MULTIFAMILY EXECUTIVE hanley wood ONLINE

Print Page

Wiped Out

The recession impairs fundamentals and stresses property performance across all markets and product types. Here's our report on the state of rents in the multifamily industry.

Source: MULTIFAMILY EXECUTIVE MAGAZINE
Publication date: 2009-03-01

By Chris Wood

MULTIFAMILY HEAVYWEIGHTS always thought they'd be safe in New York City. Even after the horrific events of Sept. 11, 2001, firms were able to navigate the economic downturn and eventually push rents upward. The Big Apple apartment market was solid to the core. Or was it?

Last September, Manhattan became prime media meat again when the cable news networks feasted on the collapse of Lehman Bros. and streamed live video of laid-off employees walking out of the company's Canary Wharf headquarters, cardboard boxes beneath their arms. That's when things finally got scary for multifamily.

"I was in New York City visiting clients in December and saw a fear in the eyes of apartment executives that I have never seen before," says Jake Harrington, director of business development for On-Site. com, a Mountain View, Calif.-based resident lease-up and screening services provider handling more than 100,000 rental applications per month.

"We handle leasing for a major multifamily REIT in New York," Harrington continues. "And they called me in September and asked specifically what their exposure was at Lehman Bros. and across the broader financial industry. It turned out that 45 percent of their resident base worked in the sector. The fall has been hard and fast, and it has been a shock to the system for many in the industry."

SOFTER MARKET: RMK Management Corp. has seen decreased leasing traffic

According to a year-end rental market report by New York City-based real estate brokerage firm Citi-Habitats, Big Apple rents across all product classes dropped by 4 percent or more in the fourth quarter and showed additional year-over-year declines of 3.9 percent, 2.5 percent, and 4.2 percent for studio, one-bedroom, and two-bedroom apartments, respectively. Some market estimates put the New York City decline even further. In an analysis for <i>The New York Times</i>, New York-based Halstead Property factored in price negotiations and concessions on asking rents and put the effective drop in rent between 10 percent and 15 percent.

and tougher renewals at its properties, such as this one, the Grove apartment community.

New York is not alone. An analysis of national apartment fundamentals released late January by Novato, Calif.-based apartment research firm Realfacts reveals that the pain is widespread. Virtually every MSA in the country has experienced a decline in both rents and occupancy between September and December of 2008.

The downgrade in macro rental fundamentals is obviously a trailing indicator of market conditions, and with a full 1.9 million of last year's 2.6 million lost jobs vanishing after Lehman's collapse in the fourth quarter, many multifamily operators fear the worse for the first half of 2009. “More than 32 percent of my move-outs are due to job losses or job-related changes. It has tripled from two or three years ago,” says Diana Pittro, executive vice president for Chicago-based multifamily owner/operator RMK Management Corp. “There is not a company out there that isn't trying to work out problematic leases. Last January, we were all in a better place. Last June, we were all in a better place.”

At the property level, RMK and other operators report decreased leasing traffic, poor applicant quality, collection delinquencies, and tougher renewals. And waiting things out no longer seems to be a viable option. Instead, multifamily players say the only recourse is to think long-term but act quickly by providing flexible lease terms, re-evaluating renter screening metrics, and marketing your amenities or concessions effectively.

“All indicators seem to point to a very challenging year,” Harrington says. “In some markets, the major operators I talk to say that if they can be down 10 percent in revenue this year—and not 30 percent—they'll be happy to look for stabilization in 2010 and an uptick in 2011. That might even be optimistic. These are serious recessionary times with serious job losses, and things are not going to go away anytime soon.”

FREE OF FEAR

If contending with real job losses wasn't enough, general anxiety regarding the state of the economy and job security has many renters downgrading in property class or moving out of the multifamily market all together. So-called “doubling-up” can be an effective way for residents to make rent but ultimately has a negative effect on absorption as the ratio between renters and units decreases.

In many markets, property managers aren't even getting appropriate notice, just an apartment gone vacant in the dead of night. “A lot of people are not coming in to tell you that they have a problem, they are just putting the keys in the mail slot and taking off,”

RMK's Pittro says. “I think the media has crucified this year already, and as a result, everyone is very cautious about money. Living at home? Being a roommate? The average consumer is going to prefer that over plunging personal finances into a rental.”

