A Quick Turnaround

BY KIM FERNANDEZ

The multifamily sector has bounced back in a big way from its low point. But questions about the lackluster condo sector and the future of Freddie Mac and Fannie Mae still cloud the outlook.

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Headlines proclaiming a budding economic recovery have largely been met with skepticism by many Americans, and for good reason. Unemployment numbers remain stubbornly high, foreclosure numbers remain up as well, and while retail spending seems to be inching forward, real estate investment just isn't bouncing back like many had hoped. ■ There's one glaring exception to that last part. The multifamily housing industry saw a huge bounce in late 2009 and throughout 2010. That has prompted many investment experts and housing executives to say that the multifamily sector is leading the overall recovery—and doing so in style. ■ By the third quarter of 2010, occupancy rates were up, rents were nudging steadily upward and developers had even started to think about building again—something the market hasn't seen in quite some time. ■ According to the National Council of Real Estate Investment Fiduciaries, (NCREIF), Chicago, the national property index for apartments (which measures the composite total rate of return measure of investment performance of a large pool of properties in the private market) in third-quarter 2010 was an astounding 6.04 percent. For comparison, the rate was -3 percent a year prior, -0.36 percent, in third-quarter 2008 and just 2.93 percent in the same quarter of 2007.

In fact, NCREIF says the index skyrocketed from 0.42 percent in first-quarter 2010 to 4.44 in the second quarter, and then was up almost another two percentage points at last available report for the year.

What does that mean? In general terms, it means multifamily rental properties appear, for the time being, to be king among investment real estate options, outperforming both single-family housing and commercial real estate by far.

Officials at Fannie Mae and Freddie Mac say the foreclosure rate on those properties has stayed far below the national average for any other kind of real estate investments, and the credit crisis that hit those businesses over the past several years appears to have simply skipped over apartments.

Add to that the fact that private bank experts are looking ahead to increased refinances and even starting to write approvals for new construction, and you have a segment of the real estate industry that's not only recovering, but doing it with aplomb.

To put it simply, experts say, it's hard to go wrong in residential rentals right now.

The trend appears to be happening across property classes, and while there is tremendous renewed interest in affordable and subsidized properties, even luxury rentals are seeing a nice bounce from lows over the past two years.

Multifamily, they say, is back. And smart investors will think about hopping on the bandwagon sooner rather than later.

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A faster-than-expected comeback

"We are getting close to moving back into the production of market-rate product," says Greg Willett, vice president, research and analysis, with MPF Research, Carrollton, Texas. "That really reflects this comeback, which has been very far from what anyone anticipated. We've moved everything ahead a year or so from what we would have thought in the cycle, and the fundamentals are looking great."

Jamie Woodwell, vice president of commercial real estate research for the Mortgage Bankers Association (MBA), agrees. "Multifamily is the flip side of the single-family story," he says. "The homeownership rate has fallen dramatically the past few years." Woodwell explains that a 1 percent drop in the homeownership rate translates to a 3 percent increase in demand for rental housing.

"The homeownership rate was 66.9 percent in the third quarter of 2010," he says. "That's down from a high of 69 percent in the third quarter of 2006." And that translates into a whole lot of new renters.

"Fortunately, a lot of the ills that have affected single-family . . . didn't come home to roost in multifamily," says Stephen Ryan, a partner with Cox, Castle & Nicholson LLP, San Francisco.

"To a great extent, financing is available. To date, much of that has been limited to FHA [Federal Housing Administration], Fannie Mae and Freddie Mac, but we're starting to see regular conventional lenders diving back into that market."

Ryan says there are very good reasons for that, including a return to renting by Americans and the overall financial picture of the country. "There is tons of capital," he says. "There is a lot of optimism. Constraints to cap rates are coming down so quickly, and there is not as much supply as we need right now."

According to the Washington, D.C.–based National Multi Housing Council's (NMHC's) quarterly survey of apartment market conditions for October 2010, 60 percent of respondents felt that apartment market conditions were tighter than three months previously, and 71 percent reported that apartment sales in the local markets they watched were higher than three months before; that number was up 10 percent from NMHC's second-quarter survey.

Forty-three percent of respondents to NMHC's third-quarter survey felt that equity financing was more available than three months before, and 64 percent felt that the third quarter was a better time to borrow than the second quarter had been.

