GlobeSt.com

In Apt. Deliveries, It's Class A All The Way

JULY 20, 2016, BY PAUL BUBNY

ATLANTA—Or almost all the way. Colliers International's Will Matthews tells GlobeSt.com why class A represents more than 80% of new multifamily product in the nation's top 10 MSAs, and what this means for rents.

"You can't price out the model to build a class B deal," Matthews says.

ATLANTA—A new white paper from Colliers International highlights the dominant role class A product plays in multifamily, especially in the nation's top 10 metropolitan statistical areas. As a percentage of new deliveries, class A apartments now exceed what we saw in 2007, when 61% of all new units were top-tier product. By the end of 2015, that had risen to 86%. Furthermore, between 2011 and year to date in 2016, rent growth has also soared, with nearly 70% growth in Atlanta, 50% in Chicago and 34% in Los Angeles during this time period.

GlobeSt.com caught up with Atlanta-based Will Matthews, VP and co-founder of the Southeast Multifamily Group at Colliers, for his take on the white paper's findings and the implications class A growth has for the multifamily sector as a whole.

GlobeSt.com: What's behind the dramatic growth in class A development?

Will Matthews: There's a number of factors here. Construction costs are at an all-time high. Wood, gypsum, concrete and especially labor are very expensive. So it's tough to financially engineer a new development model to build a class B or class C property because it's so expensive to build. Investors can't hit their own return thresholds. So the only type of product, or nearly 90% of product, that's being delivered is class A. That's a trend we anticipate will continue in the future.

GlobeSt.com: Do you expect that ratio to be maintained even if new deliveries in the MSAs tick up or down?

Matthews: In this cycle, we're already seeing lenders becoming very conservative, especially in the top 10 MSAs, because that's where a majority of the new supply has been delivered. Even really powerful developers with great sponsorships, track records and experience, a terrific capital partner and a great location find it very difficult at this point in the apartment cycle to get financed on the debt side. There's still plenty of liquidity on the equity side for new development, but it has become very difficult. So I don't think we're allowing ourselves to overbuild in this cycle, as we have in previous cycles.

I do think there's a lot of pressure on rental rates and pricing, and I do think we're starting to see, especially in class A deals, rent fatigue. In Atlanta, the average rent was for a class A deal was $950, and today it's $1,608. The change is 69%. And the difference between class A and class B rents is 41%; class B has grown 31%. What you're seeing in today's market is that the only class B and C real estate is being bought by value-add sponsors and they're executing a renovation plan. You can't afford to build with vinyl siding and a more basic finish level; you can't price out the model to build a class B deal.

GlobeSt.com: Given the predominance of class A product and the kind of rent growth you're seeing in markets like Atlanta, what long-term trends do you see in demand and occupancy?

Matthews: I don't see any effect on the demand side. We still have 81 million Gen Y–ers entering their prime renting age; we still have household formation starting much later In life. You have the homeownership rate dwindle from 69% in 2008 down to 62%. All of these fundamentals on the demand side, I don't foresee changing at any time. The reason the cycle continues to run is that we're not overbuilding. There's just not that much new supply and there's still tremendous demand.

I don't see that changing in the next 18 to 24 months. If you look at national absorption velocity, it's still north of 20 units per month, which is the benchmark that developers utilize. And some metros are still trending closer to 30. When that metric drops below 20, you're going to see occupancies drop and concessions rise. That's going to be in metros that have a significant amount of new supply coming on line. But when you look at this nationally, it's not going to be a bloodbath like you saw in 2007, 2008, because we're not going to allow ourselves to do it again.

GlobeSt.com: That 86% of new product is 86% of what's still a small base of deliveries.

Matthews: That's exactly right. And there's an interesting statistic. Households traditionally have spent between 20% and 25% of their take-home income on housing, whether it be for-sale or rental. Right now, according to ULI's Emerging Trends Report for 2016, it's 31.4%. People are willing to spend more to live, work and play in a desirable area, which is pretty impactful.

And I read a Harvard Review article in 2013 that said Gen Ys are willing to spend upwards of 65% to 70% of their take-home pay on housing, which is just jaw-dropping.

GlobeSt.com: Is the trend you've seen in rent growth across the top 10 MSAs likely to cross over into secondary markets, or is their product a little more homogenized?

Matthews: We don't focus on any secondary or tertiary markets in the white paper, unfortunately. However, I cover the entire East region, and many of the markets where I've had success have been secondary and tertiary. We sold an $81-million portfolio last week in Richmond, VA. This was 1980s-vintage product, 818 units, very well located blue-collar class B properties, and we were receiving 25 to 30 offers on each asset. There was very high interest, and this was because of the strong fundamentals and also because secondary and tertiary markets are the only places where equity can find yield in this environment, because cap rates are compressed so far in the top-tier markets. We're seeing similar occupancy rates and rental expansion in secondary and tertiary markets, and we're seeing more players, even REITs, chasing deals in these markets.

http://www.globest.com/sites/paulbubny/2016/07/20/in-apt-deliveries-its-class-a-all-the-way/?slreturn=20160620102535