

## Rental Reality

By Kim Hitselberger Fernandez

It's been said a thousand times: With interest rates hovering at record-low levels, anyone who can buy a home is buying one.

Conventional wisdom, then, would dictate that the rental apartment industry must be a mess, what with residents flocking to the closest Realtor's office to plunk down their savings on the American dream. Thankfully, at least for the rental business, that's not exactly the case.

"It's not really doing very well," admits Bob Sheehan, consulting economist to the National Apartment Association (NAA), Alexandria, Virginia, of the U.S. rental market. Still, he says, "There are very few markets that you would call really distressed, like so many were distressed in the late 1980s and early 1990s."

Vacancies, having dropped to an all-time low of 11.9 percent in the fourth quarter of 2003, rebounded in early 2004 by a statistically significant two-tenths of a percentage point. Industry experts anticipate a slow recovery during the remainder of 2004 and into 2005, buoyed by an expected rise in interest rates.

Still, "There's significant construction activity," says Greg Willett, vice president of research products, M/PF Research Inc., Carrollton, Texas. "Overall, over the last three to four years, building hasn't really slowed down." The change in apartment construction, he says, has been mainly geographical, with downtown, urban apartments outperforming the more

traditional garden apartments in the suburbs.

Experts say that apartments remain a popular housing choice, even in a strong home-buying environment, for several reasons: people without savings or consistent income remain renters; the transient nature of some careers keep people renting; and a steady influx of recent college graduates into the job market fills apartments until the young professionals can afford to buy homes—typically several years later.

Perhaps most significant in recent years has been the emergence of the renter-by-choice: the high-income, older renter who knows he or she can afford the American dream of a lush lawn and white picket fence, but would prefer to not cut grass or paint fences on weekends. Thanks to that segment of the population, A-plus apartments continue to grow, albeit not as quickly as a few years ago.

Sheehan cautions that, when it comes to apartment industry health, everything is relative. "New York went from less than 1 percent vacancy after Sept. 11 [2001] to 5 [percent] or 6 percent last year," he says. "And you'd have thought the world was coming to an end."

### ***Building continues***

While apartment construction has slowed since the late 1990s, when it seemed every horizon was dominated by cranes and "Now Renting!" signs, a healthy number of new rental units are in development. In fact, the National

Association of Home Builders (NAHB), Washington, D.C., says that nearly 430,000 multifamily housing units were built in 2003, a 20 percent increase over 2002. In March 2004, multifamily housing starts were up 16.9 percent over a year prior.

“Companies are moving forward with plans that have been deferred over the past 36 months,” says Mark Obrinsky, chief economist and vice president of research for the National Multi Housing Council (NMHC), Washington, D.C.

Still, some construction remains a struggle. “It’s difficult to get permits and zoning in many cities,” says Howard Levine, president and CEO of ARCS Commercial Mortgage, Calabasas, California. “There is a lot of negativism focusing on increasing density in some communities. The approval process is long and burdensome.”

“It’s tougher to build today than it was five years ago,” Obrinsky says. “There are a lot of barriers to entry.”

Enough developers are climbing through those hoops to create an upswing in construction numbers, however. Levine says, “There is no national market in apartment housing right now.” Rather, experts look at the market on a city-by-city basis, with some cities struggling to fill rental units and others basking in recovering or booming rental markets.

M/PF Research routinely tracks apartment construction in 25 major metro areas, and found that 2003 construction was down 11 percent from the previous year and down 25 percent from a peak in 2000.

“There’s been a significant block of construction in secondary markets,” Willett says. “Major cities are flat or down, but secondary cities like Little Rock [Arkansas]; Sarasota [Florida]; Milwaukee and other smaller areas are

seeing an uptick and getting a larger share.”

Large cities with the most significant slowdowns included Phoenix; Atlanta; Dallas; San Diego; Orlando, Florida; Chicago; Orange County, California; and Charlotte, North Carolina. Even in cities that saw increased construction in 2003 including Denver and Houston, occupancy levels were down.

“They’re not losing renters from the top tier of apartments, but from class-B and C properties,” Willett says. “In that top tier, we’ve seen as much drain as we’re going to in the movement from rentals to home purchase.”

