

It's a (Multi) Family Affair

The balance of power in multifamily investment is shifting. Over the past few years, sellers and tenants had the upper hand—driving up sale prices and driving down rents. We'll reveal why the tide is changing in 2008.

By Heidi Stout Tretheway

Multifamily market dynamics are typically a tug-of-war between buyers and sellers and between landlords and tenants. Throughout North America, multifamily housing investors are experiencing a strong swing of the pendulum as factors such as the housing and debt market slump, a strong job market, and a spike in operating costs change the balance of power.



What does this mean for 2008? We connected with multifamily investment experts around North America to understand the market dynamics and learn more about who has the upper hand now.

Sellers vs. buyers

In the past several years, sellers realized substantial gains in appreciation and were able to sell quickly, usually choosing from among several attractive offers. Many buyers in the United States were motivated by the IRS tax code section 1031, which permits capital gains taxes to be deferred when an investor sells one property and uses the proceeds to buy a similar property.

The rules permitting this tax-advantaged "exchange" transaction require sellers to identify a replacement property within 45 days and close on that property within six months—a quick turnaround time that made many buyers willing to pay above-market prices for property to avoid taxes, creating a ripple effect in driving up property values.

The strongest factor in favor of sellers was capitalization rates, which dipped sharply in most markets, causing property values to rise. When capitalization rates—or cap rates—are low, a property's value is high relative to the amount of net operating income (NOI) the property generates.

These factors—1031 exchanges and declining cap rates—tipped the scales in favor of sellers. But it was not all bad news for buyers. The debt market was flooded with capital, making loans easy to acquire and lending practices lenient. Buyers were able to secure financing at favorable rates, making even high-priced multifamily assets pencil out. But that easy-lending atmosphere wouldn't last forever.

Landlords vs. tenants

Multifamily investment properties were tough on landlords over the past five years, and have only recently recovered to pre-2002 robust leasing activity. The key factors putting tenants on top included an economic downturn, overbuilding in some areas, and increased operating costs. The economic downturn in 2000-2002 first sent multifamily investments on their downward slide. Job losses resulted in evictions and more move-outs than move-ins.

High apartment vacancies forced landlords into competition, not only to cut or hold steady their lease rates, but also to downgrade their renter profile simply to get warm bodies filling their units. This move created a loss of revenue through evictions, property damage, erosion of property status and, ultimately, created a loss in NOI.

NOI was further impacted by concessions to new tenants, such as one or two months of free rent. Ultimately, tenants were the big

winners, finding apartments easier and cheaper to rent while landlords were forced to absorb higher operating costs.

Tenants also had the advantage of historically low mortgage interest rates, allowing them to opt out of the apartment market altogether by purchasing a home. Now, particularly in areas hit hard by a decline in residential home values and foreclosures, tenants are returning to the rental market.

So what's in store for the multifamily market in the coming year? Here's a look at six key North American markets.

Vancouver, British Columbia

The past year has brought declining yields to sub-4 percent levels, and yet the availability of multifamily housing for investment buyers is even more limited than before. This is because Canada doesn't have a tax-advantaged rule such as the U.S. 1031 tax-deferred exchange.

As a result, says John Gee, vice president of Colliers International in Vancouver, "Taxes are so onerous that there's no incentive to sell." He notes that only three catalysts prompt sales in that market: "Death, divorce, or a damn good reason."

Low yields and unfavorable taxes should quell demand from investors, who are typically real estate investment trusts, local private capital and Asian investors. However, with apartment vacancy below one percent, Gee notes that multifamily is a very stable asset class.

"Every year, you get depreciation and its tax advantages, plus the property value appreciation and income growth," Gee explains. "That's why multifamily investment still makes sense."

He projects continued limited supply and strong demand in the next 12 months, with property values likely to stabilize.

Portland, Oregon

The multifamily market in Portland is presenting new challenges for sellers, who once had the upper hand over buyers. "Sales are sluggish and appreciation is stalled," says Gary Winkler, a senior broker with Colliers Private Capital Advisors.

Sellers are also challenged by underwriting, because lenders are unwilling to underwrite a property based on an optimistic pro forma. "Banks are scrutinizing borrowers more and are less confident that a landlord can hit aggressive numbers for their returns."

Another blow for sellers comes in the form of re-trading. This happens when a price is agreed upon but, during the due diligence period, buyers discover detrimental information about a property and demand a price reduction. Winkler says buyers are picking apart financials, funding and "whatever they can."

Although utility costs are up, landlords received a boost from a strong rental pool due to in-migration and home prices that are now out of reach for many families. Landlords are taking security deposits again and raising rents, but Winkler said some pockets in Portland still lack robust occupancy. In the next year, Winkler expects a balanced market for buyers and sellers as buyers become more aggressive about price concessions.

