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INSIDE:

- Will we overbuild in the next great development boom?
- How to get the most out of your resident surveys
- Boost retention with online renewals

WALK THIS WAY

On the path to prosperity, these three D.C. apartment executives prove that the entrepreneurial spirit behind a spin-off venture can fuel success.

L-R: Jim Butz, President and CEO, Jefferson Apartment Group; Greg Bonifield, Partner, Woodfield Investments; and Richard Hausler, Principal, Insight Property Group

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The Next Big BOOM?

Are tepid capital markets, changes in housing dynamics, and a Gen Y preference for urban core real estate enough for the apartment sector to refrain from overbuilding? BY CHRIS WOOD

LAST MONTH, HUMPHREYS & PARTNERS ARCHITECTS hit a milestone that the Dallas-based company hasn't seen for quite some time: Projected billings finally met pre-recession levels. "It's the first time that's happened in two and a half years," says the firm's founder and CEO, Mark Humphreys, who pegs his market share of national apartment construction starts at 10 percent and is consequently projecting annualized multifamily starts of about 180,000 units by year's end. "In September 2008, we billed the same amount," Humphreys says. "And while it's not quite back to where we were [in 2007], it still has a great ring to it."

Meanwhile, Arlington, Va.–based REIT AvalonBay Communities updated its second-quarter and full-year 2011 outlook, noting a likely deployment of $600 million to $800 million on land allocation and other development activities relative to the firm's behemoth $2.6 billion apartment development pipeline. Before the month was out, fellow REIT Birmingham, Ala.–based Colonial Properties Trust said it is likely to begin construction on a new apartment community every quarter for the next two years, joining a chorus of 2011 community ground-breaking announcements from apartment development stalwarts such as Denver-based Archstone, Atlanta-based Wood Partners, and Phoenix-based Alliance Residential.

In the cyclical world of apartment development, firms that have survived the worst of the recession are gearing up for the next building boom. With net-zero new supply delivered to the market over the past several years, a surge in apartment demand from consumers, and competition pushing up pricing on existing assets, the yields on new development ventures are beginning to look attractive once again. And

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in turn, the rush is on for the best sites and development talent as builders try to beat each other to the dirt and be the first to deliver the hottest new apartment community. "There's an anecdote when it comes to developers in the industry right now," Humphreys says. "They're all saying that they've felt like a racehorse waiting to go and then suddenly looked down to see that the gate was already open."

The racehorse mentality isn't new to development cyclicality. Nor is the preponderance of group think that the real estate industry has learned its lessons and "things will be different this time." Indeed, while the development executives, economists, builders, and architects interviewed for this article all admitted that an eventual overbuilding of apartment markets could potentially be in the offing, the near-unanimous refrain was that between the capital markets, job growth, and the economy, there are enough unknowns to prevent a building frenzy—should it even occur—at least until 2013 or 2014.

FROSTY FINANCING

As many developers are painfully aware, when it comes to scoring financing for new construction, the FHA's 221(d)(4) program is still largely the only player in the game, and loan application volume has seized the agency's processing operations and timetables. Brad Miller, president at Dallas-based Encore Multifamily, could be one reason why. Encore, which is likely to start five apartment projects this year and another five or six in 2012, isn't trying to be the next Lincoln Property Co. but nevertheless enjoyed snarling up the paper-pushing at a national HUD meeting in May. "We got a kick out of the comment that week from HUD, which moved our Denver deal to the following week's agenda because they had two of our deals on the docket already. Basically, little Encore is jamming up HUD's national pipeline, and we got a charge from that: It is always good to be in an up cycle and be one of the first ones off of the blocks on development."

"The consequences of this backlog are magnified by the fact that private capital markets still have not recovered, leaving apartment firms with few alternatives. The result is a dramatic reduction in new apartment construction at a time when the nation's demand for affordable rental housing is growing faster than in recent decades."

Perhaps sensing an opening to swoop in and grab back some of that $10 billion in construction volume, banks and life companies are opening their doors to apartment builders seeking financing, but with stringent out-of-the-gate underwriting and equity requirements—think 50 percent and 60 percent loan to value (LTV) versus heyday 80 percent and 90 percent LTVs—befitting only the most well-heeled builders out there, who can afford to have significant skin in the game. "With development and development lending, you just can't flip a switch and turn everything back on again," says economist Peter Muoio, a senior principal of Boston-based CWCapital subsidiary Maximus Advisors. "We are beginning to see some signs of appetite for development finance in the multifamily segment, but it is still tepid, and that [unavailability of construction debt] is a natural brake on the building process getting too overheated too soon."