Cleveland-based Urbane Apartments is combating that fear with a “Freedom Lease” program that will forgive the lease obligations of renters who have demonstrably lost their job. “If your resident loses their job and can't make [the payments], they are leaving anyway,” says company founder Eric Brown. More importantly, the policy prevents vacancies among renters who are merely afraid that they are going to lose their job and promotes open communication between residents and the leasing office.

Likewise, Denver-based apartment development and management firm RedPeak Properties now forgives lease obligations for pink slip holders as part of the company's “RedPeak Relief” package. “We don't want residents to move out to a community where they pay less rent just because they are worried about their job. So we are saying, ‘Hey, stay where you are; if you lose your job, no penalties,'” explains RedPeak COO Mark Windhager. RedPeak also froze all rents at their current levels through 2010. “It helps the resident from a long-term budgetary standpoint, and from our perspective, we think if rents continue to go down, it is a pretty good play on our part,” he adds.

Other companies are taking a proactive approach to renewal outreach by communicating with residents throughout the rental term to gauge their aptitude and appetite for signing back up. “The first reaction for the troubled consumer right now is to move, so from 120 days out from renewal, we are all over them,” says Ken McElroy, principal and cofounder of Phoenix-based property management firm MC Cos. “We are trying our best to counsel and retain them. I think that's the best anyone can do in 2009 because you are not going to see the rent growth. It will be flat or declining in many areas.”

QUALITY CONTROL

Also declining is the overall quality of the rental applicant pool. According to On-Site. com data on more than 100,000 monthly rental applications, the number of rental housing applicants with a serious landlord deficiency (including money still owed and/or eviction) shot up 22.9 percent and 31.8 percent in the third and fourth quarters of 2008, respectively, compared to the same quarters in 2007. That's not to mention the impact that lost wages and home mortgage delinquencies and foreclosures are having on the downward spiraling credit scores of many would-be renters.

“Our traffic is down between 5 percent and 20 percent, depending on the property, and 32 percent of our leases are denials. Every third person coming through the door is falling out because of bad credit screening,” says Pittro, who believes tweaking application metrics won't impact her denials. “For a medical bill or student loan, maybe we will get on the phone with our credit retriever and look at those items, but usually, if someone's credit is bad, it is bad all day long. There isn't any noticeable number of people who are being accepted on a conditional basis.”

The simultaneous drop in both renter traffic and quality is a double-edged sword for multifamily firms struggling to maintain occupancy levels. Nevertheless, the pros unanimously agree on the importance of utilizing resident screening software—and keeping screening parameters dialed up to the max. “Unfortunately, a lot of people get pushed on vacancies, and in order to fill units, they drop their screening requirements,” says Jesse Holland, president and founder of Albany, N.Y.-based Sunrise Management and a regional vice president for the Institute of Real Estate Management. “In the end, that strategy is just a circle of destruction that becomes really problematic.”

MC Cos.' McElroy, meanwhile, adds that resident screening is useless unless you stick to the system 100 percent. Regardless of how long an apartment stays empty, his firm will swallow the vacancy rather than let someone with poor credit slip through the cracks only to have to turn around and evict. “That's never going to be a good situation for either party,” he says.

GIVEAWAYS VS. PERKS

The refusal to lower leasing standards is a wise long-term strategy. However, the decision does further compress the band of qualified rental applicants, and that means a war is brewing to lure top-flight customers. In markets with rising vacancies, the majority of players in many rental markets are turning to concessions to attract applicants and close leases.

“The industry is never going to get rid of concessions,” says Linda Peroff, a senior vice president in apartment sales in the Kansas City, Mo., office of multifamily brokerage firm Colliers International. “In this market, the use of concessions fluctuates from a low of 40 percent of properties to a high of 75 percent. Renters just expect it. If it doesn't say ‘half off,' they don't even look at it.”

That's no longer always a bad thing, some multifamily operators contend. In a way, the widespread use of revenue management software is a de facto acceptance of the use of concessions in the multifamily business model—these systems focus on maximizing effective rents and asset revenues at the expense of occupancy levels and lease terms.

Vienna, Va.-based Mission Residential co-founder and managing principal David Wieland says the concept isn't new to revenue management. In fact, he believes renters and property managers alike see through the concession façade. “We base our decisions on net effective rent,” Wieland says. “Whether the concession is one month or two months or six months free, if net effective rent is the same, I'm indifferent. We tend to think that most renters are smart enough to understand that rent is spread out [over a period of time] with an amount that they pay on a monthly basis. Concessions are a part of the business and really just a marketing tool.”

