

Break Out the Shovels: Major Ramp-Up In Apartment Development Expected in 2011

More Multifamily Projects Expected To Come Out of the Ground In 2011-12, but Not All Markets Ripe for Developers

By [Randy Drummer](#)

January 19, 2011



Emboldened by favorable demographic trends, improving supply/demand metrics and lower construction costs, apartment developers are eager to start replenishing their development pipelines.

The 22,536 units forecast by CoStar to be added to the nation's apartment supply in 2011 is expected to spike up to 94,588 units in 2012 and just over 109,000 units in 2013 -- increases of 320% and 384%, respectively -- over the current year. By 2015, CoStar expects that development will ramp up to its 10-year historical average.

Well-capitalized investors, including REITs, have taken notice and are aiming to become first-movers in the trend before competition drives up the supply again. AvalonBay Communities and Equity Residential started nearly 1,550 apartments between them through late 2010. AvalonBay has a pipeline of nearly 7,000 units of multifamily [commercial properties](#) in various stages of construction and planning. Other savvy investors, such as USAA Real Estate, Hines, Gables Residential and Wood Partners, have announced joint ventures or stepped-up development plays and acquisition of apartment [buildings for sale](#) in recent weeks.

A look at permits pulled by single-family and multifamily builders helps illustrate the growing demand for apartment projects. Demand for housing units has tilted toward the multifamily segment of the market as Echo Boomers enter the market as renters and renter households grow due to the falling homeownership rate, according to a recent analysis by CoStar Senior Real Estate Economist Katie Pelczar.

MARKET SHIFT

Builders have historically pulled about twice as many single-family permits as multifamily permits. However, the ratio of multifamily to single-family has shifted in most regions of the country, and it wouldn't be surprising to see more apartment development than single-family development going forward, particularly in the major U.S. markets along the east and west coasts, according to Pelczar.

"As we're already seeing, I would expect permitting to ramp up going forward," said Pelczar's colleague, CoStar Real Estate Economist Dan Egan. "A much improved vacancy/rent picture will lead to developers breaking ground on new projects in 2011. With ground-up construction in many metros taking 12-plus months, don't expect to see new deliveries hit the market until 2012."

A number of positive trends are improving the national outlook for apartment developers. For the last few years, returns on new projects have been less attractive to investors than acquisitions of existing buildings. In recent months, however, those tables have turned. Improving occupancies and strong expected rent growth across the nation's 54 largest markets tracked by CoStar, coupled with lower construction costs, have boosted the "return on cost" expected by investors for new apartment development.

The run up in the prices of newer, high-quality apartment properties, the variety coveted by institutional investors,

also factors into the case for new construction. On average, properties less than 10 years old are trading at near-2006 prices, while older properties have yet to see prices rebound. As bidding wars between investors have driven up the cost of newer high-quality assets, yields have become less attractive. With cap rates tightening on high-quality assets in metros like Seattle and San Jose, developers may be able to build at an attractive spread over acquisition yields, CoStar analysts said.

Overall, projects by "first movers" that break ground in the next year should benefit from increasing demand and a low cost basis, translating into strong returns. However, individual markets do matter -- and some metros make better development targets than others, Pelczar and Egan noted in "The Case For Apartment Development," a recent white paper published by CoStar subsidiary Property & Portfolio Research (PPR). In fact, in many typically strong markets, return-on-cost expectations are still simply too low to justify new projects.

Like all real estate types, markets and submarkets have a significant impact on whether new construction makes sense, said Chris Macke, CoStar senior real estate strategist.

"It makes sense that we are seeing new apartment development, given the combination of rising apartment values, reduced land costs and reduced construction costs. These have all combined to make new construction advantageous in certain markets."

High-barrier-to-entry metros such as Boston, San Francisco, Washington D.C., and New York may see slower delivery of new projects, keeping vacancies tight in many cases and helping landlords push through solid rent increases, Egan said.

New supply may come from other quarters as well. Housing-bust markets with a lot of failed condo construction and conversion projects could see a number of projects return to life as rentals. It's already happening in some markets like Phoenix. Egan said he wouldn't be surprised to see it spread to Las Vegas and South Florida in 2011.

OPENING THE PIPELINES

Meanwhile, both REITs and private companies are positioning to capitalize on the emerging demand for new apartments, including two significant joint ventures formed in recent weeks.

For apartment REITs, development starts will be the key driver of external growth over the next couple of years. The upcoming year-end earnings season will provide guidance for analysts on the 2011-12 development plans of public companies, providing a window into not only how aggressively apartment REITs will grow, but how they view the long-term rebound in fundamentals, Citigroup analyst Eric Wolfe said in a research note. The market will likely look favorably on companies with larger-than-expected development agendas.

Atlanta-based private real estate company Wood Partners emerged as a leading multifamily developer in 2010, capped by a late-December joint venture with a co-investment fund sponsored by global real estate investment management firm CB Richard Ellis Investors (CBREI). Through the JV, Wood Partners will use \$155 million of equity to develop and build \$400 million in Class A apartment communities across the country. The venture allocated \$300 million to deals that started in 2010, with the balance to be allocated in the first quarter of 2011.

Wood Partners CEO Ryan Dearborn called the pairing a "strategically significant, programmatic equity joint venture at this critical early stage of the emerging real estate cycle," for construction of a geographically diverse and economically compelling set of development projects.

The company said it began more than 2,000 units and \$400 million in development in 2010, making it a national leader in multifamily starts. Projects are now under construction in Atlanta, Baltimore, Boston, Charlotte, Dallas, Denver, the District of Columbia, Oakland and San Diego.

Dearborn said Wood's long-standing relationships with a number of institutional investors will enable it to double its productivity in 2011 by starting at least 4,000 additional units. Wood Partners, which launched an acquisition platform in 2010, also purchased more than 3,200 units last year for a total of more than \$400 million, including assets in Dallas, Houston, Jacksonville, Miami, Oakland and San Antonio.

In another joint venture, an affiliate of USAA Real Estate Co. last week teamed up with Gables Residential to develop Class A multifamily properties at select urban infill sites, as well as purchase an interest in several of Gables' stabilized properties. Development is under way on commercial properties in Dallas, Houston and Rockville, MD.

The development and acquisitions amount to over \$400 million of Class-A multifamily assets. San Antonio-based

USAA and Atlanta-based Gables have closed on the acquisition of the first of three stabilized properties in the venture.

Gables Residential, a privately held REIT, owns, develops and manages multifamily and mixed-use developments in Atlanta, Austin, Dallas, Houston, Memphis, South Florida, Southern California and metropolitan Washington, D.C. The company has a shadow pipeline of raw land with the potential for another 4,000 apartment units.

"The multi-family markets are experiencing a strong recovery and fundamentals continue to improve," noted David Fitch, president and CEO of Gables Residential, adding that the partnership with USAA will allow Gables to develop well located communities in its core markets.

Hines Interests LP isn't staying put, aiming to expand its multifamily development activity throughout the U.S. by bringing in Alan Patton as a senior vice president in the firm's corporate office in Houston to lead the effort. In addition to site location, design and development, Patton will be involved in capital raising and financing.

"We think Hines can become a very successful player in multifamily," said Hines President and CEO Jeff Hines. "The multifamily sector is poised for near-term growth, and we are seeing strong interest among our investors."