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ON THE WEB

Are Apartment REIT's A Good Bet?

By VIVIAN MARINO (NYT)

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THE incessant talk of housing bubbles and of rising interest rates, which will make homeownership even less affordable, has some investors focusing on the rental markets.

Is there a big upswing in the works for apartment owners as more people put off home buying? And what, in particular, will this mean for dividend-paying real estate investment trusts with portfolios of rental apartment properties?

Already, rental vacancies have been creeping lower, according to the latest Census Bureau data, which puts the nationwide rate for buildings with five or more units at 10.2 percent in the second quarter versus 11.8 percent a year earlier. And the National Apartment Association, which represents multifamily housing companies, reports that owners are increasing rents in some regions because of a stronger job market.

All this augurs well for publicly traded apartment REIT's, whose stocks have risen in the last two years despite the growing trend toward homeownership. Still, market analysts are split over the investment prospects for the sector over all.

A recent report by Friedman Billings Ramsey, an investment bank in Arlington, Va., paints a somewhat favorable picture for landlords, forecasting that "the next round of interest rate increases by the Federal Reserve will put a damper on housing affordability and, hence, sales growth and pricing power."

Standard & Poor's remains more cautious, noting that weakness in the home-selling market "could dramatically improve the REIT outlook," but an oversupply of housing in general could have a negative impact as well. Comparing new construction with household formation, it estimated that 630,000 excess units would be built this year.

Many money managers are not making any big moves for now. "We're a tad lower," Samuel A. Lieber, the chief executive of Alpine Management and Research, said of his funds' exposure to the apartment sector. The Alpine U.S. Real Estate Equity Fund has around 2 percent of its portfolio holdings in apartments, and the Alpine Realty Income and Growth Fund has 10.1 percent.

Mr. Lieber says he thinks any changes in the coming months will be incremental, "not dramatic." Besides, he said, "the stocks are not cheap."

Ralph L. Block, a senior portfolio manager for the Phocas Financial Corporation, an asset management company, agreed. "This is one of the few sectors of real estate that could benefit from rising interest rates," he said.

But he added that investors seemed to have already factored that into apartment REIT stock prices, as more economists contend that a housing bubble exists in many parts of the country, especially around big cities on the East and West Coasts.

Apartment REIT's have been outpacing REIT's in general. For the first nine months of this year, the sector returned 9.54 percent, although by last week it was up only 2.54 percent, after a 34.72 percent return in 2004, according to the National Association of Real Estate Investment Trusts. The average return on the trade association's composite index of all REIT's, by contrast, was 6.94 percent for the three quarters and 30.41 percent for 2004. By last week, it was minus 1.36 percent.

Despite the economic pressures working against apartment REIT's, some companies, like AvalonBay Communities and Archstone-Smith Trust, have managed to profit handsomely from the red-hot home-buying market by selling rental properties to developers for condominium conversions. Others, like Equity Residential, have even formed units to convert their own apartments into condos.

In the first nine months of this year, 108,181 existing rental units were sold to developers for condo conversions, according to Real Capital Analytics, a New York consulting firm. In 2004, there were 75,606, and in the previous year, 22,078.

Market analysts expect more condo conversions in 2006, though not at the same frenetic pace as this year.

"It wasn't widespread in all markets," said Bryce Blair, chairman and chief executive of AvalonBay, which is based in Alexandria, Va., "just in higher-cost markets, like Washington, D.C.; New York; California; and South Florida." Of AvalonBay's \$500 million in asset sales expected for this year, he said, 90 percent are to condo developers.

Archstone-Smith of Englewood, Colo., meanwhile, sold more than \$2 billion in apartments over the last two years or so, and a large portion went to developers, according to the company's chairman and chief executive, R. Scot Sellers.

"Every year, we look at our portfolio and identify the buildings that we think will pay us a price that allows us to improve our portfolio and obtain better long-term returns," he said. "With the money that we've raised, we have bought other apartment buildings."

But Raymond Mathis, who covers REIT's for Standard & Poor's Equity Research, calls condo conversions a temporary blip on the earnings radar screen that does not really change the fundamental problem that many apartment REIT's face: supply and demand. (Analysts say the mass evacuation in the hurricane-ravaged gulf area isn't expected to have a significant impact on the apartment REIT market because the cities that evacuees are moving to in large numbers tended to have vacancy rates that were already high.)

Conversions can benefit owners of multifamily projects, of course, by shrinking the supply of rental apartments, though some of the converted units could end up as rentals again and compete once more in that sector.

Market watchers think that some REIT's are better positioned than others, pointing, in particular, to companies like AvalonBay, Archstone-Smith and BRE Properties, that build luxury rentals in pricey housing markets like California and the Northeast.

This summer, Archstone-Smith broke ground on the Mosaic, a 627-unit high-rise building in Manhattan's Clinton neighborhood, and it has four apartment projects under construction in Southern California, including the 522-unit Archstone Warner Center in Los Angeles. Two years ago, it completed the 354-unit Archstone Playa del Rey.

AVALONBAY is working on Avalon Chrystie Place, a four-building mixed-used project that will include apartments, at Houston and Chrystie Streets on the Lower East Side.

"They develop primarily in markets where housing affordability is the most constrained right now," said Craig Kucera, the senior multifamily REIT analyst for Friedman Billings Ramsey.

One potential problem, though, could be rising expenses. Higher construction and labor costs may cut into profits, analysts say.

But Mr. Sellers of Archstone-Smith says he is confident that his company has chosen wisely in deciding where to do business. "You have to have job growth, plus expensive single-family homes, plus a low supply of new apartment rentals," he said. "That's been the formula that we followed for many years, and it has worked well."

Photos: FOR RENT -- Renderings of two Manhattan high-rise buildings, the Mosaic, above, on 10th Avenue between 51st and 53rd Streets, and the Avalon Chrystie Place, overlooking Houston Street, left. The Archstone Playa del Rey in California was completed two years ago. (Photo by FxFowle Architects); (Photo by Richard Lubrant Photography); (Photo by Alan Schindler)