MULTIFAMILY EXECUTIVE

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A Dirty Shame

Multifamily developers struggle with land strategies as bottomed-out construction costs and recovering market fundamentals compete with fickle financial markets and cap rate uncertainty. Here are six strategies to get shovels in the dirt sooner rather than later.

By: Chris Wood

City Smarts: M&R Development's Parc Huron in Chicago exemplifies the company's approach to urban infill development and land purchasing.

Want to know the best time to start ground-up apartment construction? Ryan Dearborn can tell you, but you might not like the answer. “It seems contrarian to say, but last year might have been the best time ever to start development,” says the CEO of Marietta, Ga.-based multifamily development and owner/operator Wood Partners. “There was no competition, no new supply, and labor and material costs were very cheap.” Dearborn’s call on 2009 as the opportune moment to get shovels in the dirt for multifamily development is hardly 20/20 hindsight, either. For some time, apartment developers have anxiously watched construction costs depreciate 20 percent to 30 percent even as expectations regarding a decade-long rental demographic boom have been on the increase. Even now, market rents are beginning to either bottom out or trend upward, marking an inflexion point in industry fundamentals that should have triggered new construction months ago.

There’s just one problem: No one seems to know these days what apartment communities are really worth, and without dependable metrics on cap rates, it becomes difficult to pencil out development pro formas and even tougher to wrestle capital from equity providers who are still holding out hope for markets flooded with distressed acquisition deals at pennies on the dollar. Pair that with banks still trying to do work outs on land deals on the books and it looks like financing for new development—particularly when it comes to land acquisition—is a long shot for even the most seasoned of developers. Multifamily development veterans nonetheless say that a land grab is in the offing, and first movers will be able to key in on the best sites and the best locations by following some fairly straightforward steps.

1. Watch Asset Cap Rates.

“Certainly across 2009 and thus far in 2010, there’s been virtually no development activity in the multifamily sector and part of the reason is that the value of land has been the big elephant in the room that nobody can really put a finger on,” explains Drew Hudacek, senior vice president for acquisitions for Irvine, Calif.-based Sares-Regis Group’s Northern California region. “Historically, development capital is looking for a risk-adjusted return of 150 to 200 basis points over what you would expect on an investment acquisition. When the capital markets blew up, nobody really knew where cap rates were, and everybody’s development pro forma went into a tailspin.”

Now that the trading of apartments has begun to slowly pick up again, divining cap rates as a means to calculating risk-adjusted yields on replacement costs should be a no-brainer, but even industry veterans with stacks of equity and little interest in pursing development warn that current cap rates might not be a dependable barometer of multifamily asset worth. In short, prices are reaching so-called “artificial” highs because there’s way too much money chasing relatively few assets.

“In the past three months, deal flow has been great,” says Bill Stahlke, head of acquisitions for Atlanta-based Lane Co. and president of Lane Asset Management. “The problem that I see—and why we have not purchased anything—is that there is a feeding frenzy going on amongst buyers which has resulted in cap rate compression. I think cap rates have compressed 100 basis points in the last three quarters alone, and we’re right back to where we were in 2004 and 2005 trying to financially engineer deals out of a supply/demand imbalance.”

Although high trading prices traditionally benefit the development sector, trepidation in the capital markets amongst skittish bankers and deal- and yield-hungry equity players has dollars for land acquisition and development activity on the sidelines. “On the construction front, the banks are starting to look at lending, but frankly I think the equity is a little bit ahead of them,” says Tim Peterson, chief financial officer for Boca Raton, Fla.-based Altman Cos. “They look at their financial statements and recognize the need to do construction lending, and then they get pounded by the regulators on their loan portfolio and get extremely nervous about adding anything to it. You have to catch them coming out of the right meeting.”

2. Don’t Bank your land.

Bye Bye Burbies

Multifamily developers abandon the outer rings in favor of coastal and urban markets more apt to recover and meet the quality of life expectations of the 21st century renter.

As Drew Hudacek scans Northern California submarkets for straight up apartment acquisitions and land suitable for multifamily development, he's driven by real estate convention: location, location, location. Like all veteran developers, Hudacek is focused on place as much as placemaking, and although there still may be no place like home, increasingly that home—and the jobs supporting it—isn't in the American suburbs. It's in walkable urban or transit-oriented submarkets.

