COMMERCIAL INVESTMENT Real Estate

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It's No Bull.

Multifamily investment continues to charge ahead.

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MOBs Have A Record Year

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MULTIFAMILY INVESTMENT

This bull market continues to charge ahead.

by Beth Mattson-Teig

By all accounts, the multifamily investment sales market has been on a bull run in recent years. The fact that the sector was the leader in the real estate recovery and continues to produce solid occupancies and rent growth has caught and held investor interest. And despite stiff competition and record sale prices in many metros, buyers' voracious appetite for apartments has not diminished.

"We are getting demand across the board whether it is a $4 million to $5 million deal or $20 million to $30 million. It is pretty much insatiable," says Richard Knutson, CCIM, senior managing director at Newmark Cornish & Carey in Emeryville, Calif. For example, Knutson recently brokered the sale of a 2009-built institutional-quality apartment building in Oakland, Calif., that attracted 23 qualified bids before closing at $24.7 million. The 76-unit property sold for $325,921 per unit, which is more than triple the current national average.

Multifamily has been the flavor of the month among investors for the past three years, and there is still an incredible amount of capital chasing acquisitions in this sector. Although apartment sales slowed in July, the $47 billion in multifamily transactions recorded during the first seven months of 2015 is up 32 percent compared to the same period in 2014, according to Real Capital Analytics.

Key drivers behind that robust sales activity are strong demand and a positive outlook for the sector. Vacancies continue to hold steady at 4.2 percent, according to Reis. And despite a surge in construction activity, Reis is predicting only a modest uptick in vacancies over the next five years to 5.5 percent.

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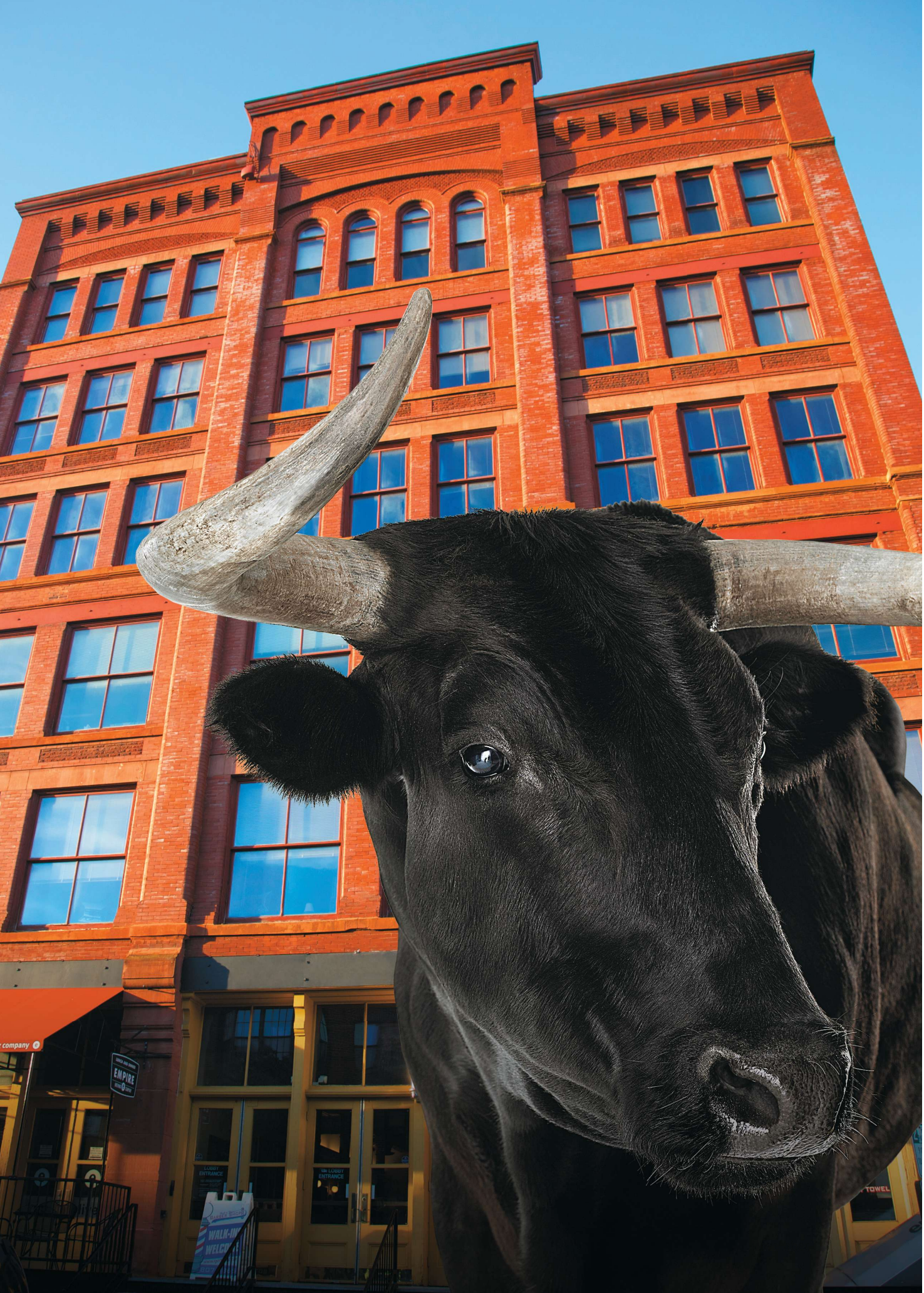
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"We have a growing population; people will always need a place to live, and Amazon.com is not going to change that," says Thomas McConnell, CCIM. "This is an asset class that cannot be replaced by technology." A managing partner at Redwood Realty Advisors in Hasbrouck Heights, N.J., he adds that apartments sales remain "hot across the board" in New Jersey for all types of apartments. Nationally, buyers run the gamut from institutions and foreign capital to syndications and local investment groups.

