REALTOR® Mag

# Mayhem in Multifamily?

Rental markets are exploding in the wake of the housing crisis. Here’s how to tell if the expansion has overheated.

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As millennials eschew home ownership in favor of renting, the demand for multifamily housing continues to grow across the country. But as construction starts and investments in this real estate category climb to their highest levels in six years, some analysts fear an impending bubble. Others, however, believe that with the ongoing shift from owning to renting, the sector will keep growing for the next five years.

At the 2015 REALTORS® Legislative Meetings & Trade Expo in Washington, D.C., Sam Chandan, founder of Chandan Economics in New York, had a warning for those who believe the expansion in multifamily to be limitless. “Investors will tell you we’re fundamentally a nation of renters now,” he said. “As house prices begin to improve… there will be a significant subset of renters in the U.S. who will say now is the right time to be a home owner.”

Still, it seems that change has yet to come.  A 2014 joint report from CBRE Global Research and Consulting and CBRE Capital Markets placed the national multifamily housing market “firmly in the expansion phase of its cycle, with vacancy rates in most markets at or below historical averages and effective rents reaching record levels.” Demand for multifamily increased 1.6 percent on a year-over-year basis in the fourth quarter of 2013, CBRE concluded, with the market showing its strongest performance since 2009.

Apartment rentals are the hottest part of the multifamily sector, far outstripping interest in condo ownership, according to the February 2015 edition of Freddie Mac’s Multifamily Research Perspectives. The mortgage giant also predicts that multifamily construction starts will continue to

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expand through 2015 and into 2016. Despite the build-out, NAR's Commercial Real Estate Outlook for May 2015 suggests apartment vacancy rates will remain below historical averages for some time to come, rising no higher than 4.4 percent in the next year.

Meanwhile, condominium development nationwide is a virtual nonstarter. While multifamily construction is at its highest level in the last 25 years, according to the U.S. Department of Commerce, 93 percent of that construction is in rental units. Part of this may be due to a decline in property ownership overall. According to data from the U.S. Census Bureau, less than 65 percent of U.S. households own homes today, representing the lowest home-ownership rate since 1995. Most of that decline occurred in the under 35 market, where rates stood at 35.9 percent in the fall of 2014 (compared with 43.6 percent a decade earlier).

### Millennials Lead the Market

Where is multifamily hottest? Mainly where job growth is high and the foreclosure crisis is still reverberating. The top markets, according to commercial real estate services firm CBRE, include Houston; Dallas; Austin, Texas; Seattle; Denver; Atlanta; Washington, D.C.; Raleigh, N.C.; Minneapolis; Phoenix; Los Angeles; Charlotte, N.C.; Orlando, Fla.; San Jose, Calif.; and San Francisco, which together accounted for half the market's national net absorption in 2013.

In Denver, approximately 8,000 new multifamily units are under construction and scheduled to come on board in 2015, according to Anthony Rael, chairman of the Denver Metro Association of REALTORS®' Market Trends Committee and a relocation specialist with RE/MAX Alliance. He says rental vacancy has stood at 5 percent or less for some time now, and he attributes the market's robustness to the wide variety of generations moving to Denver looking for affordability and the lifestyle options offered by walkable, mixed-use neighborhoods.

"The millennials are all moving here," says Bill James, GRI, CCIM, president of James Real Estate Services Inc. in Denver. He says they're attracted to the city's climate, cultural and recreational offerings, and the construction of a $7 billion transit system. "Two- to 3,000 apartment units are being built within a couple of blocks of Union Station alone," he adds.

James attributes a great deal of the new multifamily construction to the city's job gains. With unemployment at 5 percent, Denver's jobs picture is more positive than the national one, which may contribute to the fact that the city's population is growing by about 47,000 people per year. But he also cautions that rising expenses could throw a wrench in the growth calculation: "Oil prices show some writing on the wall. It's a horse race between the millennials and the economy."

James isn't terribly concerned about the pace of multifamily growth in Denver, especially when he compares his city to other metro areas around the country, where cap rates, or the ratio of net operating income to property asset value, are especially low. Chicago and New York City are prime examples. "Low cap rates mean high prices, which means higher risk for investors," he explains. "Investors perceive risk in Colorado as lower because unemployment is low."

The story is similar in Houston, which has brought in half a million new jobs in the last four to five years, mainly in the health care, construction, and oil industries, where production is booming in the Eagle Ford Shale region in south central Texas. "One thing that's driving rental rates is increased density," says Tim Surratt, real estate professional with Greenwood King Properties Inc. in Houston. He says the fastest moving units in the city are those in walkable neighborhoods, and most of those are either new construction or repurposed buildings.

