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Is The Multifamily Sunbelt Strategy In Danger Of Oversaturation?

The lanes to continued success seem to be clear, but how long can the supporting trends last?

By Erik Sherman | October 14, 2022 at 08:18 AM



The old television show might argue that it's always sunny in Philadelphia, but the creators clearly hadn't spent much time in commercial real estate around the Sun Belt.

There's been self-reinforcing cycles driving success there, particularly in multifamily. Businesses are moving down, trying to find cheaper and less regulated places, following the money. People follow the jobs. The money.

All those people needed places to live, so the developers also headed south. And the money. It's been there, but challenges are starting to surface. Is there a chance that further expansion could lead to oversaturation and spoil some of what people are looking for in the first place?

JUST THE STATS

The figures on multifamily success have been obvious. Apartment rents are above pre-pandemic levels in many cities. Walker & Dunlop documented nearly \$290 billion in multifamily transactions in 2021, double the year before.

CRE data and analysis provider Markerr said that 2022 first quarter multifamily REIT revenue growth saw a straight market average 9.6% increase over the same period in 2021.

But those are general numbers. Dig in a bit more and recognition of the hot areas float to the surface. The National Association of Realtors' Commercial Real Estate Metro Market Conditions Index saw CRE markets in the Sun Belt and West as generally the strongest

in the country. Florida had five out of the top 16; Georgia had two. Only one, Boston, was outside these regions.

Morgan Properties has about 95,000 units and has expanded southward with the purchase of a large portfolio. "We've gone into markets that we were very interested in with the purchase of the portfolio in the south," area vice president Linda Lopez says. "The numbers show [that the Sun Belt] continues to dominate as far as the rent growth market. There are a lot of major companies that have been relocating or expanding in these regions for various regions. Adding on those benchmarks are accelerating demand for housing in those areas. I do feel and will continue to be a strong market and we definitely continue to see that quarter after quarter with rent growth and occupancy."

Fifield Companies was historically a Chicago and Los Angeles developer. In the past, the company was mostly an office developer, but 20 years ago began to move into condos and apartment buildings. And now its focus is also on South Florida, Dallas, Phoenix, Denver, and the Inland Empire.

"We've transitioned pretty substantially given fundamental demands, both from a consumption standpoint and a capital standpoint," says president Erin Spears.

"It's a unique position that we are in and the reason I say that is on the capital market side you're seeing great uncertainty in the debt market, but before that you had pricing that hadn't been seen ever," Swapnil Agarwal, CEO of Nitya Capital, says. "Sub-three cap rates are

going on and people are getting really, really aggressive. Deals get multiple offers, and now with the debt markets being what they are, the [purchase] pricing has started to come down substantially. But at the ground level, things are great.”

All well and good, but there are signs that there may be some tarnish on those gilded surfaces.

TAKING OFF THE GOLD-COLORED GLASSES

A common mistake of looking at any data, including economics, demographics, and business, is to assume an average applies evenly everywhere. But it doesn’t.

There is no single Sun Belt according to David Lynd, CEO of the Texas-based Lynd Group, who has been acquiring and developing real estate in the Sun Belt for 40 years.

He understands the appeal. “The pandemic forced everyone to hit pause,” Lynd says. “Human beings are very behavioral. It was like someone putting a stick in a wheel of a bike. You get thrown off the bike. It forced people to deal with mortality, made them assess if they liked what they did for a living, and made them think about what they valued. People said, ‘I want to live in a place with good weather, good government that lets you keep most of your money.’”

But there’s a lot of variation in the Sun Belt. “It’s divided into a lot of different submarkets,” Lynd says. “Like Arkansas, Oklahoma, Texas, Florida. It is not a one-size-fits-all solution. The bottom line is they’re having their ‘day in the sun.’ We love the Sun Belt, we love everything

it represents, but this pandemic certainly threw gas on the fire and accelerated markets into a big population boom.”