Non-rent-related concessions—goodies such as the freebie flat-screen TVs and $500 Visa gift cards—don't impact effective rents and can be successful at driving traffic to a property. But they don't seem useful as a closing device.

Instead, multifamily veterans believe that in the current market, renters are pinpointing a barely negotiable baseline price and then shopping harder than ever on underlying community value to get the most bang for their buck. To that end, investments in capital improvements and amenities—particularly those that can conserve renter income—are winning the day.

“You've got to have concessions to get people in the door just so you can impress them,” RMK's Pittro says. “Then, you sell on service and amenities: You can drop your health club for a year because I have a 24/7 fitness room. You don't have to buy that lap-top because I have a cyber café and a business center. You can send me a work order or pay me online, and if you go out of town, I'll feed the cat.”

Wieland agrees, though he admits that capital improvements won't put a rush on the leasing office. Still, such investments enable the good to get better, as weaker players let assets languish to focus on concessionary one-upmanship. “Right now, to be sitting on a significant pool of cash that is dedicated to adding amenities and repositioning our product is a great place to be. It might not get us rent growth today, but it will keep our occupancies up and differentiate us in the sub-market,” Wieland says. “In the good times, you stack your cash, and in the bad times, you spend your dollars to maintain your assets, get market share, and build competitive advantage over everyone around you.”

SIGNS OF LIFE

Exactly when the bad times will end and the good times will roll still seems to be anyone's guess. Most observers extend the downward pressure on rents and occupancy levels across the whole of 2009.

One silver lining the apartment sector might have going for it is an extremely limited supply. Across the 60 MSAs surveyed by Realfacts, only 9,428 units were added to supply in 2008, compared to an annual average of 65,000 units over the past decade. That puts the majority of competitive stock in the single-family home and condo shadow market. (For more on the effects of the shadow market, see “Shadow Boxing” below.) Paradoxically, then, it is in the best interest of the multifamily rental industry to see an economic recovery in those sectors.

What's more, many apartment firms point hopefully to the Obama administration as a catalyst towards economic recovery. “Whether you voted for Barack Obama or not, I think he has brought a new level of hope to what is going to happen,” sums up Sunrise Management's Holland. “While it is not going to be easy, and it's not going to be short, the ‘we can do it' attitude is what people need to lead towards opportunism.”

Indeed, in its inaugural bimonthly economic pulse real estate report, New York City-based brokerage and advisory firm Cushman & Wakefield noted that while U.S. markets are approaching their worst point with employers shedding hundreds of thousands of jobs, “political change in Washington combined with an aggressive economic stimulus package and a loosening in credit markets” could produce a resumption on GDP growth by the third quarter of 2009.

Beyond obvious improvements in the national economy and the for-sale housing market, the No. 1 indicator that positive rent fundamentals will resume is likely to be in the office sector, where companies traditionally initiate leases immediately before a ramp-up in hiring. “Our business is all about job creation and job loss,” RedPeak's Windhager says. “So we are staying in close contact with local office brokers. When that activity picks up again—and right now, it is close to nothing—we'll look and hope for rent fundamentals to improve.”

If that's the case, then all rental submarket eyes will likely be on the relative success of the small, regional Dunder Mifflins of the world as opposed to the next Lehman Bros.-esque Wall Street implosion. And, if all real estate is, indeed, local, then perhaps that's exactly where the focus ought to be.

Statistics large and small offer insight on the state of multifamily rent fundamentals.

BY THE NUMBERS	
92.2%	National apartment occupancy rate as of December 2008, *Source: Realfacts*

2 months	Concessionary rent offered at select shadow condo properties in Florida, *Source: KW Property Management*
2.6 million	Total no. of jobs lost in 2008 (1.9 million losses in the fourth quarter alone), *Source: U.S. Department of Labor*
3.85%	Operating cost increase to apartment communities in 2008 due to inflation, *Source: Realfacts*
$100	Online-only concessionary discount off first month's rent for first-time renters, *Source: RMK Management*
31.8%	Year-over-year increase in applicants that had been evicted or left a landlord owing money, as of the fourth quarter of 2008, *Source: On-Site.com*
10	No. of notices to vacate received in one day at a 163-unit Cleveland property after a crash in corporate housing leases, *Source: Landmark Management*
20%	Approximate vacancy increase among the worst Northeast multifamily operators, versus sub-5 percent increases in better markets, *Source: Sunrise Management*
6	No. of straight quarters that the Market Tightness Index has been below 50, indicating worsening occupancy and rent conditions *Source: National Multi Housing Council*