ALL-IN ON THE FRONT OF THE WAVE

With solid apartment fundamentals and encouraging job-growth forecasts silver-lining an already appealing multifamily backstory of critically low supply and attractive customer demographics, some apartment builders aren't bothering to wait around for a capital markets recovery. In Seattle, a development group spearheaded by Bentall Kennedy USA broke ground in June on Sixth and Lenora, a $200 million, 654-unit apartment tower that will be paid for entirely with cash.

"We're funding the project entirely with our own equity, which takes the financing problem out of the way," says Bentall Kennedy

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—Mark Humphreys, CEO, Humphreys & Partners Architects, Dallas

To be fair, it's not just Miller's projects gumming up the works at HUD. The department's 221(d)(4) construction loan, administered by the FHA, has been the only financial instrument available to apartment builders for the past several years. Traditional sources of construction lending—national and local banks, life insurance companies, even CMBS—were forced out of the market during the recession, and although the volume of multifamily starts has also dwindled to a historical crawl, the FHA has not been able to handle the recent loan application onslaught resulting from being the only game in town.

On May 25, Peter Evans, a partner at Chicago-based Moran and Co., testified as much on behalf of the National Multi Housing Council and the National Apartment Association before a subcommittee meeting of the House Financial Services Committee, telling lawmakers that demand for FHA apartment financing has increased from $2 billion in annual project applications to $10 billion. "FHA has been unable to keep up with this demand, however. Loan processing times can now exceed 18 to 24 months, and borrowers often have no idea where in the pipelines their applications are," Evans testified.

USA CEO Michael McKee of the deal that has received broad media attention from *The Seattle Times*, *The Wall Street Journal*, and *Businessweek*. "We don't have to deal with banks or lenders, and from an unlevered internal rate of return perspective, it still fits our investment criteria quite nicely, so we're excited about it."

McKee is also excited about the job-growth prospects within Sixth and Lenora's submarket: The project is within blocks of the new Gates Foundation headquarters, and Amazon.com has recently taken a big position in the city to augment traditional aerospace, high-tech, and consumers goods employers.

"The job pattern in Seattle with Starbucks, Nordstrom, Nike, Amazon and the Gates Foundation is quite good," McKee says. "We have it on our list as a primary market in the same bucket with New York; Washington, D.C.; and Los Angeles. We believe in the Echo Boom cohort, that 80 percent of the new renters over the next decade will come out of that generation, and that they will look to rent in downtown areas. We also know that we're not the only smart guys on the street in that regard. Several developers are purchasing land in key urban areas and getting their entitlements and plans together."

Broadstone Camelback
Phoenix
Developer: Alliance Residential

Encore Alsbury
Burleson, Texas
Developer: Encore Multifamily

Count AvalonBay in that group. Even as CEO Bryce Blair announced his retirement from the REIT's executive board in June, he'll remain on through 2012 as chairman of the board, focusing at least half his working hours on company operations, particularly when it comes to construction and the firm's development pipeline. Blair has his work cut out for him: By the second quarter of 2011, that pipeline had burgeoned to $2.6 billion in size, as measured by total capitalized costs.

"$2.6 billion is a big number, and a loose number that changes constantly, since obviously we have things coming into and going out of our pipeline every day," says AvalonBay's executive vice president for development and construction for the West Coast, Stephen Wilson. "That's just the list of the deals that are likely to go. It's about 9,500 units, and that's the total cap cost, not the money we've spent."

Like Bentall Kennedy, AvalonBay's balance sheet development model does not rely on debt for construction, and the REIT is pleasantly aware of the competitive advantage that capital structure gives it over its historical peers in the merchant building sector, many of which were forced to dismantle their operations and staffs during the nonbuild years of the recession.

