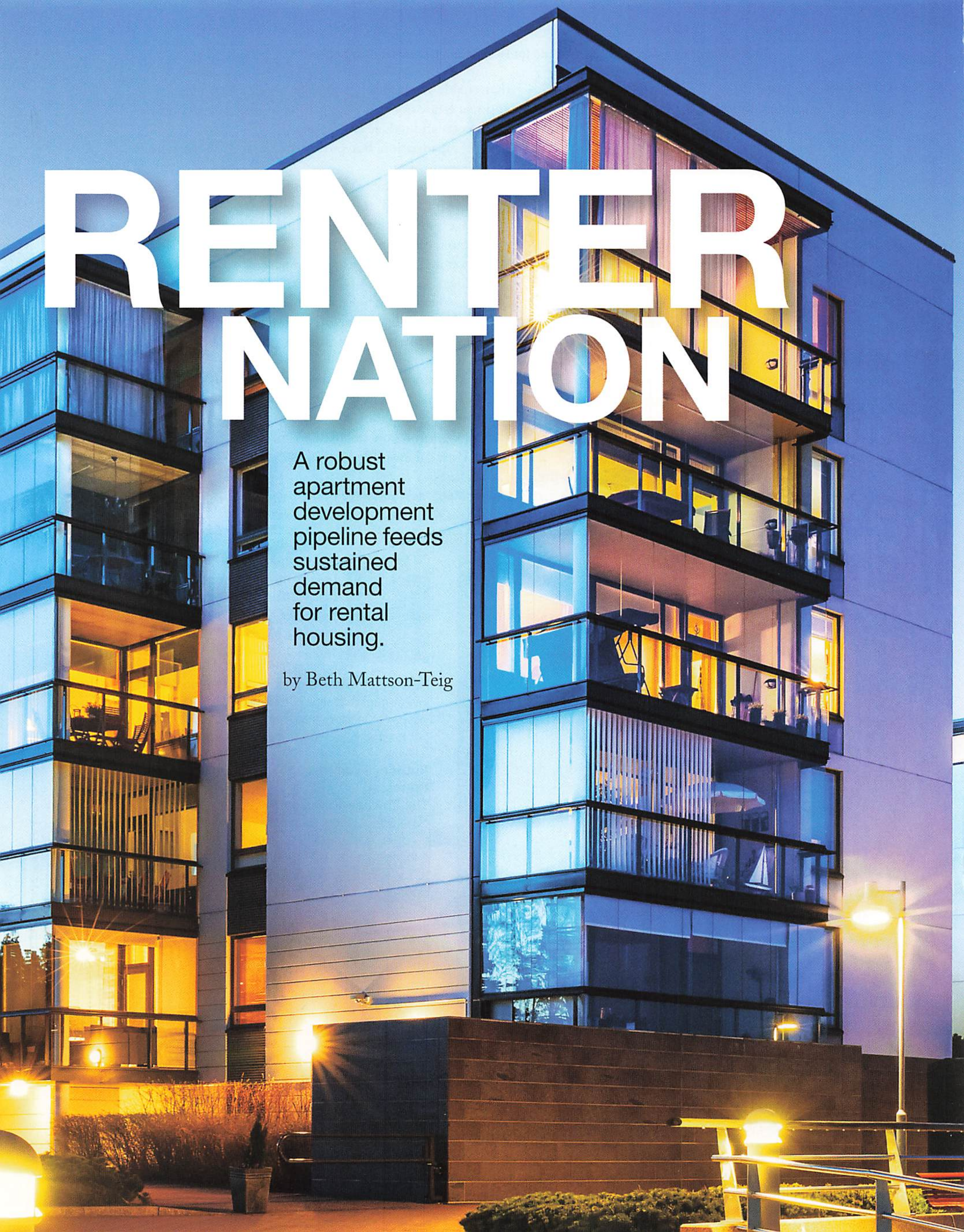
RENTER NATION

A robust apartment development pipeline feeds sustained demand for rental housing.

by Beth Mattson-Teig




Scanrail

A decade into this growth cycle, apartment developers in many metro areas still can't build projects fast enough to keep up with demand. At the same time, rising costs and increased competition for renters are pushing both developers and investors to fine tune late-cycle strategies to avoid potential missteps.

