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Washington Faces Apartment Glut After Boom: Real Estate

By Oshrat Carmiel - Apr 23, 2013

Washington is poised to be one of the only major U.S. cities with a decline in apartment rents this year after a surge in construction outpaced job growth, leaving the nation's capital with a glut of properties.

The Washington metropolitan area, including the suburbs of Maryland and Virginia, will see average rents decrease as much as 2 percent, making it only market other than Detroit to have a drop among the top 20 U.S. cities, according to Delta Associates. Rents will fall further in 2014, data from the Alexandria, Virginia-based property-research firm show.

Washington is at the forefront of a nationwide surge in apartment construction, as home foreclosures, stricter lending standards and a growing number of young adults forming households create the highest demand for rentals in a generation. Work on U.S. multifamily homes jumped 31 percent in March to an annual rate of 417,000, the most since January 2006, the Commerce Department said last week.

"Everyone around the country is really watching D.C. because it's on the front wave of all these markets -- all the supply is coming back," said Jay Denton, vice president of research at Axiometrics Inc., a Dallas-based multifamily research firm. Investors are looking "to see how it could play out if there isn't enough demand for the new supply."

Real estate investment trusts including Equity Residential (EQR), whose chairman is billionaire Sam Zell, and Home Properties Inc. (HME) are selling buildings in the region as more competition looms. About 30,211 apartment units are under construction in the Washington area, more than half of which will open this year, according to Delta Associates.

Budget Cuts

Job growth in the region, which is heavily focused on the government, has been too weak to support the construction, said Greg Leisch, chief executive officer of Delta Associates. Federal

contracting has declined by \$7 billion in the last two years and the spending cuts known as sequestration have limited employment and demand for rentals, he said.

“The supply would have been consistent with Washington’s job performance had the federal government not shrunk,” said Leisch, who expects the oversupply to be temporary. “In the new world with austerity and sequestration, it’s too much supply.”

Washington-area building began booming in 2010, after rents during the real estate crash fell half as much as in the rest of the country and began climbing toward a new peak sooner. That year, developers began work on 5,186 new apartments, and the region was among the top three U.S. markets for employment growth, according to Axiometrics.

New Units

In 2011, construction started on an additional 13,606 units, including 458 new apartments at CityCenterDC, a \$700 million retail and residential project on the site of the former Washington Convention Center, which is being built by Houston-based office developer Hines.

“During the downturn, everybody knew that was the place to be,” Denton said. “But then that becomes the problem -- when everyone thinks that’s the place to be.”

Slideshow: Best Big Cities for Renters

The Washington area tops the nation in the number of apartments in the pipeline for development, while it ranks 11th in job growth, Axiometrics said. The region added 39,700 jobs in the 12 months through February, a pace that signals there will be 2.8 new jobs created for every new apartment being developed, among the lowest ratios in the country.

“We need job growth to double that for it to be a healthy relationship,” Denton said.

In New York, there will be 8.3 new jobs for every new apartment unit under construction and in Houston, the fastest-growing employment market in the country, the ratio is 15.6 new jobs to apartments, according to Axiometrics.

REIT Decline

Concerns that rising construction nationwide will lead to excess properties has contributed to a 2.3 percent drop in shares of apartment REITs in the 12 months through yesterday, the only property type to decline, according to data compiled by Bloomberg. The worsening performance by equities led Lehman Brothers Holdings Inc. to abandon plans for an initial public offering of apartment

owner Archstone last year and instead sell the company to Chicago-based Equity Residential and AvalonBay Communities Inc. (AVB) of Arlington, Virginia.

After announcing the deal in November, the two REITs moved quickly to reduce their exposure to the Washington market. Equity Residential, the largest publicly traded apartment owner, sold the 914-unit Crystal Towers in Arlington in March. It also agreed to sell six other properties, totaling more than 1,700 units, in the region in January as part of a \$1.5 billion portfolio deal with Goldman Sachs Group Inc. and Greystar Real Estate Partners LLC.

Crystal House

AvalonBay, the second-biggest apartment REIT, last month sold the 828-unit Crystal House that it acquired in its hometown through Archstone. It also sold the 564-unit Avalon Decoverly in Rockville, Maryland, part of which it acquired in 1995. It built the rest in 2007.

