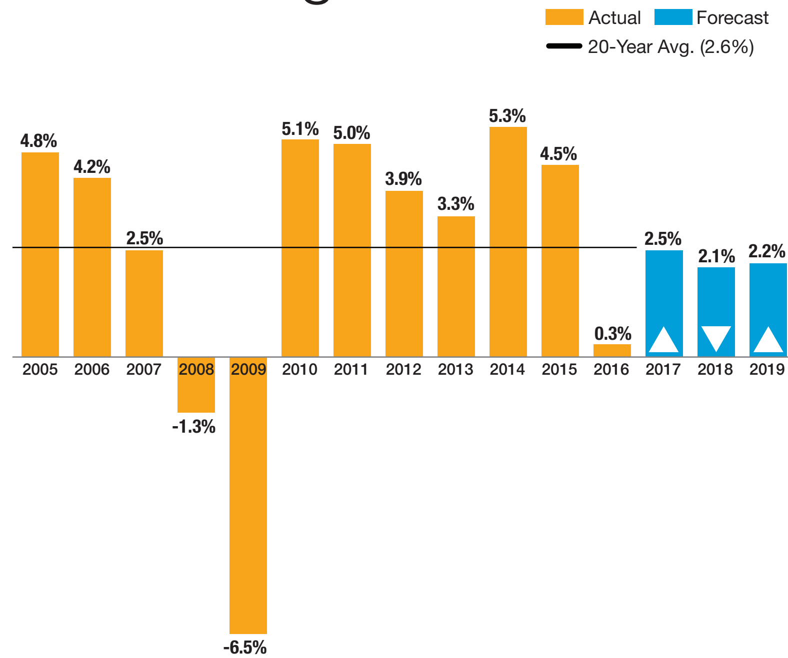
The growing supply is just one of several potential market risks giving investors pause. “There is still plenty of capital in the market,” Lance says.

However, there seems to be more temperance from the investment community that they are not willing to overpay for assets, which is keeping sales activity in check. As asset appreciation has slowed, investors also are being more cautious in how they are deploying capital, he says.

However, people still love the value-added deals. Buyers want to buy Class B properties in Class A locations, where they can invest in upgrades that will bring it to an A-, but there is demand all across the board, Gremillion says.

“Multifamily has been one of the best-performing products for the past eight to 10 years,” he says. That being said, many owners who may be considering a sale are asking themselves what they are going to do with the money, which may be stopping people from selling, he adds.

Apartment Rental Rate Change



Sources: 1997-2016, CBRE; 2017-2019, ULI Consensus Forecast.

Note: The previous ULI Consensus Forecast (released in April 2017) projected 2.0%, 2.0% and 2.0% respectively, for 2017, 2018, and 2019.

Markets such as Los Angeles continue to see high investor demand for assets, with cap rates that have dipped below 4 percent, according to Carz. Some owners are taking advantage of that market pricing to sell assets and reinvest in other areas of the country that offer higher yields.

“I see a lot of people sitting back and thinking creatively about how they are going to make their next investment move,” she says.

Even with a few warning signs emerging, it may be business as usual in many metros around the country. Unless there is a major geopolitical event, the multifamily market probably is going to trudge along at much the same pace for the next 12 months, according to Cervelli.

Interest rates are going to move higher slowly. There will be some softening in the market that will take sellers at least six months to catch up. However, there could be a 10- to 15-percent reduction in values, and the market could get hot again, he says.

Beth Mattson-Teig is a business writer in Minneapolis.