Industry data sources paint much the same picture. Vacancies remain incredibly tight with rent growth that is still positive, although moderate, and outpacing the rate of inflation. According to a Mid-Year Market Update from Freddie Mac, national vacancy rates were hovering at 4.1 percent with annual rent growth averaging 4 percent. Data from Reis show stable, but slightly higher vacancies at 4.7 percent and effective rents that increased by 1.3 percent in the second quarter.

"Everything that I see and read seems to indicate that we have more runway left in terms of the positive metrics that are contributing to multifamily being the darling of real estate," says Reid Bennett, CCIM, senior vice president, National Council Chair of Multifamily at Sperry Van Ness | Chicago Commercial.

Some believe that sustained demand represents a secular shift in housing. "I think we're more of a renter nation now," says Bennett. People across the spectrum from baby boomers to millennials and up-and-coming Generation Z appreciate the flexibility of not having to mow the grass or be tied to a home if they want to move to another city. They also saw friends and family that either lost homes or lost significant equity during the Great Recession, notes Bennett. "[O]wning a home has become less and less a part of the American dream," he says.

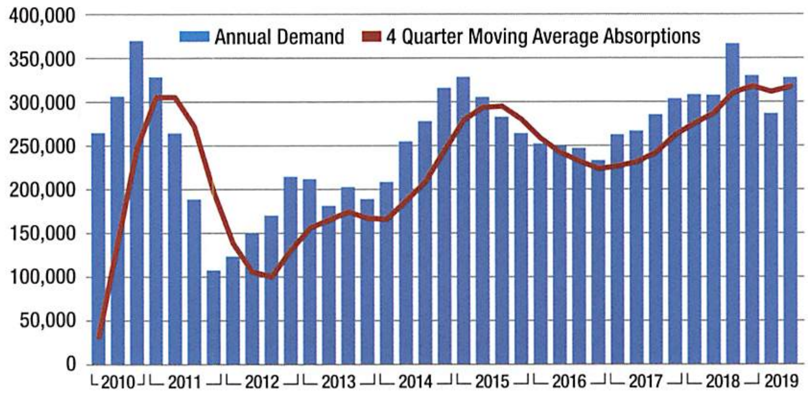
Rental housing remains in short supply even with elevated construction levels. According to Freddie Mac, the annualized pace of completions for multifamily projects with five or more units was at 365,000 units in June — the highest number in the past few years. It also comes on top of a robust supply of properties completed over the past several years. In fact, 345,000 units were delivered each of the prior two years. Reis expects supply growth to hit its cyclical peak this year and then slow significantly in 2020 and 2021.

Potential Headwinds on the Horizon

Yet there are some indicators that could signal caution ahead. The size of the rental market shrunk over the past two years, while homeownership edged higher to 64.4 percent, according to Harvard University's 2019 State of the Nation's Housing Report. Investors also are keeping a close eye on potential headwinds, such as the impact of high rental costs and slowing economic growth on new household formation, as well as aging millennials that may be ready to trade renting for homeownership.

That caution is pushing developers, investors, and lenders to assess the location, type of property, and price point much more carefully. "It has been more difficult for developers to secure market rate construction financing," says Heather Olson, CCIM,

Annual Multifamily Absorptions



Source: RealPage, Inc.

vice president at Walker & Dunlop in Atlanta. Lenders have pulled back and want to see developers put in upward of 20 percent equity with recourse and forward commitments on loans to ensure that loans will be taken out with permanent financing once properties have stabilized, she says.

Lenders also are keeping a close eye on trends within individual markets in terms of vacancies, the pipeline for new construction, and any changes in the employer base that might bring in new workers. "In general, lenders are taking a more conservative approach on underwriting market rate rents," says Olson. "We're still seeing rent growth around 4 percent, but we're keeping our underwriting pretty conservative, around 2 percent on average," she says. In addition, many lenders are underwriting to rents in place and not underwriting future rents. "We're not basing what we're lending on what could be achieved on future rents," she adds.

