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U.S. Multifamily Market Strengthens in Third Quarter On Rising Demand, Falling Vacancy

Though Some REITs Are Cautiously Re-Entering the Development Arena, Supply/Demand Balance Bodes Well for Apts. Through 2015

Almost every multifamily market saw strong leasing, rising demand and falling vacancies in the third quarter as the nation's apartment market continued a solid 2010 rally. As of now, apartments should continue to surge over the next five years, with a growing supply of renters and very little new product in the planning pipeline.

Granted, vacancies remain above historical averages and the level of concessions to lure renters is still uncomfortably high for landlords in many markets. However, "of all the property types, people are feeling the apartment market has clearly turned a corner," said CoStar Global Strategist Michael Cohen, who presented the fourth and last in the company's State of the Commercial Real Estate Industry series for the third quarter, along with Jay Spivey, director of analytics, and Kevin White, real estate strategist. "Improvements in the U.S. economy overall will favor the apartment market."

Here are a few salient facts about national multifamily leasing fundamentals delivered by the CoStar team this week during the Third-Quarter 2010 Multifamily Review and Outlook:

The national vacancy rate compiled from the 54 largest markets tracked by CoStar declined for the third straight quarter in 2010, falling 20 basis points to 7.7%. The national rate was a record 8.4% at the end of 2009, rising 130 basis points over the course of last year.

The third quarter saw positive demand of around 47,000 additional units. Year to date, renters have absorbed about 140,000 units. In 2009, demand was a negative 60,000 units.

So far in 2010, 20 metros have recouped their total demand for apartments lost due to overbuilding and other factors during the real estate downturn and recession. There's a wide disparity across the country in demand growth. However, metros grew an average of 1.3% in the first nine months of 2010. Four of the five markets where demand is rising the fastest are Sun Belt metros, including Charlotte, NC, which saw the strongest growth at 3.5%, followed by Raleigh-Durham, NC; Phoenix and Dallas/Ft. Worth. Richmond, VA, also saw strong demand, mostly as a result of realignment of military personnel. In terms of absolute growth, Dallas/Fort Worth blew away all other metros with fully 10% of the total positive year-to-date demand across the 54 largest markets. New York came in second place with 11,200 units of demand followed by Washington, D.C. with 8,300 units. The average metro saw vacancy fall about 76 basis points over the past six months, with Charlotte, Raleigh, Nashville and Dallas-Fort Worth seeing the sharpest drops.

So why such marked improvement in apartment fundamentals in light of less-than-stellar growth in the broader economy? A number of factors are likely contributing to this reversal of fortune in apartments, CoStar said.

New Supply: Slim to None. By the end of 2010, CoStar expects that apartment developers will have delivered about 54,000 new units -- slightly less than half of 2009 levels. The miniscule increase of about 0.4% in inventory this year is just half the average annual pre-recession level of 2003-2008. Next year will be even slimmer pickings: CoStar forecasts a record-shattering low in deliveries totaling only about 0.2% of inventory.

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Waning Homeownership. The percentage of Americans owning homes has dropped to an 11-year low -- though it's still well above historic rates, which ramped up in the mid- to late '90s in a strong economy and baby boomers occupying apartment space. Since 2004, declines in home ownership have moved a net total of more than 4 million people into the rental market.

Echo Boomers Are Finally Getting Their Own Crib. Many of these new renters are people ages 20 to 34, the prime demographic for apartments. About 3.6 million people have entered that age group since 2005.

Re-Employed Younger Folks. While echo boomers suffered disproportionate job losses during the Great Recession, Bureau of Labor Statistics household survey data shows they are now getting the lion's share of net new jobs as the economy recovers.

The news is not all good. Many markets are still seeing high levels of free rent and other concessions, a challenge for landlords hoping to boost effective rents and NOIs. As of third quarter, average concessions as a percentage of face or asking rents was 5%. Phoenix ranked at the top with 12% of concessions as a percentage of asking rents, followed by Atlanta and Las Vegas at around 11%. In all, 15 metros among the top 54 are still above their long-term average for concessions.

On balance, however, landlords are starting to gain some pricing power in effective rents, with a few markets reporting gains in asking rents as well.

Over the next few years, the forecast is quite bright. CoStar forecasts supply additions through 2015 at a level less than half the rate of deliveries historically going back to 1982. Demand growth will trail the historical rate of growth by only 40 basis points.

"We have a favorable balance between demand growth and supply growth through 2015," Cohen said. "By end of this year, vacancies in all but a couple of markets will be lower than they began the year."

National vacancies are expected to fall by more than 2 percentage points from their historic 2009 high, ending at about 6% in 2015.

Multifamily sales are showing similar, but far from stellar improvement. While the overall investment market remains soft and weighted toward distressed properties, certain segments are performing and investor confidence and optimism are returning to the market, Spivey said. Sales in Phoenix, Long Island, Atlanta, Columbus, OH; Sacramento, Raleigh-Durham, South Florida and Orlando are above long-term averages.

But most markets are still below historical averages, with distressed transactions -- REOs and foreclosures -- making up a high percentage of total transaction volume.

An interesting exception is Phoenix, which has seen a better balance of distressed vs. non-distressed property trades. Despite being a housing-bust market, capital for non-distressed deals is flowing into Phoenix -- in stark contrast with Atlanta, where most properties trading hands are distressed.

Investors appear most interested in newer properties less than 10 years old. Other positive signs for strengthening liquidity include a shorter average length of time on the market, fewer unsold properties withdrawn from the market, and a narrowing of the gap between asking and selling prices.

Real estate investment trusts are the most active buyers -- in fact they're the only net buyers in the market at present. Institutions, owner-users and private equity investors are all net sellers. REITs are buying the best large assets in attractive markets, and they're generally willing to pay a decent price due to their low cost of capital and the diminishing supply of new apartment product.

In recognition of the latter, some apartment REITs, including AvalonBay Communities, are starting to restart their development programs, though most of this supply is probably a few years away from delivery.

"We're beginning to hear a lot more noise about new supply, particularly from the REITs with their capital market access. They're beginning to talk about moving ahead on projects," Cohen said. "Other types of investors would like to move, given that fundamentals are beginning to make construction a little more palatable. However, development capital remains tough to access for most non-REITs, making it difficult sledding for early movers.

Some of the emerging development is legacy projects and land planned for and acquired in the last cycle and now being dusted off as demand metrics improve. That said, analysts will closely monitor apartment permits and starts, Cohen said.

In any case, REITs are definitely in the hunt for apartment product. Overall capitalization rates have declined for several quarters, with larger sales of over \$20 million seeing the largest cap rate compression and distressed deals seeing higher cap rates in the bifurcated market.

"Many REIT buyers at sub-5% cap rates are banking on some real rent growth that will flow nicely into NOI," Cohen said.

Apartments have seen the biggest increase in pricing in the CoStar Commercial Repeat Sales Index, which uses a methodology similar to the Case Shiller Index in the residential market. The U.S. multifamily index rose the highest within the four major CRE types in the CoStar Commercial Repeat Sales Index, with a positive 8.98% increase in the third quarter. The office index increased 6.08%, followed by the retail index at 5.56%.

The top 10 multifamily markets saw a larger run up in pricing during the boom and a smaller decline during the downturn. Of all the 30 sub-indices tracked by CoStar, the top 10 multifamily metros is the best performing, with the highest return over the last 10 years.