Making the case for multifamily: Stars align for market

Jerry Kendall
Managing director, Multifamily Capital Advisors, Greenwood Village

Apartments are the shining star of commercial real estate investments. What do investors, real estate professionals, institutional owners, banks and lenders know? Why choose multifamily over office, industrial, retail and other commercial property types?

In terms of commercial real estate, the stars rarely align in the way they have for multifamily rental properties. Fundamentals are everything, and the fundamentals are strong in every area of apartments. This element gets the capital markets players, from local bankers to Wall Street dealmakers, on board from both from a debt and equity perspective.

Multifamily rental housing serves a fundamental purpose as shelter, unlike all the other commercial property types. Multifamily properties do become functionally obsolete but renter profile and quality requirements are much more vast and diverse than a commercial property tenant profile. The most important fundamental difference multifamily rental housing serves is very easy to understand. People need a place to live no matter their situation – whether it is to survive and just hang on or thrive. Second, apartments are primarily a cash flow business in which the returns are driven by managing the cash flow of the property. Other types of commercial real estate returns are driven by the sale of the property in the future, the potential exit value. Third, the physical property itself is typically the simplest construction (since most are sticks and bricks) to maintain and turnover for the next tenant. Typically downside is limited because the worst a tenant can do is destroy his own living space. There is insurance for the bigger things. Facility maintenance care can largely be done in-house with a good maintenance guy. Larger capital items for major items like roofs, landscape, paint, carpet and appliances are competitively bid to professionals; even some of those can be handled by a skilled maintenance guy. Fourth, because of the income structure with multiple tenants, the creditworthiness of the cash flow is based on a number of diverse income streams (the renters). No one tenant controls a critical amount of the income stream. On a 20-unit property, one unit is only 5 percent of the income. If a competent operator is teamed up with competent management, the income stream stays consistently intact. Basically, predictable income delivers predictable returns. Even if market rents are up or down, there is still income. In comparison, appreciating asset-driven models for investment returns like office buildings have large capital risk items like the tenant improvements, leasing commissions and even occupancy. Occupancy can change dramatically, along with cash flow, as well as valuations and creditworthiness of the tenants. The risks are tough to manage and it takes deep pockets to clean up situations that can linger for months or years depending on the size of the event.

Multifamily Capital Advisors financed Cinnamon Ridge in Arvada in 2012.

Commercial real estate markets are impacted by a lot of factors. First and foremost there has to be an actual demand for the real estate type by the end user; somebody needs to want to use the property. When evaluating any type of real estate market, you must look at existing inventory, new construction, forecasted supply, market occupancy, market vacancy and absorption. With regard to the top 50 metro areas in the country, in virtually all multifamily markets, with limited exception (certain markets in Arizona, Michigan and Nevada), demand is strong, evidenced by decreasing vacancy, rental increases, lower to no concessions for rents, lower economic vacancy, and positive absorption above new product inventory delivery.

Denver is looked at as one of the darlings for the apartment market in the U.S. As a sponsor of the Denver Metro Apartment Vacancy & Rent Survey, Multifamily Capital Advisors closely follows market trends. The survey tracks more than 100,000 units per quarter. The trends for virtually all multifamily Denver metro submarkets are stable with decreasing vacancy forecast and stable to upward trending rents.

Lenders are actively pursuing lending opportunities for multifamily properties in the Denver area. However, not all lenders are created equal. Rates are not the only driving point on a deal. Lenders use a wide range of underwriting criteria in ultimately funding loans on multifamily properties. With that said, many lenders have strict and varied borrower guidelines, property guidelines, stress tests for property cash flow, rate structures, term structures, covenant requirements, carve-outs, geographic constraints and many nuances that often are not disclosed or discovered until midstream into the transaction. It is critical to work with an experienced professional in a loan advisory role who has a firm grasp on the debt and capital market arena while representing your interests and strategies.▲