Continued Appetite for Luxury

Development has been concentrated at the top end of the market with projects that need to achieve higher rents to make the numbers work amid increasing construction and land costs. Equity is still very interested in multifamily development, but developers are cognizant of rising costs and scarcity of land. They are scrutinizing projects very carefully. "You don't want to be the last in on a project when you have a significant number of units that are coming online," says L. Matthew Hare, CCIM, president and chief investment officer at Pivot Development Company in Carmel, Ind.

Pivot Development focuses on live-work-play markets in Arizona, Colorado, Tennessee, Indiana, North and South Carolinas, Georgia, Florida, Virginia, and Minnesota. Most Class A renters either want to be close to where they work or near amenities. The farther away they are from both, the more difficult it is to retain those renters, says Hare.

For Pivot Development, one key to developing viable projects is putting together a good team of architects, general contractors, site engineers, and other groups that work on furnishing and finishes. "If you have a team that has familiarity, it is easier to discuss on the front end as you are

Solutions Target Workforce Housing Sector

The elephant in the room in the multifamily market is the voracious demand for workforce housing that can serve low- and middle-income renters.

"What we're seeing is that 85 to 90 percent of the new multifamily development across the country are occurring in the high-end, highly amenitized Class A product, so there is still a huge affordability gap," says Bennett. Non-profit groups that are building subsidized housing are not able to build it fast enough to satisfy the demand. "Then you have that middle portion, which is the vast majority of the country, that doesn't qualify for affordable housing and definitely can't afford the Class A," says Bennett.

The opportunity (and challenge) in many markets is providing moderately priced workforce housing. Building new housing for this demographic is a daunting task given high construction costs. At the same time, value-add investors have been targeting naturally occurring workforce housing. They are swooping in to buy and rehab older assets and raise rents.

Many cities are introducing incentives that allow developers to increase mixed-income density in exchange for adding affordable units. For example, in August, the Sarasota (Fla.) City Council approved a plan that would allow for 40 units per acre to be increased to 100 units per acre if projects meet certain affordability standards, including making units available to renters at 80 percent of area median income (AMI).

Such measures often get pushback from developers. "Depending on what the density bonuses are, it may or may not make sense for them to develop the project with those extra units," says T. Sean Lance, ALC, CCIM, a principal at Vertica Partners, a Tampa-based apartment brokerage and advisory firm. The typical concern that developers have is whether adding an affordable or workforce component will negatively impact lease-up on their luxury-priced units, as well as potential concerns in financing or selling an asset with an affordable component.

investigating a project if the numbers come together well from an overall budget perspective, and also if a project works within the parameters of returns and long-standing viability," says Hare. It is also important to have the creativity to know what can be built to maximize site density in relation to construction costs. A lot of different types of projects can be built on a site, such as a 5-over-1 or 5-over-2 design, he adds.

Developers are finding other ways to make the numbers work, such as building smaller units that can achieve the desired rent per square foot, while offering lower cost options to renters based on smaller square footage. Microunits, studios, and one-bedroom apartments have become more popular as properties have added more common area amenities, such as common area workspaces, lounges, and rooftop decks. "People don't have to feel confined within their units because these buildings are highly amenitized," says T. Sean Lance, ALC, CCIM, a principal at Vertica Partners, an apartment brokerage and advisory firm based in Tampa, Fla.

Some emerging boutique projects are focusing less on offering resort-style amenities and more on location as the main amenity. For example, Bennett is working on a project in the Quad Cities on the Illinois-Iowa border. The developer didn't put in a pool, spa, or fitness center because the property is near a YMCA that has indoor and outdoor pools and most of the facilities one would want in a modern fitness center. Without that huge amenity package that many core market developers are forced to build, Sperry Van Ness can build to a lower rent than what some of its peers in the market are building, notes Bennett.

Shifting Strategies

Many metros are continuing to see high levels of construction. However, in many cases, there has been a shift in the location and type of projects being built. The Tampa metropolitan statistical area, for example, has about 33,000 units currently under construction, planned, or proposed. Development activity that focused on urban infill locations at the start of the cycle is now shifting to the suburbs where projects are less expensive and can be delivered at more modest rents, notes Lance.

