Evaluating Apartments as an Investment

The NBA Combine is an event spanning several days, in which the top college prospects participate in drills testing their skills. Some of these skills include the vertical leap, a 185-lb bench press, and lane agility. At the end of the Combine, players compete in five-on-five games, which are attended by NBA scouts and coaches. The results of the Combine can determine a player's draft status, as well as their potential salary. But it's a measure of potential, and not always accurate. For example, Kevin Durant couldn't complete one bench press, but he ended up becoming one of the greatest in the league today. Much like the Combine evaluates players, apartments can also be evaluated -- but this evaluation is not always correct.

Understanding the factors that drive apartment values, and why those factors matter, can go a long way toward helping an investor make the right investment decision. From knowledge of not only the factors, but how those factors work together, an investor can make the right financial decision for their future.

<u>What drives Multifamily Valuations?</u>

There are a number of factors that drive multifamily valuations. The primary driver on the demand side of the equation is the performance of the economy in general. Home ownership trends are a second factor to consider. Another factor to consider in measuring demand for rental housing are population trends. On the supply side of multifamily valuations, the biggest consideration is the number of apartments delivered. You often hear about the number of apartments units completed based upon a nationwide or even regional basis. Here it is critical to look beyond the headlines and focus on the number of units delivered into a particular submarket.

Let's break down these supply and demand factors in some more detail. The most important thing to remember is that all real estate is local so it matters more what's happening locally than what's happening at the national level.

Economic Influence and Job Growth

As mentioned, the performance of the economy in general will have the strongest impact on investing in apartments. When there is significant job growth in a metro area, more people are going to be moving into that area that area than moving out, thus, driving up household formations. As the economy grows individuals who have roommates or are living at home will move out and look to rent an apartment on their own, or they may choose to marry. In each of those situations a new household is formed resulting in increased demand.

A high percentage of those young people will rent as opposed to purchasing a home. Generally, anywhere from 30%-40% of households will look to rent an apartment as opposed to buying a home.

Investors who have multifamily properties in areas where job growth is strong should see demand for their apartments increase measurably. Likewise, during a downturn in the economy, people may elect to move in with a roommate or move back home. This results in a shrinking supply in the number of households, thus reducing demand for apartments.

Home Ownership Trends

When housing prices are low, more people buy homes. The opposite is also true. When the prices for houses are higher, there are more people renting. Which direction, up or down, that housing prices are trending will definitely increase or reduce demand for apartment rentals.

Population Trends

Another important metric is how current population trends impact housing. What is the population in a particular area doing? Are there a lot of people coming into the area, or are most of them moving away? If they are younger and single, they may be more likely to rent. If they are older couples, buying may be more preferable. Studying and understanding current and future population trends is an important consideration in gauging future demand for apartment rentals.

Supply Trends

A rising supply of new apartments is generally a sign of a strong economy. It is also a sign that rent increases may be softening in the near term. Again, national supply trends tell us something but local market supply trends tell us much more. For example, CBRE reported that in 2018 267,900 apartment units were completed which was the second highest number of new units in 30 years. The highest number of new apartments units was in 2017. Are we headed for some overbuilding? Maybe. A closer look at the numbers shows that the top eight markets accounted for almost half of the units in 2018. Some metro markets had almost no new construction. This shows the importance of understanding the local market where you are looking to invest.

Looking at the Multifamily Sector's Return on Investment (ROI) Performance

From the standpoint of return on investment (ROI), the multifamily sector has put up impressive total return results over the last 10 years. Rents have also been rising and apartment valuation have followed. One way to measure apartment valuations is to compare REIT (real estate investment trusts) apartment returns with other REIT commercial real estate sectors. They outperform other types of real estate investment with an average return of 11.8 percent annually. There will certainly be ups and downs, as is expected with any investment, but the overall value of multifamily real estate appears to be rising.

Drawing Conclusions About Multifamily Real Estate Investing

The impact of the economy on multifamily properties is the most important driver for investors. But other factors play a role also. And each variable needs to be examined in the context of the local market. Careful examination of all the factors can help ensure an investor chooses the right locations in which they can invest.

Like the NBA combine, evaluating apartments based upon proven metrics is a smart approach to making investment decisions. Just like the NBA, a little bit of serendipity helps too.

Source
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