

Apartment Buildings Lose Their Immunity To Housing's Chill

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For the past year, apartment buildings have been one of the few bright spots in the real-estate industry as people forced out of the home-buying market by foreclosures or the credit crunch have turned to renting.

But now the specter of job losses is beginning to spread the gloom into that sector as well. As would-be renters are doubling up in apartments or moving in with friends and families, rents and occupancy rates are beginning to fall in many cities.

“In many markets, our new prospects are beginning to resist the current and increasing levels of market rents we’ve enjoyed over the past quarter,” David Neithercut, chief executive of Equity Residential, told investors during this month’s earnings call. While the Chicago-based apartment owner, one of the largest in the U.S., reported an increase in funds from operations of 1.5% last quarter, it lowered its estimates for comparable-property revenue growth.

Job losses bode poorly for apartment-company stocks, which have outperformed their real-estate rivals so far this year. The Dow Jones Residential REIT subindex is up 14% year-to-date, while the overall Dow Jones Equity REIT index, which includes hotels, retail, self-storage and office properties, is down 1.8%.

‘Shadow Market’ Competition

Investors have been buoyed by the 1.5 million rental households that have entered the market in the past year, including buyers locked out of the for-sale housing market and those who defaulted on their mortgages. The one downside of the housing crisis for apartment owners has been the “shadow market,” made up of unsold homes that owners have put on the rental market.

But that competition isn’t nearly as big a problem as job-loss trends. “A lot of folks think it’s the shadow market that’s softening rents. It’s really a jobs issue,” says Richard Campo, chief executive of Camden

Property Trust. The Houston-based REIT saw rents fall 1.4% last quarter from a year earlier in Phoenix. Arizona shed some 87,000 jobs in June and July. Meanwhile, rents are up in cities such as Houston, where job growth remains strong and where Camden saw 4% rent growth last quarter. Nationally, the apartment owner expects to see rental growth of 2.5% this year, compared with 4.1% growth in 2007 and 7.4% in 2006.

The biggest impact from job losses could be seen in cities such as Charlotte, N.C., and Atlanta, which haven’t seen large shadow markets develop. “That group in the middle is starting to show signs of slowing,” says Haendel St. Juste, an analyst at Green Street Advisors Inc. “When you look at the markets that are starting to slow, it’s spreading beyond the markets that were burdened by housing.”

That led to disappointing second-quarter results at Mid-America Apartment Communities Inc., a Memphis, Tenn., REIT with 42,000 rental units. The company reduced its 2008 revenue forecast by 1% and saw year-over-year revenue growth for the second quarter fall to 2.6% from 3.8% last year. The results surprised some investors because Mid-America has long been considered to have one of the least-volatile portfolios. Analysts blamed the declines, in part, on a weakening economy across the Southeast.

Meanwhile, Atlanta-based Post Properties, Inc., announced that it canceled its planned 300-unit apartment building in Charlotte and delayed three Florida projects.

Cap-Rate Problems

For investors, concerns about falling rents and rising vacancy has resulted in a decline in prices for apartment buildings. The “capitalization rate,” which measures the relationship between the price and cash flow of properties, dropped one-quarter of one percent from the second quarter of 2007 to second quarter of this year, accord-

ing to Real Capital Analytics Inc., a real-estate research firm. The cap rates are now at levels last seen at the end of 2004, the firm says.

The decline in prices has led to a pickup in sales activity. Real Capital Analytics reported last month that sales in June were “well above” recent months’ figures, with \$5.5 billion already having closed or in contract in the third quarter compared with \$8.7 billion in sales in the second quarter.

Apartment-building sales already were far outpacing deals involving other commercial property, such as office buildings and strip malls. The availability of credit from government-sponsored Fannie Mae and Freddie Mac has buoyed values and fueled new deals. Turbulence at the mortgage titans, which together with Ginnie Mae hold 35% of the mortgage debt on multifamily housing, riled apartment owners last month as investors worried about the fate of Fannie and Freddie. But those worries dissipated as the housing bill signed into law last month made the government’s implied guarantee of Fannie and Freddie’s \$5.2 trillion in mortgage securities more explicit.

“There is seemingly no limitation to how much production we can sell to them,” says Peter Donovan, who heads up CB Richard Ellis’s multihousing group. “I think the market is maybe a little surprised by that.”

Indeed, Fannie Mae announced last month that it would increase its commitment to buy loans on multifamily housing of up to \$5 million to provide additional liquidity for rental housing. Fannie said it invested \$20 billion in multifamily housing in the first half of the year. While that is down 25% from \$27 billion in the first half of 2007, the number of total deals has fallen by 45%. Multifamily also remains a safe investment so far this year: Delinquencies on Fannie- and Freddie-backed multifamily loans in the first quarter were just .09% and .04%, respectively.