According to Wilson, AvalonBay's ability to keep development and construction platforms comparatively intact working on legacy assets and entitlements well-positioned the REIT for a quick start-up as development opportunities returned. "We think the rewards from that will show up next year," Wilson says. "We've got the biggest construction pipeline [in the industry] today, and these are all jobs we started in the past 12 months. While everyone now is talking about starting to do new business, we are under construction. We are probably 12 to 18 months ahead of a lot of our competitors who will be going into the ground this year and next year for the first time."

$85 MILLION, 300,000 UNITS AT A TIME

It's telling that Bentall Kennedy and AvalonBay both characterize part of their competitive advantage as essentially being in front of the wave and ahead of the pack of legions of developers who are likely to follow in their stead. The argument is a simple one: With continued incremental job growth and economic recovery comes the improvement of apartment rent fundamentals that will make investment in ground-up multifamily development impossible to ignore. Throw into the mix a depleted (and, some argue, decreasing) stock of total apartment units in the United States, along with a consumer psyche bent on eschewing single-family home purchasing, and you've got a nearly insatiable market for new apartments.

In his testimony before the House, Evans practically pleaded with Congress to take steps to help catalyze the sluggish capital markets that have become ineffective at fueling new construction. "In 2010, new apartment construction set a post-1963 low at just 97,000 new starts," he said. "We need to build 300,000 units a year to meet demand, yet we'll start fewer than half that many this year."

And while certainly the majority of apartment industry professionals at large concur with Evans' assessment—and could desperately use the financing—the lack of apartment stock, particularly if development starts have already troughed and are on the rebound, is quickly being interpreted as an opportunity rather than being used as evidence of an industry in crisis.

"Basically, we have not built anything in the past two years," architect Humphreys says. "Even when we were building 65,000 to 100,000 units per year, it was widely understood that we tear down about that many units annually, so we are net-net zero new units and yet had an additional 150,000 apartment units leased last year."

Factoring in a 2011 job-growth projection of 2.4 million new jobs (and a traditional industry metric that sees one unit rented for every four jobs created), Humphreys calculates that there should be a market of some 600,000 renters coming online as those jobs materialize and lead to household creation. "In the past 14 years, when we were going through this great boom, we were building an average of 280,000 units," Humphreys says. "So if these kids get their jobs, we are going to have a large number of renters, and a very low supply of apartments."

The demand that Evans and Humphreys refer to (and that apartment developers like AvalonBay and others often allude to) hinges largely on the household choices that will be made over the next decade by "those kids": the so-called Echo Boomers, the Baby Boomer children who are now cycling out of high schools and universities and entering their prime renting years. Tabbed at anywhere between 75 million and 85 million Americans, Gen Y is believed to be suspect of the single-family home as an investment vehicle and disinterested in the suburban preference that dominated the lifestyle decisions of their parents. To some in the apartment sector, Gen Y is hard-wired to rent, more so than any consumer demographic before it.

L-R: Courtesy Alliance Residential; Courtesy Encore Multifamily

A TALE OF TWO CITIES

High-barrier or not, every metro has its development and absorption trade-off.

AS DEVELOPMENT INCREASES over the next several years, high-barrier-to-entry markets will dole out fewer construction opportunities to more capitalized players, while traditional "easy-access" markets will make starts more prevalent with a corresponding compression on rent fundamentals. "When it comes to overbuilding, the devil is in the details and it will depend on the market," says Ron Johnsey, president and CEO of Dallas-based apartment data firm Axiometrics. "The only market that I have seen that I would be concerned about is the San Jose market: Their current level of permitting is equal to their peak. Other than that, I don't see any problems in any markets until 2013 or 2014."

Those two years fall squarely in the middle of the next boom cycle and, along with 2015, are considered a period of potential overbuilding. In an analysis of potential rental revenue growth, which combines rental and occupancy rate changes, during that time, Axiometrics forecasts, not surprisingly, that the high-barrier markets will see less of a decline in revenue growth. However, when it comes to the cumulative growth rate of the 2010 to 2015 period versus the 2003 to 2009 period, both high-barrier and low-barrier markets will see roughly similar deltas in improvement.

And the degree of decline and improvement really is market-specific. "We are very bullish on the apartment market, but we do think that cycles exist, and where we do see some softness is more in the 2013 range for markets like Seattle, Fort Lauderdale, and San Antonio," Johnsey says. "Come 2014, you start seeing Houston, Atlanta, Tampa, Long Island, and the Orlando markets starting to soften as well."