### Home Ownership Isn't Everything

With so many displaced families reeling from recent foreclosures in the city, multifamily demand is high in Las Vegas, where Petra Latch, principal of appraisal company Criterion Group, points to massive growth in multifamily in one of the markets hardest hit by the Great Recession. "We've gone


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so low and have had such a drastic pendulum swing in our market the past five years," she says. "There's been a backlash… People are less excited these days about home ownership."

Latch points out that today's young adults came of age in an economy where they couldn't get jobs, couldn't qualify for mortgages, or just didn't want to assume the financial risk of being unable to sell property in down markets. "Millennials realize how illiquid real estate really is." She adds that rentals are scarcer today due to residential patterns established during the housing boom. "A lot of rental supply was lost to condo conversion during the high market."

In Las Vegas, the Class A apartment market is strongest, Latch says, and a lot of new construction centers around "concierge-style" living where apartment buildings have movie theaters, dog grooming areas, and plug-in stations for electric cars. But the big sticking point for builders is the city's budget woes. "Government services have been cut, so it takes a long time to get new construction approved," she notes. "On average, it takes nine to 12 months for permitting and final mapping."

### Take the Long View

Ron DeVries, vice president of Appraisal Research Counselors in Chicago, says the multifamily market in the Windy City "is hotter than it has ever been." He notes that 17 multifamily buildings are under construction in downtown Chicago alone. DeVries says the city will see about 3,000 new units in 2015 and another 6,000 in 2016. Normally, Chicago renters snap up about 2,000 new units a year, but now, he says, "the market has been absorbing a lot of these units on the demand side." However, he anticipates an imbalance in the market in the near future.

"If you're looking to get in and out, it will be a problem," he warns potential multifamily buyers and investors. "But if you can take a longer view, investing in multifamily rental properties isn't an issue."

Meanwhile, as in other metro areas around the country, the condo market is all but dead save for high-end, luxury buildings. "In the last boom cycle, the market was dominated by condo projects," he says. Now that many of the condos built during the boom times are still vacant, "condos are over-supplied."

However, downtown Chicago's multifamily boom could start cooling as well. DeVries expects that as rents continue to rise, more renters will shift into the buyer market, which could bring a halt to multifamily's burgeoning construction as well as low vacancy rates.

"The returns investors are getting have declined because pricing is getting so high, relative to income," DeVries explains. "They're starting to look at suburban deals now, particularly the North Shore."

### Rapidly Shifting Values

The constantly changing market makes accurate valuation tricky in multifamily rentals. A lot of construction is underway, but not enough product has been delivered and sold to provide solid comps. Complicating things further is intense competition, which is driving up prices, resulting in cap rates under 5 percent in some areas, as well as purchases completed before properties are even built.

Rapidly rising values make it hard for appraisals to match sales prices in some places. "We have to warn buyers that properties are not necessarily going to appraise at the sales price," Houston-based Surratt says. But then, he's also seeing a large influx of cash buyers, which makes appraisal problems less urgent.

So long as demand keeps pace with supply in most markets, as it has been, a multifamily bubble won't materialize. As Freddie Mac's Multifamily Research Perspectives white paper noted in September 2014, "For a majority of the markets, high demand paired with the dearth of construction during the Great Recession means that new supply will continue to be absorbed as it enters the market and rents will continue to rise."

Demographic trends point in this same direction. Freddie Mac estimates that an estimated 3.9 million potential young-adult households failed to form during the downturn, as Millennials moved in with parents in a weak job market, meaning a substantial pent-up demand for entry-level housing remains. In fact, the U.S. Commerce Department notes that even while rates of home ownership are the lowest they've been in 25 years, household formation in the first quarter of 2015 increased by 1.5 million year-over-year. Generation Y is finally moving out…and *up.*

Of course, markets are always changing, and multifamily investors ought to be looking for indications of what's to come in their local areas. In the case of multifamily, bubbles are likely to be localized rather than national in scope. For example, Eric P. Haims at Jerome Haims Realty Inc. in New York says he's already seeing "over-building" in apartments in the Big Apple.

Surratt cautions the same in his area. "We expect it to level off soon in Houston," he says. "Land prices have gotten really high, which should put the brakes on price growth." Being in touch with what's going on in your local market may be the best defense against potential bubbles in multifamily.

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***Deborah Huso***

Deborah R. Huso writes extensively on real estate, construction, and housing finance. Her credits have included *HousingWire* , *Valuation* , *USA Today* , *The Washington Post* , and *Green Builder* . Visit her online at www.writewellmediallc.com.