During the start of this cycle, the Tampa MSA set a new high watermark on rents — \$2 psf for new infill construction projects. Today, the new peak is \$2.50 psf for infill projects and \$2 psf for suburban projects. In addition, one new high-rise projects currently leasing up, Icon Central in St. Petersburg, Fla., has 16 percent of its units priced over \$3 psf, notes Lance. "The question has always been, how deep is that super high end of the market?" he says.

So far, new projects that have been built in the Tampa MSA have leased well. At the same time, groups that have been successful in stabilizing those projects indicated they are not necessarily looking to duplicate them. Instead, developers are shifting attention to mid-rise or suburban product versus a high-rise with rents that are set right at the peak of the market, says Lance. "At this later stage of the cycle, people are trying to keep their development pipeline

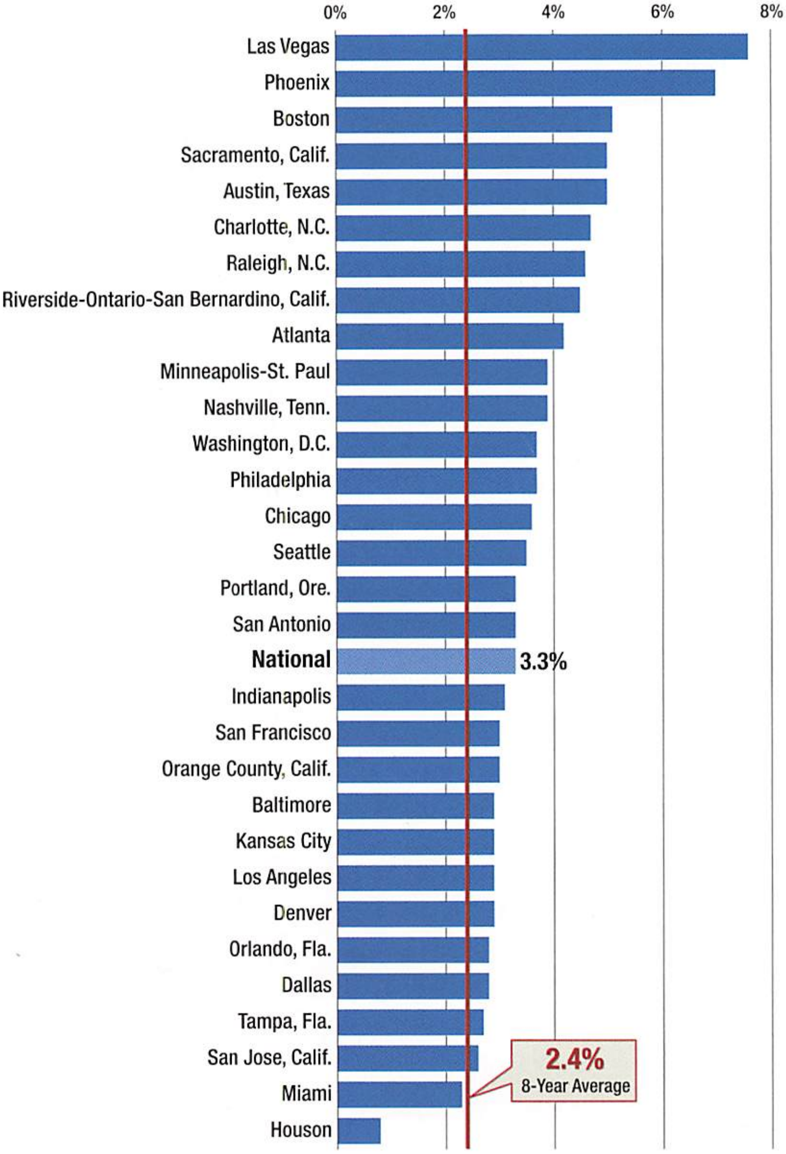
Dakota Enterprises is one for-profit developer proving workforce housing can be built without public subsidies. "I know that other people are struggling with it and saying that it can't be done," says Rick Guttman, Dakota Enterprises founder and CEO. "I would argue that it can; it just takes a whole lot more work and a whole lot more focus on the projects." The firm focuses primarily on building market-rate workforce housing in its home market of Houston.