Jason Reilley, a spokesman for AvalonBay, declined to comment on the sales. Marty McKenna, a spokesman for Equity Residential (EQR), didn't return a call for comment.

David Neithercut, Equity Residential's CEO, said on a conference call after the Archstone deal was announced in November that while the purchase gave it more properties in the Washington area at a time of increased supply, "there have been bumps in the road from time to time over the years in this market but over the long-term, the greater D.C. market has been a terrific performer and should continue to be such."

Scaling Back

Other companies are also seeking to reduce their presence. Home Properties (HME), a Rochester, New York-based REIT that owns apartments mostly in the mid-Atlantic states, announced the sale of its 450-unit Falkland Chase apartments in Silver Spring, Maryland, for \$98 million this month. It wants to lower its exposure to the D.C. area to 30 percent of its net operating income from the 34 percent it had last year, according to Rod Petrik, a REIT analyst with Stifel Nicolaus & Co. in Baltimore.

"The state of the D.C. market, given the exposure of all the public companies, is probably going to be front and center in the earnings calls," when apartment REITs announce first-quarter results this month, Petrik said in an interview.

REITs own close to 62,000 apartment units in the Washington area, or more than twice as many as they do in any other metropolitan region, according to Axiometrics. The publicly traded landlords are also developing the most units in Washington, with 2,947 under construction.

Nearing Peak

Deliveries of newly constructed apartment properties are expected to peak in the fourth quarter with 5,000 new units, before tapering to fewer than 400 each in the second and third quarters of 2015, according to Delta Associates. The region has historically been able to absorb about 1,425 new units per quarter in the last 18 years, according to Delta.

“It’s a supply problem and not a demand problem, which is the better kind of problem to have,” Leisch said. “When you have a demand problem, you’re called Detroit. When you have a supply problem you generally have a market that is attractive to investors.”

Buyers are still paying top dollar for apartment properties in the region as they bank on better times once the oversupply has been absorbed. Dweck Properties Ltd., which purchased Equity Residential’s Crystal Towers complex, paid \$322.3 million, the largest amount ever spent on a single apartment property in the Washington region, Delta Associates said. Also last month, JPMorgan Chase & Co. bought the newly constructed 125-unit District building at 14th and S Streets for \$76 million, or \$608,000 per unit, another record, according to Delta.

Cap Rates

The dollar volume of Washington-area apartment-building sales increased 22 percent last year to \$6.08 billion, according to data from New York-based research firm Real Capital Analytics Inc. There were 126 properties that changed hands, the most since 2007. Buildings in Washington proper traded at an average capitalization rate of 4 percent, the lowest the firm tracked since 2005. Cap rates are a measure of investment yield that fall as prices rise.

“If you look at it over the long run, we’re very comfortable,” said Sylvain Fortier, an executive vice president at Ivanhoe Cambridge, the real estate arm of Caisse de Depot et Placement du Quebec, Canada’s largest pension fund. It teamed with Goldman and Greystar to buy the apartment units in the region from Equity Residential.

“Will there be an impact the morning 500 new units open in the market? Probably,” Fortier said. “But in the longer term it’s OK. It doesn’t concern us.”

Charlotte Powell, a New York-based spokeswoman for JPMorgan Asset Management, which oversees the division handling real estate purchases, declined to comment. Ralph Dweck, a principal at Washington-based Dweck Properties, didn’t return a phone message.

Financing Deals

William Walker, chief executive officer of Bethesda, Maryland-based commercial lender Walker & Dunlop Inc., which financed the Crystal House acquisition, said his firm continues to fund deals in the Washington area, even as there will “no doubt” be a “glut” of apartments in the next 12 to 18 months.

Job growth through the private sector, as well as the omni-presence of the government and the procurement jobs related to it, means apartment properties can achieve more than enough cash flow required to service the debt, even at record prices being paid today, Walker said.

“We’re happy to do it all day long,” he said of multifamily financing in the region. “We’d do it till we’re blue in the face.”

Washington’s apartment market should be back to normal levels by around 2016, with annual rent growth of more than 4 percent, once the excess supply has been absorbed, said Leisch of Delta Associates. His firm forecasts an average of 48,000 new jobs added annually over the next five years, with a peak of 63,000 jobs added in 2016, just as the newly built supply becomes scarce.

“This stuff moves in cycles,” Leisch said. “The apartment market will be just fine in a couple of years.”

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