NATIONAL REAL ESTATE Investor

Housing Wobble Lifts Apartment Industry

By Parke M. Chapman

Dec 1, 2006 12:00 PM

Falling vacancies, rising rents and limited new supply have bolstered the apartment market in recent quarters. With one month left to go in 2006, many investors and market watchers believe that the coming year looks promising because of continued weakness in the single-family housing market and limited new apartment supply. The only potential downside is less condominium conversion activity, which helped thin nearly 150,000 units from the national apartment market last year.

"Based on what we've seen this year, it appears that the apartment market will continue to improve in 2007," says Mark Obrinsky, chief economist at the National Multi-Housing Council (NMHC), a trade organization based in Washington, D.C. "Investors are still flooding the market with capital, and we expect that demand to carry into 2007. The condominium conversion wave removed apartment stock, [but] the apartment market can't really rely on that anymore."

Housing market anxiety is a plus

What's bad for the single-family housing market bodes well for apartment investors. David Nethercutt, CEO of Chicago-based Equity Residential Properties Trust, believes that ripple effects from the volatile single-family market will boost rental demand. Equity Residential, which was founded by legendary investor Sam Zell, owned 197,404 units at mid-year.

"As long as there is uncertainty about owning a home, many people will continue to seek rental units. That's why we see what's happening in the housing market as a net positive," says Nethercutt. When the appreciation of housing prices stalls or begins to slow down, fewer people are anxious to buy homes.

Another positive factor for the apartment market is the so-called affordability gap, which is defined as the average monthly cost between renting and owning. The NMHC reports that it cost roughly 30% more on a monthly basis last year to own a home vs. renting an apartment.

Nethercutt is acting on these signals. In late October, for example, Equity Residential decided to operate five condominium conversion properties in Phoenix and northern Virginia as rental properties. Home values in Phoenix and northern Virginia increased by roughly 29% between 2002 and the end of last year, according to the National Association of Realtors. "We see plenty of opportunity in markets where home prices shot up in recent years," adds Nethercutt. "And we'll certainly be looking to buy properties in these markets."

Bring a fat wallet. With apartment vacancy hovering around 5.4% at the end of September — down from 5.8% one year earlier — Reis expects steady tenant demand through the end of 2007. A full 73 of the 75 markets that Reis tracked during the third quarter posted effective rent gains. By comparison, 68 of 72 markets tracked by the firm during the second quarter accomplished that feat.

Reis chief economist Sam Chandan believes that asking and effective rents in 2006 should post their biggest increase, roughly 6%, since the national vacancy rate reached its lowest point of 3.2% some six years ago.

Waning condo effect

New supply appears to be in check despite a measurable slowdown in condominium conversions. Reis reports that approximately 85,000 new units will be completed in 2006, similar to the levels of 2005. Next year should also bring about 83,000 new units to the market, and that represents a measly 2% of national inventory.

Against this backdrop, the total number of apartment units converted into condos has consistently fallen over the past four quarters. While 54,730 rental units were converted during the third quarter of 2005, only 7,440 rental units were culled from the inventory during the last quarter.

Fewer conversion deals has put a dent in sales volume, however. Sales of apartment properties worth $5 million and higher registered $17.8 billion in the third quarter, reports Real Capital Analytics. The same quarter in 2005 posted a record $28.4 billion in apartment sales, and as much as $14 billion of that total was attributed to condo converters.

Despite the dip in sales volume, huge deals have become more common. A total of four transactions in excess of $1 billion have closed during the first 10 months of 2006, reports Real Capital Analytics.

Portfolios and REIT privatizations have also been strong. Out of the $62 billion in apartment deals closed through the first 10 months of 2006, portfolio and privatization deals accounted for $16 billion of that total. By comparison, only $11 billion of apartment sales closed during the same period in 2005 were spurred by these types of deals.

“It's not hard to see the wisdom of buying apartment properties now,” says Obrinsky of NMHC. “The single-family market is wobbly and people like the flexibility of renting an apartment.”