Dakota Enterprises is currently developing Millwee Apartments, a 170-unit project in the Oak Forest area of northwest Houston that is expected to be complete in February 2020. The firm was also expected to break ground in October on its newest project, Bridges at Bingle, in Houston's Spring Branch area. The 250-unit project is located adjacent to the Kempwood Industrial Park, with rents for one-bedroom units averaging between \$1,000 and \$1,100.

One way that Dakota Enterprises keeps costs down is by offering a more moderately priced amenity package, such as granite versus more costly quartz countertops. Many of its properties offer nice quality swimming pools and fitness centers, but those facilities are not designed to resort-style standards that high-end Class A projects offer. Its projects also offer practical perks for renters, such as package lockers for deliveries and dog parks. "We don't go off the charts with those amenities," says Guttman.

Another part of the strategy is buying land in areas of town where people want to live and working closely with communities, schools and municipalities to build a product that both tenants and communities will want. "We work really, really hard on the pricing and construction and management so that we can provide responsible and moderately priced housing for communities," says Guttman. Going forward, Dakota Enterprises sees plenty of runway ahead to build good quality properties at an affordable price point, while at the same time helping to provide a better quality of life for individuals and families.

Year-Over-Year Rent Growth — All Asset Classes (August 2019)



Source: Yardi Matrix

going, but they also are leery of not delivering at the height of construction costs and being able to get rents needed to support that if the market takes a dip," he says.

Similar trends are present in markets across the country. Developers that have been firmly focused on urban infill are starting to widen targets to include the suburbs and secondary and tertiary markets where construction is less costly — and renter demand is once again on the rise. Cap rate compression in urban markets also pushes investors out into secondary and tertiary markets in search of better yields.

"We're increasing our property management presence and investor presence in those tertiary markets as a result of that shift," says Gary Hunter, CCIM, principal and managing broker at Westlake Associates Inc. in Seattle. Examples of tertiary markets in that area that are benefiting from that shift include Spokane, North Bend, and Kitsap County. "Some of the suburban markets also are experiencing demographic net migration in population increases along with job growth," adds Hunter.

Metros Vs. Soft Spots

National apartment vacancies remain incredibly tight, though markets may be softening facing a surge in new supply. Among the top 82 apartment markets that Reis tracks, occupancies declined in 30 markets during the second quarter, largely due to new construction, as compared to 36 markets that saw an improvement in occupancies and six that had no change.

Seattle is an example of a market struggling to absorb a heavy load of new supply at the high end of the market. In early 2019, vacancies were below 4 percent in the Seattle market. Vacancies have since ticked higher to nearly 6 percent for stabilized properties, whereas some of the newly delivered luxury projects are coming online with vacancies of about 40 percent, notes Hunter. "What's happening is that the asking rents on these multistory buildings remain high, but they are not leasing up," he says. Institutional investors are often unwilling or unable to reduce rents to attract tenants. In some cases, the reps and warrants in the investment offering preclude rents being reduced below a certain floor rate, adds Hunter.

Developers have pulled back significantly within Seattle due to the current supply and rising construction costs that make it difficult to deliver projects at market rate rents. "Land prices, construction costs, and entitlement fees are prohibitive for new development in the city," says Hunter. In addition, buildings that have been completed in the past two years are not being sold, because developers are not able to get the desired IRR with the rents and disposition value. "It has become more of a hold and wait-and-see market versus a complete, lease-up, and disposition market," he says.

Despite the unprecedented demand for housing nationally, examples of softening in Seattle and other pockets around the country speak to the nuances that exist on a micro level. At this stage of the market cycle, the days of the "build it and they will come" strategy are in the past. Developers, investors, and lenders are all working harder to read demand drivers within individual markets. What do renters want in terms of location, property type, and amenities? What are they willing to pay for market rents? Additionally, developers and owners are paying close attention to how those new projects will stand up over time, given shifts in demographics, economic, and market factors.

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