One of the frustrations in multifamily is that the amount of available for-sale product can't keep up with the buyer demand. "Unfortunately, there is a lot more demand in the market," McConnell says. For example, Redwood Realty recently introduced a listing for a 40-unit apartment building in a high barrier-to-entry market in Morris County, N.J. The 1940s-built property generated 15 signed confidentiality agreements in the first day.

High Prices, Low, Low Cap Rates

Given the buyer demand that exists at all levels from class A trophy properties to value-add class B and C assets, it is no surprise that investors are paying a premium to win deals. Both multifamily rents and sale prices are in record territory across many metros. As of July, the average capitalization rate nationally on all apartment properties valued at $5 million and above was 6.1 percent, according to RCA.

In particular, prices have soared across primary markets such as New York City, San Francisco, and Chicago. Pricing for the six major metros is now 163 percent higher than the lows we saw in 2009 and just over 100 percent higher in garden style assets, says Reid Bennett, CCIM, senior vice president at Sperry Van Ness—Chicago Commercial and national SVN multifamily council chair. "There was a small blip in July in terms of pricing on a national level, but we're still seeing prices for multifamily assets across the board pretty much 21 percent to 27 percent higher than the peak values in 2007," he says.

Competition is especially heated for high-end class A properties. "Especially with the class A deals, we're seeing 40 to 60 offers come in on a single asset," Bennett says. "That leaves 39 to 59 buyers that didn't acquire the deal looking for another opportunity and potentially stretching their acquisition criteria, perhaps dropping [to lower] asset classes."

Steady economic growth, strong rental demand, and soaring rents are adding intensity to an already highly competitive investment market. "After 30 years in the business, even I have sticker shock at rents and sales values being achieved in the San Francisco East Bay area," Knutson says. For stabilized class A buildings in that area, the going-in cap rate, which is based on existing rents, is at sub-4 percent, he says.

Many investors are underwriting deals aggressively, anticipating higher rents. Inves-

RENTS: HOW HIGH CAN THEY GO?

by Beth Mattson-Teig

One of the factors fanning the flames for investor demand and red hot sale prices in the apartment market is rents that continue to rise. Although some are beginning to question whether a bubble could be forming, data appears to support a rosy outlook for more growth ahead — at least in the near term.

Experts are predicting sustained growth for the U.S. apartment market driven by a number of factors, such as an improving economy, job growth, and a growing renter pool led by baby boomers and millennials. The "renter by choice" generation coupled with still stringent lending practices has home ownership at its lowest level in more than 50 years.