Sacramento, California

The key trend in multifamily housing is its return to favor as a strong investment product type, both as a result of decreased vacancy and increased investor interest. Although multifamily prices have not substantially increased, landlords are achieving much higher NOI with reduced vacancy.

"When there was a boom in housing and financing was readily available, we saw investor interest in multifamily housing falling off because investors could realize a better return in other product types," explains Garrick Brown, director of research for Colliers International in Sacramento, California. "The shift in our housing market has changed that."

Brown expects continued strengthening of the multifamily market relative to other commercial property investments, as well as stable to moderately increasing prices. "For about three years, multifamily investment had dropped off the map," Brown adds. "Cap rates were so low, often those offered under a 6 percent cap were untouchable, yet sellers couldn't lower prices further because they'd bought at the top of the market."

The investor outlook is already showing greater interest in multifamily, and Brown suggests now is the time to buy. New tenants and rising rents will help a landlord's bottom line.

Los Angeles, California

Southern California may be a land of movie magic, but in multifamily investment, lenders want the unvarnished truth in the numbers- without the "special effects" of pro forma projected rental income. Lenders are now careful to ensure that actual rental income supports loan underwriting for a better-ensured return on investment. Jennifer Song, a senior associate with Colliers Private Capital Advisors, says both the velocity and volume of sales has fallen off compared to previous years. What was once a seller's market has shifted in favor of buyers.

"When we qualify sellers, we're really looking at their motivation," explains Song. When the market favored sellers, many owners would put their property up for sale just to go fishing for an astronomically high price. "The market is just not supporting that anymore; it has really flipped to put buyers in control."

Song adds that cap rates are beginning to spread out as the prime areas near the beach maintain historically low cap rates and high property values, whereas less desirable areas are gradually dropping prices to attract more investors.

"Going forward, there will be less volatility in the market; the gap between sellers and buyers will shrink and the capital market for private investors will be stable," says Song of the 2008 outlook. There are still investors looking to place capital in this market, and a slower market may offer owners the opportunity to trade into a property that works better for them without the urgency of previous years.

Investors looking for more certainty should opt for geographic areas with strong market fundamentals and a stable operating history. Most importantly, notes Song, placing properties for sale on the open market is critical to finding the highest-paying buyer.

Phoenix, Arizona

"We've seen a number of buyers sitting on the sidelines and sellers with a degree of uncertainty," says Cindy Cooke, senior vice president at Colliers in Phoenix. "We saw intense activity in 2007 until the shift in the capital markets started in June 2007. Investors started feeling the impact strongly in August and September."

There are a couple of large loan pools currently on the market, and until they sell, lenders will proceed with extra caution. Lenders are requiring more substantial equity in each transaction and a conservative approach to underwriting.

Landlords have suffered from the housing slump that has affected most of the United States, particularly in Class A multifamily product. In cases where single-family homeowners are unable to sell, they are renting their properties instead, luring tenants away from Class A apartments.

Cooke expects the next 12 months to be interesting. "While we are seeing price adjustments, the desire for investments is still very strong. Investors want to place their capital in Arizona; however, they are being cautious. I expect investors who see the value of owning real estate in high-growth areas will take advantage of the opportunity to acquire properties without having to compete as aggressively as they did in the first half of 2007."

She advises, "If you're a seller today, look at your position and asset, and see if you can hold for the long-term. If you can't, get ready to sell now, because it's definitely taking longer to sell properties, and buyers perceive more risk."

With buyers in the driver's seat, sellers should prepare for a bumpy ride.

Toronto, Canada

Private capital investors are responsible for the boom in Toronto's multifamily investment market prices. Inexpensive, low-equity loans fueled the fire, prompting private capital to bid up the price of many assets.

But with the capital market crisis in August-and subsequent crackdown on lending practices-institutional investors have returned as the power players, using their own substantial equity to purchase multifamily assets.

Karl Innanen, managing director of Colliers International's Southwestern Ontario office, says this power shift has created a chasm in the market dynamics of property. Large, A-grade assets with strong fundamentals are attracting bids and have stable or even declining cap rates as their values rise.

However, those "value-added" opportunistic investments, which have always been the domain of the private investor, have seen much weaker sales and cap rates on the rise.

"What we'll see for those value-added buyers in the future is some partnering of those players to pool their equity, because with their combined resources they can compete in the marketplace," Innanen says. "They can't do business like they did last year."

Innanen expects a reconciliation in the marketplace in the next year, as buyers hold the line on their demand for reduced prices and sellers finally adjust their expectations to lower prices for the multifamily assets geared toward private investment. Meanwhile, institutional investors will bring so much capital to the table that prices are likely to edge higher.



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