

RENT OR OWN? THE MULTIFAMILY INDUSTRY IN FLUX

The Midwest multifamily structure is increasingly interested in the potential homeowner's classic debate.

A decade or more ago, the ever-difficult, ever-agonizing decision of whether to buy a home or rent one's residence was easier. Rents were low, interest rates were high and the condo supply was relatively small — it was smarter to continue renting. In recent years, rates have fallen and home prices have steadily risen along with fervent demand. Until very recently, the United States was in the midst of one of its greatest interest rate — and, consequently, home buying — markets ever. The decision to buy was easy.

Now, prospective buyers that have put off making this important decision until today may be looking to sign another lease renewal rather than a purchase contract. The market is changing once again. It may not be the bubble burst that so many have predicted, but interest rates are increasing, and it is not as affordable to attain financing and acquire a home as it was in past years.

During the last few years, multifamily property owners have seen to see a marked shift in the thinking of prospective homebuyers. The historically low interest rates that began earlier this decade have made home ownership as affordable as ever. This contributed to a wave of condo construction and, perhaps more importantly, the conversion of rental properties into for-sale housing. As more and more would-be renters took the plunge into home ownership, mortgage lenders continued to compete for that business, offering higher leverage and increasingly flexible underwriting standards. In many cases, down payment requirements were less than what was required for security deposits for rental properties.

While this certainly hurt apartment owners from a cash-flow perspective, their per-unit values have continued to increase.

Lower occupancy and decreased net rents were more than offset by plummeting cap rates, which were being driven lower by both falling interest rates and increased demand for multifamily product.

Many developers seeking to convert apartments to condos have been attracted to high vacancies, which allow them an immediate supply of units to upgrade and place on the market. Lenders love the concept of having immediate inventory in response to current market trends as opposed to ground-up construction and its lead times, which can translate into greater market risk.

But what about the landlords that have not sold or converted their properties in the hopes that occupancy would soon return to stronger levels? Certainly the condo craze has not fully emptied these projects. After all, the decreasing supply of units due to conversion has bolstered occupancy rates to some extent. The hidden factor seen by many landlords is tenant quality. While many tenants choose to stay for good reasons, such as temporary job assignments, others have remained due to credit issues and/or the lack of suitable funds for a down payment.

There is no doubt that today's economic conditions are causing a shift in end-user thinking. Higher home mortgage rates and rising construction costs are widening the economic spread between renting and owning. Rising land and construction costs on new projects are making it harder and harder for developers to bring affordable product to the market. Suffice it to say, homebuyers today cannot project huge amounts of rapid appreciation into their analysis, and more and more potential buyers are now likely to renew their leases.

So where does this leave today's landlord? They must accept the fact that falling cap rates have bottomed out and are

actually beginning to rise. The potential purchasers that are still seeking investment property are a bit fewer in number and less aggressive with their pricing, and converters are facing tightening loan underwriting standards. Many lenders are only financing conversions that still underwrite as apartments. The landlords are also facing the fact that occupancy rates in many markets are still low relative to normalized levels. Some might say that current rental property owners have missed out on the condo conversion trend. But what about selling to another operator? As apartment owners look to acquire properties, they must face the basic fundamentals. Buyers must keep in mind that they can build new product at yields higher than the levels at which converters have been buying. However, if landlords can continue to increase occupancy and tenant quality, rising rents will soon follow. This may actually drive a property's value higher the old-fashioned way — by increasing cash flow. This, together with the lending community's appetite for multifamily loans, will drive apartment owner's cash-on-cash return back to normal levels.

Overall, the for-sale residential market may not be as remarkably strong as it was in recent years, and prospective buyers would benefit from careful consideration and research before deciding whether to make a purchase or renew their lease.

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