"When it comes to recovery, job growth is No. 1 and demographics are No. 2," says the senior vice president for acquisitions for Irvine, Calif.-based Sares-Regis Group's Northern California region. "The Gen Y story is compelling: Not only are more college-age folks coming out of school in the last five years than in the previous 20, but for the most part, they've been entering a pretty bad job market, particularly further away from metro markets."

As the multifamily development machine recovers, however, some builders don't anticipate returning to suburban locations for at least another three years—if ever.

"One of the real problems in the suburbs is that the land is either back in the hands of the bank or it's in the hands of single-family builders still looking to get what typical apartment land values were as of four or five years ago," says Tony Rossi Jr., president of Chicago-based M&R Development. "With the discounts given to maintain occupancy over the past year or so, you are looking at 98 percent occupied incomes based on $1.20, $1.25 rent per square foot. To justify development, you probably need to be closer to $1.60 or $1.65."

Even though Rossi sees construction costs flat-lining and municipalities becoming more favorable to development as they search for tax revenue, he still doesn't think suburban deals pencil out until rents show substantial improvement—an eventuality that looks grim given the Gen Y propensity toward urban-oriented product.

"We're looking for more unique locations, and for some time those are still going to be in downtown locations," Rossi says. "There might be an apartment development boom over the next several years, but it won't be felt in the suburbs."

Capital availability has thus put speculative land acquisition and development on hold, with only builders brawny enough to engineer a distressed deal or otherwise with the capacity to resume projects on hold as the ones able to clear the starting gate in 2010. Other than a distressed mortgage acquisition Wood Partners was able to snag nine months ago for the City Walk project in Oakland, Calif.—264 Class A apartments across six buildings that bankrupted the original general contractor three years ago—the company is going to be working on legacy pipeline projects that have survived the recession before even thinking about purchasing new land tracts.

"We don't have any land bank strategy to speak of and don't ever acquire land to inventory," Dearborn says. "In the last cycle, we bought three land sites that we ended up keeping because we couldn't begin development right as the crash hit, but that's something we'd rather not do. We would rather pay full retail price for fully entitled land, and we see value in paying for the entitlement process."

Even if Wood Partners was in the market for new multifamily dirt, buyers and brokers currently in that space say deal flow is suffering from a wide bid-ask spread identical to the one that has kept stabilized apartment assets from trading normally. "We're not seeing any large multifamily developers bank land holdings," says Mike Chapman, a first vice president of Los Angeles-based CB Richard Ellis' Tucson, Ariz., office who, in addition to brokering some 15,000 apartment units, has worked on the sale or lease of more than 1,600 acres of multifamily-zoned land. "There are sellers in town who have wound up with multifamily pieces but that wasn't by choice. It was because they got caught with them before they could build on them in the last cycle."

3. Know Your Seller.

The hold dynamic on zoned and entitled multifamily land thus parallels the transaction difficulties on the asset side: Only the most distressed of assets are hitting the block as lenders and borrowers work out extended terms, and non-distressed portfolio holders wait for valuations to meet or match the prices they paid for holdings at the height of the market. "Most of the multifamily land holders right now are either banks or developers who purchased land with hard capital or A&D [acquisition and development] loans," says Hudacek of Sares-Regis. "They've been able to weather the storm and carry the loan for a couple of years and have little interest selling into a trough market."

And then there's the distress holder who can't hang on for two or three more years. "Some people just want to get out, and some people are hanging onto the future to make money again," Hudacek continues. "Either way, there's an inflexion point approaching in the curve where selling makes sense. The folks who are in a little bit more stress are the ones who are going to sell first as the numbers start to rise."

However, difficulties determining value in the land markets isn't spooking off all multifamily development. Equity-backed builders such as Dallas-based Palladium USA are tracking land opportunities to take down deals before the market gets overheated, with the expectation that debt financing will be slow to work its way back into the market. Normalization of cap rates in the disposition market coupled with a little bit of unit absorption is likely the first sign of a construction recovery.