"The Treasury rate has gotten so low in the recent past that it's a heck of an opportunity to lock in for 10 years or longer," says Michael May, executive vice president, multifamily, for Freddie Mac. "We're seeing fixed rates that are about where adjustables were just a couple of years back, which is unbelievable."

Ken Bacon, executive vice president of Fannie Mae's multifamily mortgage business, agrees. "We're starting to see more sales take place than we did in 2009," he says. "That's a good indication of the market's health. And we're seeing stirrings of people beginning to develop projects in some markets. It's not anywhere near where it needs to be to meet the growing demand, but things are moving in the right direction."

May says that's also true for people who've been holding out on refinancing. While the multifamily refinance business has been robust for some time, he thinks the boom there isn't over by a long shot.

"Two-thirds of our volume lately has been refis, and the rest is acquisitions and new construction," he says.

"A lot of people couldn't refinance until now because the numbers didn't work. But debt-coverage ratios on apartments have improved, improved, improved, and cap rates have tightened up. At some point, the numbers all work. And when they work, people come in for a refi. Any more improvements in cap rates going in the right way will create a whole new population of people who can refinance."

"Certainly, people who have been sitting on the sidelines until now are coming in again," May continues. "Trammel Crow [Co., Dallas] just started up a new operation for construction purposes. The big REITs [real estate investment trusts] who'd been sitting on the side are now, in some markets, interested in building. In the right markets, if you bought land in the past and you've been sitting on it, now is certainly a good time to build," May says.

Demand for nice—not ultra-luxury—product

While industry experts say that on one hand, multifamily is rapidly improving across the board, there is no doubt that some markets and property types are doing better than others, leading what is already a surprising recovery.

"People on the development side are starting to work on deals now, getting land in place and dealing with all of their entitlements," says Willett. "I think the start numbers for conventional housing for the last half of 2011 will probably be pretty substantial, and looking ahead at 2013 [starts in later 2011 and completions two years later], I think we'll see some pretty significant completions."

Feldman says the market value of many condos is as low as 50 percent of what it was four years ago, and consumers still aren't biting.

That's not to say you'll see the same ultra-luxury product as five or 10 years ago, he cautions.

"What seems to be targeted is nice product, but certainly not as high-end as what we saw during the last cycle," he says. "A lot of that was built with the assumption that they'd convert to condos or even start as condos. So what we're seeing now is not ultra-luxury, but it is very nice."

Willett says that so far, developers seem to be looking at smaller property sizes and smaller apartments, to keep costs and rents down.

"We're seeing properties with 200 units instead of 300," he says.

If there is an albatross around multifamily's neck, it is the condo market, which hasn't even begun to think about a recovery.

Condo lending a hidden opportunity?

"We've completed a handful of transactions this year where a client acquired a multifamily property—typically a conversion—that didn't go through," says Christopher Kelly, managing director and head of real estate in the Structured Finance Business group at CapitalSource Finance LLC, New York. "We had a few deals where the multifamily property had some condo units mixed in. Other lenders are less willing to finance those type of assets."

That said, he thinks there may be a hidden opportunity for those willing to take a little risk.

"We're not lending on condo projects," he says. "But that's an interesting area to keep an eye on in the coming year. If you've got a contrarian bent to you, you might want to go where nobody else is lending. Right now, that's condo projects."

Kelly adds, "We're seeing some equity investors buying condo projects, but they're typically doing it with no debt and all equity. There's no capital available for condos. But I do think we'll start to see some interesting opportunities and that market becoming more active. I suspect they're a little ahead of the curve, however—2011 may be the time for some lenders to dip their toes into the water for condo lending. I think we'll see other lenders in those markets."

Others are not as optimistic, and say the condo market may very well be among the last to recover.

"There are dead condo projects all around America and everywhere in between," says Alan Feldman, chief executive officer of Resource Real Estate Inc. (RRE), Philadelphia. "There are excess condominiums, and a lot of those were not built to the medium end, but built to the high end. That's a soft spot right now."

Feldman says the market value of many condos is as low as 50 percent of what it was four years ago, and consumers still aren't biting.

"People are a little gun-shy," Feldman says. "They're not going to plunk down $200,000 or $250,000 just because the unit is cheap. They're a lot more concerned about getting burned."

