Development Déjà Vu

Multifamily construction revisits secondary and tertiary markets.

by Rich Rosfelder

An oil-producing formation called the Cline Shale was recently discovered in West Texas. Soon workers descended upon the tertiary cities of Midland and Odessa, drawn by the new oil-field jobs. Brian J. O'Boyle, CCIM, managing broker with Apartment Realty Advisors in Dallas, along with ARA's small-market specialist Bart Wickard, has been tracking the resulting uptick in multifamily development. He notes that, as of April, Midland had approximately 3,150 apartment units planned or under construction and Odessa had 2,800.

"In these two markets, developers are targeting any land they can get their hands on," O'Boyle explains. Texas-based development companies see the growing demand and lack of supply in the area firsthand, and they've recently found themselves competing with oil companies for land sites, O'Boyle adds.

But Midland and Odessa aren't the only noncore cities seeing an uptick in multifamily development activity. Job growth and pent-up retirement demand are drawing new tenants to markets from Seattle to South Florida. And with access to inexpensive debt and flexible loan terms, developers have begun to respond to the new demand outside of primary markets. This is reflected, in part, in the numbers: There were 233,900 new multifamily starts in 2012, up from 167,300 in 2011, according to the U.S. Census Bureau.

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That's not to say that all markets are seeing new multifamily product. Investors, developers, and lenders are carefully evaluating opportunities and potential challenges in their quest to build the right property in the right location for today's renter.

Dissecting Demand

About 1,700 miles north of West Texas, Calgary, Alberta, is also seeing multifamily development demand driven by a thriving energy sector. "I would be able to secure offers from my buyers on almost any serviced and properly zoned land right now," says D'Arcy Browning, CCIM, of Re/Max Real Estate in Calgary. Investors in his market are looking at multifamily development opportunities in all locations, comparing per-square-foot land costs and absorption rates among sector niches such as luxury and affordable housing.

Indeed, replacement cost is a key factor for investors considering multifamily construction. "We have only recently become interested in new development due to the narrowing gap between the cost of existing product and new construction," says Michael Anderson, CCIM, owner of RealSource, a Utah-based investment firm specializing in multifamily opportunities in growing markets.

In some markets, demand is up and the existing multifamily properties are simply obsolete. "We need to replace our inventory," says Todd D. Clarke, CCIM, chief operating officer of NM Apartment Advisors in Albuquerque, N.M. "The average apartment was built in 1965, is red brick, pitched roof, master metered, and built furnished — none of which is what the baby boomers and Generation Y are looking for." Developers are expected to deliver 560 units in Albuquerque this year — up from 158 in 2012, according to Marcus & Millichap.

Generation Y, in particular, is expected to be key to multifamily leasing and development. A significant portion of this 87.3 million-strong population segment will form new households as they leave their parents' homes during the next two years, Marcus & Millichap notes.

So, what are these renters looking for? Updated amenities and "more-efficient living spaces that cater to their technology needs," says T. Sean Lance, CCIM, managing director of NAI Tampa Bay in Seminole, Fla., who has multiple development sites listed or under contract in North Carolina, Georgia, and Florida. "The developers have taken note and I think the evolution of the product that is being delivered today is better than for-sale condominium projects delivered even 10 years ago."

Urban and Beyond

But where's a developer to put all of these new units? In some secondary and tertiary markets, the choice is as clear as Petula Clark's voice: downtown.

"Developers, equity, and debt are all clamoring for infill," Lance says of South Florida, which has more than 80 rental apartment projects planned or under construction. The appeal of urban locations goes beyond proximity to employment, he explains, citing amenities such as restaurants as well as walkability factors. And based on rents and absorption levels, the market likes these projects as well.

AN INVESTOR'S PERSPECTIVE

Michael Anderson, CCIM, and Nate Hanks, CCIM, are co-owners of RealSource, a Utah-based investment firm specializing in multifamily opportunities in growing markets. Anderson shares his company's approach to development.

***CIRE*: What's driving multifamily development?**

Anderson: Existing demand and availability of inexpensive debt and equity are the two primary drivers. In the last few years, most high-growth [multifamily] markets have experienced soaring job growth, new family formation, and in-migration fueling unmet demand.

***CIRE*: How do you determine whether a market is prone to overbuilding?**

Anderson: We examine the correlation or gap between the demand line and supply line. Future rental demand is primarily driven by service employees, which are the direct, ancillary of base employment within the area. Base employment serves as a leading economic indicator of future demand by at least 12 months as the service economy catches up to new base employment.

The leading indicator for supply is the entitlement process, which can lead actual construction by as much as two years. With these two factors, it's fairly easy to predict a gap in demand or if oversupply conditions are likely to exist within the next 24 months. But it's difficult to stop the development process even when headed toward oversupply due to commitments made during the entitlement process.

***CIRE*: What's your company's role in multifamily development projects?**

Anderson: We seek a relationship with multifamily developers where we provide the initial investment capital to acquire the land and complete the entitlement process, including plans and permits. We also provide the capital gap between the construction financing and the anticipated costs to complete the project. We expect our development partner to bring the project to a stabilized occupancy level of more than 80 percent, at which time we will arrange for permanent financing and acquire the development partner's interest. We pay considerable attention to community tapestry considerations and shifts in social economics to understand what type of property to build and market.