That’s meant developments that makes Lynch uneasy. “It’s changing the markup of the places where they’re moving,” he explains. “I’m in Miami quite a bit. Miami is not what it used to be. It used to be the party town, had some business going on, and yet 389,000 moved down there. You [now] have to plan out everything, sitting in traffic to get where you’re going. It’s a nightmare. It’s more serious, everyone’s trying to get where they’re going faster, traffic’s worse, all that.”

OTHER DYNAMICS

One of the advantages that the Sun Belt has enjoyed has been shrinking. Markerr measured the rent-to-income ratio as an indication of affordability of different urban markets in the first quarter of 2022. The study showed that Sun Belt markets continued to be more affordable than coastal cities at about 23.5% versus 26% rent to income ratios, “however the gap between the two continues to shrink” because the rent growth rate in the Sun Belt has outpaced income growth. There’s still a 2.5 percentage point difference, but that won’t necessarily last forever, especially as one of the drawing points for businesses is lower wages.

“It’s one reason that the Sun Belt has seen such explosive growth—that it’s been affordable, relatively speaking,” Spears explains. “That dynamic is abating somewhat in a meaningful way. Anecdotally, I’m

seeing people coming back to Chicago who say, 'I miss the seasons and the soul of the city.'"

Then there's doing business. "Financing was very competitive until two months ago," Agarwal says. "There were deals where the bridge lenders were at 80% leverage. Now they're down to 60%." All because the times are uncertain, with inflation and rising interest rates. Floating debt rates "were basically zero until four or five months ago and now they're at 2.50 or 3." Interest rate caps are so expensive now they are no longer a reliable form of hedging.

"It's harder to underwrite deals, even though the rent roles are coming," Agarwal continues. "A lot of people are betting on rent growth." They justified low cap rates with the promise of future higher rents, but how long will renters have the same income multiples of rent that have been available?

And it's become just so damned expensive and hard to put buildings up. "The cost to build has just skyrocketed," laments Spears. "It's 40% to 50% more expensive to build apartments in the Sun Belt market generically speaking today than pre-COVID." Labor can also be very hard to secure.

"If you were to pick one market if you looked at the statistics of what's planned, like Phoenix, it's eye popping," Spears says. "As a developer who has active projects in Phoenix, we're being told by general contractors that they're not bidding new work because they don't have enough labor to build the projects. I have to believe

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them. In Denver, a city the third the size of Chicago, there's three times as much construction."

OKAY, AT LEAST FOR NOW

Those changes aren't killing business—not yet.

"With that I see hiring nowadays, you've got a very tight pool of applicants and many employers are faced with having to pay a higher wage to fill these positions than you would have historically paid even three years ago," says Lopez. "Even though we hear the rents are increasing, the story that isn't being told is that companies are paying higher salaries, even for entry-level positions, because the demand is there. It's an employees' market. They're demanding more benefits, more flexible time, they want to work remote, and it's impacted the landscape from a recruiting standpoint. People can afford these higher rents."

Or they still can afford the higher rents. And yet, so much of multifamily dynamics, and anemic cap rates, is built around the promise of the future. More people will come. Rents will go up. There will be additional supply. Businesses will keep heading into the area.

"You've got a really strong demographic trend that is not going to abate," Brett Forman, executive managing director, Trez Capital, says. "For that reason, I think the demand is there. The supply is not yet at the point of saturation, but what might hasten is if the price of land has continued to go up exponentially, the price of labor continues to rise fast, and supply is out of control. I think people still

want to live in the southeast because of the weather, the taxes, and the business-friendly climate.”

However, the importance of the location, location, location cliché can give way to another saying, often attributed to baseball player Yogi Berra but a much older joke: Nobody goes there anymore, it’s too crowded.

“But it gets to saturation,” Forman adds about what can happen when a destination is too popular for its own benefits. “When you get there and the price is the same [as where you left], there’s a limit to how many people are going to stay.” By the time they move, the advantage is gone and so might be the desire.

For now, though, there are a lot of people who have already moved and who could use an apartment. If you can get the land, materials, labor, and, ultimately, the rent to make it all worthwhile, there are still opportunities in the sun.