And it's not as easy as taking those units and renting them, he says. The very way they were built precludes success in that area.

"Condos that were built to specs of granite countertops and stainless-steel appliances and tile backsplashes and expensive packages translate into rental values at the very top of the market," he says. "That's not what people need right now. Garden apartments are very efficient and can be rented reasonably priced. It's very expensive to take a condominium with 100 units and convert that to apartment prices. The rents that you get don't restore enough value."

Affordable rental housing in demand

Couple that with an increased need for affordable rental housing, and the condo glut doesn't appear to be looking better for quite some time. It's simply not what people need, say experts.

"There is clearly a need for affordable housing," says Feldman. "We need work-force housing—housing to house people who make median incomes. That is an aging stock and a depleting stock of rental housing, and it is clearly needed in this country. Not subsidized, but just affordable."

"The affordable market has been explosive in its growth and health," agrees Ryan, who attributes the boom to the greater availability of tax-credit financing.

"Tax-credit equity pricing was yielding over a 10 percent internal rate of return in product in 2010," he says. "It made all the sense in the world [and that's] why big institutional investors got back into the tax-credit marketplace, and they've done it with a vengeance."

They're not alone—the government-sponsored enterprises (GSEs) and FHA announced a renewed commitment to affordable/subsidized housing in 2010 and said they'd focus largely on preservation deals into 2011, offering more flexibility with the programs and, in some cases, offering favorable treatment to properties that offered rental assistance.

"Fannie Mae was started as a mission business," says Bacon. "We've always wanted to run it in a business-type manner, but we started out in multifamily because a lot of the early founders had worked at HUD [the Department of Housing and Urban Development] and believed passionately in what I call rental housing for working families. They wanted to have a program to help support that, and they always had a commitment to do things in that area."

A continued commitment there makes sense, he says, particularly in an economic climate where more families might need help making the rent every month.

"We feel it is an important component of our overall strategy," Bacon says. "We want to help restructure or refinance that debt and provide some liquidity."

The seniors' rental niche

The agency is also looking more toward extended rental housing for seniors, particularly properties where elderly residents can transition from independent living to assisted living to full-out nursing care, without needing to move.

"You want them to go in one place, get to know the staff, get comfortable and be able to stay," he says. "And we've done that. It requires some expertise. To be honest, when I first looked at this, I was scared of it. But my mother, my grandmother and my great-aunt have all been in assisted-living and nursing homes, and I realized first-hand that this is important. If you visit these places, you quickly learn the difference between those that are operated well and those that aren't."

That said, the future roles of Fannie Mae and Freddie Mac are unclear at this point, as the conservatorship of the two agencies is supposed to end in 2012. The Obama administration has voiced its support for replacing them with a different kind of federal subsidy and perhaps an updated mission. Bacon and May both declined to comment on the possible changes to their agencies.

"Fannie and Freddie have done a good job of supporting the market," says Bacon. "Our credit performance is good and we've been profitable most quarters. So the best thing for me to do is continue doing good business and providing housing for families."

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Others say that while it's impossible to know for sure what may happen with the GSEs, they have serious doubts that Fannie and Freddie will disappear anytime soon.

"I suspect they're going to be around," says Feldman. "In the current political climate, I think it's quite likely that their emphasis will be placed toward the middle and not toward the upper end [of properties]. And one concern we have is that when we look at a higher-end property, there will probably be more risk that it'll be harder to get a Fannie or Freddie loan if we want to fix it and sell it to someone else."

Ryan agrees, saying he doesn't envision the complete disbanding of the two entities. "We don't have a sense of whether Fannie and Freddie will exist or they'll break up like the phone company," he says. "There are quite a few people who are agnostic on that subject. But at the end of the day, we need to know whether the delivery system is supported and backstopped by the government. The market will depend on the balance of that."

For his part, Kelly says now is not the time to consider dismantling the existing system.

"For the government to just pull the rug out from everybody and eliminate those programs . . . it's just not reasonable to expect that would ever happen," he says. "Any kind of key change in that capital source for the multifamily industry is unlikely to occur for decades. It's analogous to saying that we're probably going to get rid of Social Security. It's not necessarily a bad idea, but it's something that would take forever to implement." MB

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