

With Record Rent Increases, Return Gap Between Stabilized, Value-Add Multifamily Shrinks

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News

With multifamily rents having shot into the stratosphere in virtually every U.S. market, there has never been more capital seeking to invest in the sector. Among all that competition, those seeking value-add investments are hard-pressed to make such deals live up to their name.



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The multifamily capital markets set all kinds of records in 2021, including rent growth, transaction volume and total returns, according to Newmark's annual research report. Despite all that, the amount of dry powder also ended last year at a record high, which stands to maintain the downward pressure on cap rates. With buying multifamily so expensive at the same time owning active apartments is so lucrative, a number of investors have pivoted from value-add strategies to buying newer, stabilized properties.

"In the hottest markets like Texas and Florida, an apartment bought for \$200 per unit in 2019 would go for \$300 per unit in 2021 without [the owner] putting a penny into the property," Philip Sharrow, co-founder and managing director of Philadelphia-based

brokerage firm Scope, told *Bisnow*. “It’s all about the path of least resistance for growth.”

Investors are still hunting for value-add deals wherever they can be found, since older and lower-quality properties need to be renovated to keep their rents growing at the same rate as the market at large. Even as everything from construction materials to home appliances continues to grow in price, it hasn’t caused many new owners of Class-B and C properties to defer improvements and attempt to ride the rent wave passively.

“The tenant market is still so competitive,” said Maria King, vice president of Bull Realty’s The Apartment Group subsidiary, which focuses on the Southeast. “A tenant may choose to go to a property with better amenities and the same rents, so they do have options, which makes it really advantageous for a property owner to spend a little more time getting a unit upgraded so they can command top rents and compete. And then when it’s time to sell, they can sell at higher prices.”

Though the gap in returns between value-add and stabilized assets continues to narrow, an apartment building constructed as late as the 1990s will never rent for as much as one built within the last decade even with a comprehensive renovation, JLL Philadelphia Director of Capital Markets Fran Coyne said. Even investors committed to value-add investing acknowledge the tension at play.



Bisnow/Ethan Rothstein

CBRE's David Webb, Nuveen's Nikita Rao and Menkiti Group's Melissa Lee at Bisnow's multifamily conference Nov. 30, 2021.

"Our value-add fund, which is in the market currently, has reduced its return targets [compared to] prior funds, so we're seeing overall a decrease in total returns," Nuveen Managing Director Nikita Rao said at a Bisnow event in December. "From my perspective on the core side, we've been able to maintain our target returns."

Despite the current environment, hundreds of billions of dollars are bound to the value-add strategy. In the past couple of years, a growing share of capital has been invested in non-traded REITs, according to a Cushman & Wakefield report. Almost 25% of residential-focused funds that took in capital last year explicitly targeted value-add deals, Newmark research showed.

Given the scarcity of available properties, sellers have never been in a more advantageous position, King said. Investors in the market looking for short-term holds, like closed-end private equity funds, will have to contend with the near-term implications of the current inflationary environment and the prospect of aggressive interest rate hikes by the Federal Reserve over that time frame, even if the industry is in virtually unanimous agreement over the long-term growth prospects for multifamily.

"It's why we're encouraging clients to either make a decision to sell now or be prepared to hold the property [long-term]," King said.

The inventory for multifamily properties with viable value-add prospects is vanishingly small and likely to remain so indefinitely, but if more investors pivot to stabilized, new construction properties, they will be entering a market where inventory with record levels of development happening across the country and virtually no chance of supply overtaking demand.

"People are able to invest in stabilized assets right now and still create real appreciation in the best markets," Sharrow said.

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