Finally, Willett says, several cities have seen both healthy construction and high occupancies. He says southern California, the northeast/mid-Atlantic corridor and south Florida are all enjoying relatively healthy apartment economies. “The economy slowed down in those areas, but it didn’t struggle,” he says.

Overall, Sheehan says, “New construction is up this year. Based on what’s going on, we’re forecasting starts of 275,000 units.” That said, he cautions that new units are taking longer to rent up, and that an influx of new units will take renters out of some older housing stock.

## ***Rehabilitation***

For the last 10 years or so, industry buzz about class-A-plus apartments has been relatively constant. The new “renter-by-choice” swooped into rental offices across the country, demanding granite countertops, hardwood floors and concierge services. These high-income renters--often empty-nesters or young, single executives--wanted all the benefits of living in a top-tier country club development or luxury hotel without the responsibility of maintenance or the

long-term commitment of a 30-year note.

While luxury rental homes remain popular, particularly in large cities with transient workers, they have been hit by the surge in home-buying brought on by record-low interest rates. Enjoying a resurgence are the B-plus to C-plus class apartments—traditional garden units or urban rentals—that are being snapped up by young professionals enjoying rent cuts.

Rents in November 2003 were down 1.9 percent over the same period in 2002. Realizing they can get more space for the money, more renters are sacrificing surface amenities and perks for plain-Jane units--as long as the ZIP code is right.

“In many cities, there is demand for close-in, urban apartments,” Levine says. “Young people want to be close to the excitement of the city, and they prefer to work and sleep in the same neighborhood.” As a result, he says, there is a huge demand for urban apartments that can be rehabilitated from C-class to a B or better.

“The hottest thing for opportunistic buyers is upgrading the apartment to a B-plus from a B-minus,” he says. “Congestion and commute times are getting longer and more difficult. People are tired of spending an hour and a half in their cars every day.”

Margaret Allen, AGM Financial Services Inc., Baltimore, agrees. “The rehabs tend to be downtown,” she says. “Downtown, modern, urban living and the rehabilitation of 1970s or 1960s product is hot.” While most of that development translates into market-rate rentals, some has gone under the wing of tax credits and affordable-housing loans.

According to M/PF Research, Houston’s West Inner Loop enjoyed a 93.3 percent occupancy rate in

September 2003, besting the metro average by almost three percentage points. At the same time, effective rents dropped by nearly 5 percent in the West Inner Loop submarket from a year before.

Rents for in-town Dallas held steady from September 2002 until September 2003. Rents in the rest of the metro area fell more than 3 percent.

Urban core occupancy in Atlanta grew by half a percentage point during that same year; the metro area saw an overall drop of 1.2 points according to M/PF Research. And although rents there did fall by 3.8 percent, the overall metro drop averaged 4.1 percent.

Rehabilitation efforts in cities such as Atlanta, Houston, Dallas and some Washington, D.C., suburbs have brought new restaurants, theaters and life to those areas. Riding the wave are apartments, with increased starts, renovations and rents in those same cities.

“You can go across the board,” says Levine. “Urban, downtown, close-in apartments are in demand, and at relatively high rents.”

As some of those apartments are renovated, they are being re-launched as condominiums, marking another major trend.

### ***Condos on the upswing***

“We’re seeing a fair amount of condo conversions, and the product we’re seeing built is primarily condos,” says Paul Saint-Pierre, executive vice president, Wall Street Realty Capital Inc., New York.

Others agree. “Condo conversions have been very, very hot over the last year,” says Levine.

“Developers in soft apartment markets are building condos,” agrees Allen.

“There are as many condo units on the market as apartments in a lot of metro areas,” says Obrinsky. “There is a lot of new construction, and a lot in the pipeline.”

It makes sense—where people won’t rent, perhaps they’ll buy the same type of property. And where single-family and town homes sell for prices out of the range of most beginning professionals, condo prices remain reasonable, all things considered. Converting older, class-B apartments to condos is a hot trend in urban areas where rentals remain soft.