	Potential Rental Revenue Growth (PRRG)*		Period of Potential Overbuilding		
Market	Cumulative, 2003–2009	Cumulative, 2010–2015	2013**	2014**	2015**
LOW-BARRIER					
Atlanta	-3.0%	29.2%	5.3%	2.9%	2.6%
Las Vegas	-1.9%	24.4%	7.8%	4.2%	2.9%
Phoenix	-1.7%	34.1%	6.0%	4.3%	1.8%
Dallas	1.0%	30.5%	3.7%	2.4%	2.1%
Charlotte	2.8%	30.8%	4.5%	3.6%	3.3%
HIGH-BARRIER					
Chicago	11.7%	31.9%	4.4%	3.1%	2.8%
Washington, D.C.	12.5%	34.3%	4.3%	3.3%	3.5%
San Jose	15.3%	40.4%	2.5%	2.3%	2.4%
Seattle	17.1%	30.0%	2.6%	1.9%	2.3%
San Francisco	18.5%	38.7%	4.1%	4.7%	3.6%

* Note: Potential rental revenue is the combined change in effective rental and occupancy rates.
** *Forecast*
Source: Axiometrics

FIRST-MOVER ADVANTAGE

Developers who are adding to the multifamily housing start total—expected to hit 180,000 annualized starts by December and one that Humphreys predicts could outpace single-family starts for the first time in 2012 or 2013—are consequently focusing construction efforts on apartment stock tailored for their Gen Y customers. But that design and destination DNA—downtown, urban product close to jobs, nightlife, and transportation—could in and of itself slow down a boom in multifamily development.

"As asset values begin to exceed replacement costs, development will begin to attract capital, replacing older assets with newer assets and newer designs, in hopefully better locations," says Alliance Residential's managing director for the Southwest region, Bob Hutt. "If you can buy locations attractively at the beginning of the cycle, multifamily can be very competitive, wherein past cycles, we were not able to compete with retail, hotel, and office pricing. But there is a lot of competition for the good sites from well-capitalized, experienced players and generally those with a higher-density background."

Even while he espouses a gradual-recovery view, Cleveland-based Zaremba Group senior director of residential property management Nick Secue sees the first-mover development mentality as one that could feed directly into at least localized overbuilding. "What often happens is that people are drawn to a market, start buying dirt, and then they're all coming out of the ground at the same time in the same place with the same product. That can cause overstock," Secue says. "I think everyone wants to be on the front side of the demographic curve. You always want to be the first to an emerging market and get full and let all the other guys worry about catching up. You want to be on the edge in terms of the designs and amenity packages that complement their lifestyle."

Markets that are likely to boom first are obviously those with comparatively lower supply, rising rent fundamentals, and a lower barrier to entry without the substantial single-family housing overhang (see "A Tale of Two Cities," opposite). "Lenders are acutely aware of the problems that they and their competitors ran into in those markets, and it will take them awhile to get comfortable with doing development lending in markets that have gotten a black eye," Maximus Advisors' Muoio says.

So the question remains: Will simple, recovery-mode development eventually unlock the yields that lead to more risk-averse lending and consequently a faster-paced construction trajectory at less conservative underwriting standards? "With a solid 2010 behind us, and 2011 off to a torrid pace, that capital will come, but it is only going to be for the more national players or established local players that have strong balance sheets and good track records," says Ron Johnsey, president and CEO of industry data consultancy Axiometrics. "Over time, the financing challenge will be overcome because the yields will be so attractive. 2013 could be a watershed year in terms of supply hitting the market."

At AvalonBay, the eyes aren't on starts as much as on demand, suggesting that how rent fundamentals, job growth, and household creation unfold will have the most impact on whether the boom goes bust. "Overbuilding comes when demand drops. Nobody thinks about it when things are growing to the sky," Wilson says. "Demand will follow jobs, and it's not construction starts you're worried about, it's the supply number that hits about 18 months later. 2014 to 2015 are the years where you start to think about that: That's when you might run into some traffic. Of course, overbuilding is possible, but you'd like to think there's more discipline in the system and more rigorous underwriting that will control that. You'd like to think the capital side of it from equity and the banks will exercise some kind of restraint, because developers all have short memories." **[M]**