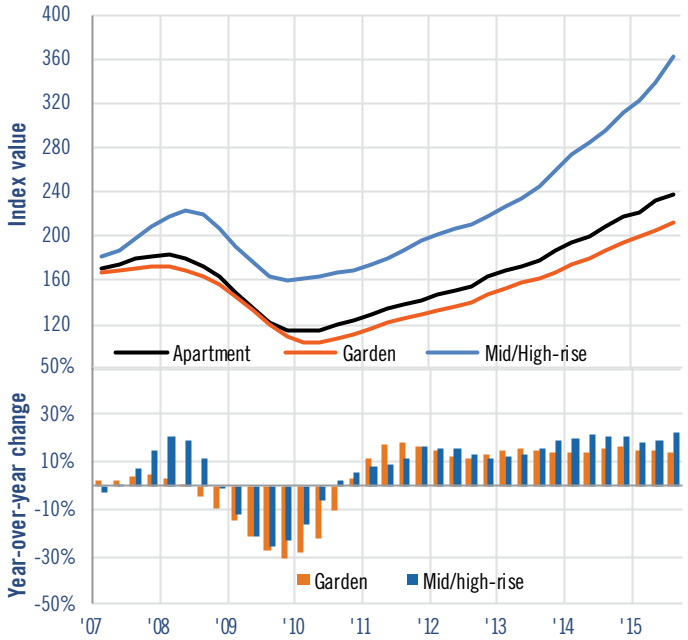
The high occupancies hovering around 96 percent along with strong renter demand are creating a favorable outlook for rent growth. Yardi Matrix started 2015 with a healthy rent growth forecast of 5 percent for the year. At the end of August, the firm reported that year-over-year rents had increased nationally by an average of 6.5 percent, an indication that "rent growth does not seem to be slowing down." The top three markets in the country were reporting double digit increases with Portland, Ore., leading at 15.3 percent followed by San Francisco at 11.7 percent, and Denver at 10.3 percent. Seattle and Sacramento, Calif., rounded out the top five, at 9.6 percent and 9.4 percent respectively, according to Yardi Matrix.

"Multifamily is sizzling hot right now. Occupancies are up and rents keep on bumping in the right direction with indications that apartment fundamentals will be strong for the coming years," says Joe Rubin, CCIM, owner of JG Realty Advisors in West Palm Beach, Fla. Sellers are capitalizing on this market to cash in on some cheap product they were able to buy from 2010 to 2014, he adds. "I am even seeing deals bought one

tors look at the going-in cap rate, but what they are really buying is where they think the cap rate is going to be when they get rents to market levels, Knutson adds. For example, he brokered the sale of a 1950s-built apartment building in Oakland, Calif., in May that sold for $5 million or $147,059 per unit. The going-in cap rate was 3.7 percent, but with anticipated rent increases the cap rate will likely be closer to 5.5 percent. In addition, the buyer borrowed money at a rate of less than 4 percent, which will give him good cash flow on a nice asset, Knutson says.

"Cap rates have compressed. However, they do seem to have leveled off in the majority of markets that we are in," McConnell says. In northern New Jersey, for example, class A cap rates have compressed approximately 100 basis points to 4.5 percent from the five-year average of 5.5 percent. Cap rates for class B and C properties in the area are hovering close to their five-year average at 7 percent, he says.

National Apartment Price Trends



Source: Real Capital Analytics

year ago flipping at large profit potentials," he says.

Although investors are by no means writing blank checks, they are being fairly aggressive in underwriting based on current market conditions. Investors seem to be banking on the fact that the renter demand, high occupancies, and rent growth are here to stay.

Yet some in the industry question whether rents are approaching a tipping point where elevated prices may push renters toward home ownership or less expensive rental options. The new development that is occurring is focusing primarily on class A properties that are commanding top dollar — $4 and even close to $5 per square foot in major metros such as Chicago and San Francisco. Construction of new luxury rental units is widening the gap between very high-end rentals and more affordable mid- and low-priced properties. "Rent is becoming less affordable, and people are paying more for rent today than we have seen in the past 30 years," says Reid Bennett, CCIM, senior vice president at Sperry Van Ness—Chicago Commercial and national SVN multifamily council chair.

Higher rents among class A properties are creating a ripple effect in the broader market. Owners of class B properties are increasingly bumping rents higher, either after completing renovations and repositioning, or in some cases, with no improvements at all, notes Bennett. In high demand markets, there are a number of cases where owners are raising rents $50 to $100 per month per unit without any rehab to the property, he says. Although that creates some good opportunities for value-add investors, it also raises concerns about the lack of affordable and workforce housing for renters.

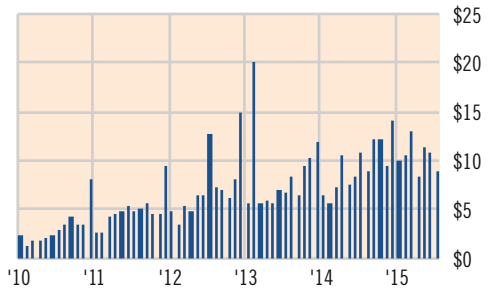
Nationwide, renters making the median income of just over $53,000 can expect to spend about 30 percent of their income on rent, notes Bennett. This is 5.5 percent higher than the historical average that existed from 1985 through 2000. Renters in the top six most expensive metros — New York, San Francisco, Los Angeles, San Jose, Calif., San Diego, and Miami — are spending upwards of 40 percent of their income on rent.