“There hasn’t been an overconversion,” Obrinsky says. “It does have an impact on [rental] occupancies, but it really isn’t the big player you might think. The condo market is very risky—the problem with that market is that it will change overnight and you’re stuck.”

Saint-Pierre says many developers he works with have planned for a tumble in condo sales and values by employing fallback clauses that would allow them to rent the new units as conventional apartments should condos fail before construction is finished.

“If they won’t sell as condos or if mortgage rates are adverse in a year or two, everybody generally underwrites them as multifamily,” he says. “Directly or indirectly, we’re seeing multifamily product being developed as a default option behind condo construction.”

### ***Affordable housing grows***

One of the biggest buzz-phrases in the industry is “affordable housing,” which normally translates to tax credit or other subsidized rentals. The need for affordable housing has grown exponentially with the rise in home prices, and most look to rental owners to fill that niche.

Unfortunately, a perception that affordable housing finance is overly

complex has driven many multifamily owners away from pursuing it.

“It certainly is a growth industry,” says Levine. “There is a need to have this type of housing constructed.” He says that fairly new constraints imposed by individual states, and a not-in-my-back-yard (NIMBY) attitude in many major cities have stymied owners who might be otherwise interested in taking advantage of low-income finance programs for rental housing.

“We have legal constraints and we have communities that have negative impressions of affordable housing. It’s a double fight,” he says.

Sheehan agrees. “Everybody is interested in affordable housing,” he says. “Making it work is another story.”

Levine says that lenders that are willing to publicize affordable housing programs and do a bit of hand-holding with apartment developers stand to tap a large market. “We need to let [developers] know that it is complicated. It is costly. But there are a lot of experts available in this field. We can make the process much smoother and educate them.”

M/PF Research studies show that affordable housing is hot in several major markets, including Orlando; Atlanta; Los Angeles; Tampa, Florida; Oakland, California; and San Francisco. Its data also shows that more than half of the 2004 new housing stock in San Antonio, Texas, is being constructed using Low-Income Housing Tax Credits (LIHTC).

Saint-Pierre says many of the older rental stock his clients are buying for renovation are becoming tax credit projects. “They can spend \$28,000 per unit and come away with new wiring, new plumbing, new carpet, new kitchens, new baths and new windows,” he says. “They get repositioned a little

bit and become a tax credit property. It's part of that trend [of] back to the cities."

### ***Marketing to multifamily***

While multifamily owners aren't quite as in demand as traditional single-family homeowners when it comes to financing and refinancing, it can be a challenge to match the right deal to the right property at the right time.

Multifamily refinancing options are limited, but Allen encourages lenders to spread the word that this is the time to do it if at all possible. "This is still the lowest interest rate market in 30 years. Anybody who's coming out of a rate lock needs to refinance," she says.

Saint-Pierre says that marketing to the industry can be as simple as setting up an introductory meeting with a developer or investor. "One of the most frequent complaints I hear from players in the industry is that they're spending 50 [percent] to 60 percent of their time looking for capital," he says. "They're seeking institutional relationships that will provide them with an array of financial alternatives."

Additionally, Saint-Pierre says, many deals go down so quickly that there isn't much time for due diligence or for establishing a relationship with a lender. Owners are often on the hunt for lenders that can be ready on a moment's notice to write up and deal and deliver, with settlement often in 30 to 45 days.

Obrinsky encourages lenders to make multifamily owners aware that there are creative, flexible options available to them. "The industry in general is looking for long-term mortgage debt," he says. "That's typically being done in tandem with subordinate financing such as mezzanine capital, which is in high demand. If owners have had a variable rate, there is some movement toward fixed-rate."

"The trend today is for as much flexibility as possible. Many investors want the ability to get out early, and they're going for shorter terms. They're also looking at hybrid products," Levine says.

"Most borrowers are very sensitive to pulling out money during the term of the loan," Levine says. "Make it available. That's very important."

Levine's company updates its Web site every day and sends representatives to industry association meetings and events just to get to know the decision-makers in each major company. It also sends out a newsletter each week.

"People are pretty savvy today," he says. "It's not like five or 10 years ago, when finance was an education process. We have a very sophisticated audience."