However, such locations also have drawbacks, Lance admits. "Infill projects typically offer unit sizes that can be 25 percent smaller than those of their suburban cousins," he explains. "That said, these properties offer more-dynamic common areas for the residents to gather and socialize and the amenity packages we are seeing rival many hotels and condominiums."

Such amenities appeal to young renters in Kansas City, Mo., too, which has caused the majority of new multifamily development to take place in the city's central business district. But the market's urban core is more susceptible to job losses as it can't offer companies the same economic incentives as other cities in the metro area, according to Daniel Kann, MAI, of Valbridge Property Advisors in Overland Park, Kan. So some developers are looking to the outskirts of town, where job growth is occurring.

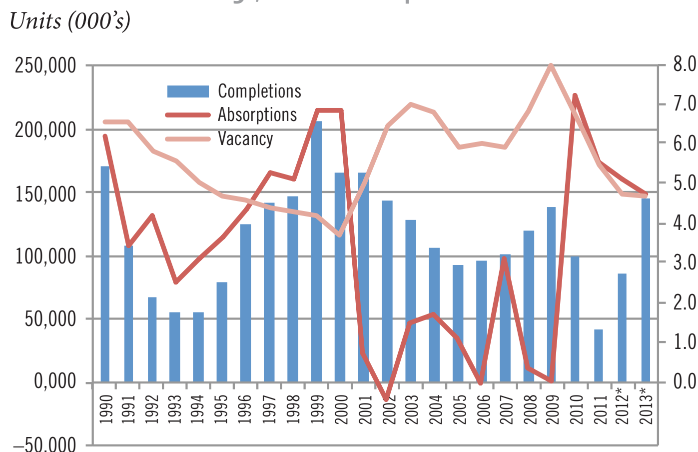
"Kansas City has traditionally been a suburban apartment market due to the availability of inexpensive land, good infrastructure, and minimal traffic congestion," Kann explains. "Additionally, the [city's] entitlement process is less demanding than in other parts of the country, allowing for increased development on the suburban periphery." New luxury projects in the area are seeing asking rents from $1.00 to $1.50 per square foot.

But these aren't the sprawling complexes often associated with suburban living. "Several of these projects are higher density than a traditional garden project, feature podium or attached parking, and are being marketed as a new urbanism design," Kann adds.

Jerry Hall, CCIM, of NAI Ohio Equities in Columbus, Ohio, is seeing a similar bifurcation in central Ohio. He notes that approximately 2,700 multifamily units are expected to be delivered in his market this year, with almost half located downtown. But the cost of land, accessibility, schools, and destination retail are also drawing developers to Columbus' outer belt, Hall says.

Multifamily Completions vs. Vacancy, Absorption

Units (000's)



*Forecast

Source: Reis/Marcus & Millichap

He cites the flurry of multifamily construction activity in the Polaris area, north of Columbus, which has a 97 percent apartment occupancy rate. Approximately 800 units were under construction there as of March, according to the *Columbus Business Journal*. Edward Rose & Sons is expected to deliver the largest project, the 309-unit Avenue at Polaris, this summer. "They bought the dirt right before the crash," Hall says. "The timing was right for building."

Building Block?

But the uptick in multifamily development activity in secondary and tertiary markets worries players. "The concern is: Are we going to overbuild as in the past?" Hall says. "Back in the 1990s we saw the level of supply exceed demand, which was affected by first-time home buyers. Occupancies dropped to 85 percent to 88 percent where they were normally 94 percent to 97 percent."

Lenders are watching such markets closely, and financing may become scarce. "As of the beginning of 2013, there are plenty of options available for the entire capital stack," Lance says. "But there are concerns that lenders will become much more selective as the pipeline of new projects continues to grow."

But markets such as Lafayette, La., may be safe, thanks to what Jeremy Harson, CCIM, calls "prudent decision making." Despite favorable multifamily development conditions — vacancy and unemployment are both under 5 percent — "All involved are a bit gun shy to start building too much too quick," says Harson, a commercial agent with Van Eaton & Romero in Lafayette. He expects this trend to continue for the next two to three years, based on current permit applications.

And is it possible that, across the U.S., fears of overbuilding are unfounded? In a March 30 post in his blog, "Jones on Real Estate," Ted C. Jones, senior vice president and chief economist for Stewart Title Guaranty Co., looked at job creation vs. residential and multifamily building permits issued in 2012. He noted that 2.1 net additional new jobs were created for each dwelling unit. As the normal range is 1.25 to 1.5 net additional new jobs, he argued that overbuilding is, in fact, not an issue.

Anderson suggests that we may be overlooking the bigger problem. "At this time we are less concerned about oversupply than we are about overpricing," he says. "The gap between the purchase cap rates and finance rates is now less than 100 basis points in some of the gateway markets. This is a strong indication that many markets are now on a pricing bubble rather than oversupply."

Will this situation eventually help to drive construction activity beyond the Midlands and Odessas of the world into riskier secondary and tertiary markets? If Tampa, Columbus, Albuquerque, and other select cities are any indication, it's already happening. Demand is beginning to well up. And developers and investors who recognize the potential in such markets may find themselves sitting on the next boom.

Rich Rosfelder is associate editor of *Commercial Investment Real Estate*.