# Investment Outlook Grows Brighter For Apartments

*By Charles Krawitz*

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When the tech bubble burst in 2001, real estate suddenly became the darling of America's investors. The shift in investor sentiment made perfect sense: real estate is tangible, provides steady cash flows and is immune from the vagaries of a punishing stock market.

The rise of real estate as an asset class is compelling; the population continues to expand and the need for space is growing. Yet, real estate is fundamentally cyclical, and macro-economic factors indicate that the haven for investors stung by the stock market has lost some of its allure vis-à-vis a rebounding corporate America.

With rising interest rates, tepid job growth and stagnant wages, residential real estate has come under pressure. The press is full of stories about overbuilt condo markets and overpriced single-family homes. Consequently, the public mood toward real estate — both residential and commercial — has softened.

At the same time, the corporate world is showing renewed strength. Sarbanes-Oxley legislation has boosted investor confidence in corporate reporting, concurrent with high-profile trials of corporate executives. That has caused dollars to flow back into the stock market. One sign that capital is beginning to flow out of real estate is that cap rates have risen slightly in the apartment sector. This trend is creating opportunistic buying situations.

**The apartment attraction**

The answer for savvy real estate investors may lie in the multifamily market. Apartment buildings will benefit from current economic conditions, and the fundamentals of this asset class should improve for a number of reasons: Occupancy rates are climbing in most markets and landlords no longer offer concessions, or free rent to prospective tenants. Of the 59 markets tracked by Moody's Investors Service, 54 showed a decline in the multifamily vacancy rate year-over-year in the third quarter.

Demographics are driving some of this demand. The Echo Boomers are turning 21 at an enormous rate (1 million per year for each and every year between now and 2014), and those young people are renting their first homes away from parents and college.

At the same time, interest rates are rising (30-year, fixed-rate mortgage rates averaged 6.30% in mid-December compared with 5.68% a year earlier), and prospective buyers who might have purchased homes a few years ago now are staying in the rental market.

Low interest rates created a group of home buyers who did not have the financial resources to own a home for the long term, and many are slowly returning to rental housing. The PMI Group reports that several housing markets stand a 50% chance or greater of registering falling prices in the next two years. Those markets include: Boston; Long Island, New York; Oakland, Calif.; San Diego; and Santa Ana, Calif. With prices falling, potential homeowners may opt to rent rather than invest in a declining market.

Furthermore, any new supply of multifamily product is likely to be curtailed as construction costs increase due to the demand for steel and other commodities as part of the rebuilding in the Gulf region.

The Class-A and B properties are likely to capture the homeowners turned renters, but C properties should also benefit as manufacturing jobs are transferred overseas and workers are forced to move down a notch on the housing ladder. A related category is mobile home parks, which give those who cannot afford a single-family home some of the features of home ownership.

**Winners and losers to emerge**

Market forces make multifamily a sensible investment, but some of those same trends may put downward pressure on other real estate asset classes. As single-family home prices decline, and owners perceive that they have less wealth, the grip on their wallets will get tighter.

Less interest in shopping equals less value for retail properties. And if retailers don't need as many goods, then suppliers don't need the industrial space to build and warehouse those products. Moody's reports industrial vacancies remain above historical norms at 10.4%.

All the money that went into real estate during the past few years broadened the number of players. Unsophisticated investors — those unfamiliar with the fundamentals that drive real estate — entered the picture en masse.

It will not be long before the real estate market is buoyed by true real estate mavens, experts who understand what drives a particular market, and who have more of a grounding in property ownership and management. These investors will change the tempo of the real estate market as properties once again find themselves in the hands of experienced professionals with a long-term outlook.

**Charles Krawitz** serves as the managing director of the multifamily finance group at LaSalle Bank. He is based in Chicago.