"I think we're seeing a lifting of cap rates, and then with the amount of inventory being gobbled up out there, we will start developing again," says Tom Huth, Palladium's president. "We're big believers that if you can't use good equity to take down your dirt, then you're in a position where that dirt could end up taking you down. That's what we've seen over this last down cycle: Those who financed land on their balance sheet for an extended period of time have found themselves in a challenging position."

4. Gauge Infill and Pre-Entitles Complexity.

Like most multifamily developers, Chicago-based M&R Development (the development arm of Chicago-based RMK Management) is finding that seller distress and unrealistic price expectations coupled with rent fundamental depreciation is preventing development and land deals in all but the toniest of non-urban markets. (See "Bye, Bye Burbies" on page 42.) "No one is willing to take that leap of faith in the suburbs," says M&R president Tony Rossi Jr. "The only suburban deals we've been looking at really are in areas that would be college oriented or a pedestrian market with a great downtown and a [commuter] train station."

Land opportunities in infill situations that come zoned and entitled can traditionally be a plus for developers, but land plans drawn up on yesterday's rent fundamentals and pre-recession growth expectations are proving challenging for builders who are able to take deals down via acquisition. Not that planning boards have a reputation for going easy on the developer set, but recession-fueled reticence to changes in zoning and density is making it difficult to get creative with site plans. "It's not necessarily a fight; it's really a time and money issue," Hudacek says. "If the city is going to be accommodating, I might be able to get a deal retooled within six months. If the city is going to be difficult, it might take me 18 months or two years, and I still might not ever get there. So if it's a marginal location and it's a tough city, it's a pretty easy deal to pass on."

5. Build it or Buy it—Not Both.

One strategy floated by developers—including industry REIT Englewood, Colo.-based UDR—has been to make apartment acquisitions and let properties cash-flow with the intention of ultimately using the underlying land as a redevelopment opportunity and eventual exit strategy. While creative, the tactic isn't resonating with many builders due to its inability to guarantee a resolution of the issues preventing development now.

First Things First: Atlanta-based Wood Partners will work out land holdings already on the books, including for City Walk in Oakland, Calif., before taking a harder look at raw dirt deals.

“It’s just a little bit riskier because the market is a dynamic environment that is constantly changing,” says Palladium’s Huth. “I’m not real comfortable in taking down an existing asset that I’ve got to pay X amount for with the knowledge that I’m going to have to scrape it at some point and put something else up to get a return. Regardless of the exit strategy, I think the property economics have to work in the first place on the initial acquisition.”

Hudacek says Sares-Regis has been looking at the buy it/re-build it strategy throughout the first half of 2010 but agrees that market conditions don’t warrant the complex nature of buying an asset simply for the underlying land. “Right now in the Bay Area, Class B and C products that are three or four years old are still going to trade at $125,000 to $150,000 per unit, and land value from new development is nowhere near that. It’s not a straight one-for-one calculation, either, because typically that three- or four-year-old product is built at a lower density. So maybe you’re buying an older project at 32 units to the acre versus a new project at 45 units to the acre. If you buy that old project at $150,000 a door or more, we think it’s still 10 to 15 years off before you make the cap ex decision to raze it and build something new.”

6. Prepare for the Races.

How the multifamily land market shakes out will likely be a trailing indicator of the broader recovery in the apartment market and might take a few first movers to set a bar comfortable enough for the masses to follow. In a market known for its cyclicality, the firm consensus is that normalcy—if not yet on the immediate horizon—is just a vantage point away. “People are still a little skeptical of being the first ones out there to make land acquisitions and want to see neighbors go out there and jump in first,” Huth says. “But once we start to see more development activities pick up and lending requirements loosen where we can get deals financed, then it’s going to be a run to the market as quick as you can to try and get the greatest sites.”

Expect Wood Partners to be one of the first out of the gate. Dearborn says the firm has enough capital to pursue projects in Boston, Washington, D.C., South Florida, and of course California, where the company restarted construction on City Walk in late June. In all, the firm plans on starting 2,000 units in 2010 with 3,500 additional units on tap for next year. “A lot of the equity that was raised for distressed real estate acquisition that did not materialize is gravitating towards new development,” Dearborn says. “The costs make sense, the demographics make sense, and it gets the yield these folks are looking for in their investment funds.”

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