

Looking for Value in Class-B Apartments

Demographics and the housing bust are creating opportunity in the middle market.

BY SAMANTHA ROWAN

THE MIDMARKET APARTMENT sector doesn't usually get much attention. It is below the radar screen of most institutional investors and real estate investment trusts, which generally focus on either high-end or low-end rental units. But now investors are taking a look at the middle market, particularly in midsize U.S. cities. Optimists believe that U.S. demographic and immigration trends will fuel growth in the sector and shield it from the effects of the current economic downturn. They also say a weak housing market will add to demand, as people who would have been home buyers two years ago look for affordable rentals.

Midmarket apartments are well-located, well-maintained class-B properties that don't have the frills of high-end, class-A apartments, like stainless steel appliances or

concierge services. They also tend to be smaller and cheaper. According to REIS, which provides data on supply, demand and vacancies in the U.S., rents on midmarket apartments are about 72.5 percent of those of class-A units. Typical residents are recent college graduates, new immigrants to the U.S. or senior citizens who have sold their homes. Echo boomers — people born between 1980 and 2001 — have been joining the employment rolls and will be prime renters of middle-market units, says Keith Meissner, executive managing director of apartment brokerage

services at Cushman & Wakefield Sonnenblick Goldman. "Middle-market apartments are an overlooked area that is intriguing to everyone right now," he adds. "The echo boom is going to be a great run for the apartment community."

Christopher Finlay, managing principal of Oakton, Virginia's Mission Residential, which buys and rehabilitates midmarket properties, agrees: "Land is scarce, and the apartments that are available are inadequate for the population of echo boomers that is entering the workforce." Historically, about 60 percent of the population between the ages of 18 and 34 have been renters. And data from American Housing Survey, a Census Bureau unit, shows that 70 percent of the rental housing in the U.S. is more than 30 years old; few midmarket units have been built in recent years.

The last time the middle-market sector saw a major influx of renters was in the 1970s, when the baby boomers came of age in a time of stagflation, unemployment and lowered expectations (sound familiar?). Mission Residential's Finlay says: "When you get out of college and you get your first job, are you looking for that high-end place with granite countertops and all of the services? No. You're looking for a place that's close to work and is safe and well maintained."

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concerning inflationary pressures. As owners, we want to be in a necessary product where you can increase rents to reflect inflation." Mission Residential focuses on markets like Dallas, Nashville, Phoenix, Raleigh-Durham in North Carolina, and Salt Lake City. All are expected to have above-average job and population growth over the next ten years, according to data from Moody's Economy.com.

Bobby Turner, a managing partner at Canyon Capital Advisors, which operates funds focused on apartments geared toward midmarket and workforce housing, believes that more people will choose to live in an urban environment because they wish to avoid higher energy costs and other headaches of commuting. "Phoenix and Nashville are cities with fantastic infrastructure that were designed intelligently, with good public transportation that will see growth," he says.

There is ample debt available for acquisitions and renovations, according to Tom McManus, chairman and CEO of Cushman & Wakefield. The primary sources of financing are Fannie Mae and Freddie Mac. "The debt capital for middle-market apartments is attractive, relative to other asset classes. This is not to say there aren't strains in certain markets," he says.

As with any market segment, there are potential pitfalls, but Mission Residential's Finlay says, "We think that the data is compelling toward middle-market assets."