"We are hearing so much in 2015 that we have become this renter nation. I believe that is going to change," says Bennett. "How long can the rental market sustain 30 percent to 60 percent on rental income when the cost of owning is half or less than half of this number?"

Multifamily Stats

Cap Rates

Transaction Volume (in billions)



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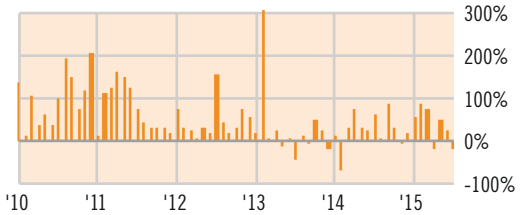

Source: Real Capital Analytics

Yet buyers are still willing to push cap rates lower for assets in extremely high barrier-to-entry locations. "There are many desirable submarkets in New Jersey in which a B or C asset can easily trade for a sub-5 cap rate," McConnell says.

The Search for Higher Yields

Certainly, there is still plenty of money chasing the relative safe haven of well-located class A assets in major metros. However, buyers are increasingly looking for opportunities that offer higher returns, whether that is new development, renovations, or target markets in secondary and tertiary metros. "Buyers are looking elsewhere for opportunities in growing markets," says Joe Rubin, CCIM, owner of JG Realty Advisors in West Palm Beach, Fla. "I am working with a ton of buyers who can't pay the prices in Orlando or Tampa. So, they are looking at Sarasota, Fort Myers, or even Melbourne or Lakeland, which are all becoming very hot markets," he says.

Rubin is also seeing more activity from investors buying 1980s- or 1990s-built properties. Investors upgrade interiors with more upscale finishes as well as modernize property amenities in order to push rents higher. For example, investors are re-doing pools to make them more resort style or converting existing tennis courts to multiuse sport courts.

Tertiary market Albuquerque, N.M., has seen a jump in sales activity in the past two years with more room for growth fueled by both local and outside investors. Albuquerque has an abundance of very small apartment properties; about 45 percent of its total inventory contains four units or less. As a result, the city mostly attracts small, "home-grown" investors from the local market, as well as investors from western markets, such as California or Las Vegas, that are looking for higher yields, according to Todd Clarke, CCIM, CEO of NM Apartment Advisors in Albuquerque.

Multifamily properties in Albuquerque are selling at about 6 percent cap rates with the potential for cap rates to drop even lower, Clarke says. A fair amount of that compression will be driven by the fact that investors are not so much cap rate buyers as value-add buyers, meaning that investors anticipate that they will be able to come in, make changes to the property or the management, and increase rents, he says.

One of the hot investment opportunities in Albuquerque is revamping existing housing properties to cater to millennial renters, Clarke says. "Our city has been very big on recruiting millennials and catering to them. So, for the first time since the 1980s, we have seen a lot of product coming online that is geared just to this one demographic."

For example, Clarke recently sold a property to an out-of-state buyer that is getting the highest one-bedroom rents in the city at about $1,195 per month. It has no amenities — no swimming pool or clubhouse. "Those really aren't the millennial amenities. The millennial amenity is location. They want restaurants, grocery stores, mass transit, and this property fits all of that," he says. Some investors also are coming in and converting older properties to trendy condo-style units with a more artistic design aesthetic that appeals to young renters, he adds.

At $1.35 to $1.85 per square foot, rents in Albuquerque for those new millennial units are a far cry from the rents being charged in major metros. Rents that top the $2 psf mark would support a different construction type, such as mid-rise apartments. "There is a lot of enthusiasm in the marketplace for what may be coming, and I think we are right on the cusp of seeing more interesting product come into the market," Clarke says.

Nationally, development is back in full force with an estimated 230,000 new units expected to come online this year, according to Reis. So far, absorption has been keeping pace with that new supply, which is a testament to the strong demand that exists in the market. Investors also are keeping a close eye on potential interest rate hikes and how that may impact underwriting and deal flow. But, for now, there doesn't appear to be any major events on the horizon that could derail the current momentum.

"There is still so much capital in the market. I have five to six groups that call me weekly to ask for new deals, when typically I would be bugging them," Bennett says. Investment groups that have raised capital are under pressure to deploy that money. "I don't see an end to the buyer pool, and I don't see interest rates doing much until after the election," he says. The amount of capital in the market combined with strong fundamentals may mean that multifamily' s bull run continues for at least another 18 months.

Beth Mattson-Teig is a business writer based in Minneapolis.