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Multi-Family Market Optimism Prevails Despite Pandemic-Related Disruptions

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Despite the move to the suburbs and falling rental rates, Allen Matkins/UCLA Anderson Forecast California Commercial Real Estate Survey panelists are bullish about the coming three years in the multi-family housing space. Rental rates are forecast across the board to increase faster than the rate of inflation and vacancy rates are expected to fall between now and 2024. This optimism is caused by both the re-opening of city amenities attracting people back to city apartments and the beginning of the return to the office.

Multi-family housing industry leaders, Kitty Wallace of Colliers International and John Condas of Allen Matkins, discuss what lies ahead for this sector of the California commercial real estate market.

DESPITE A PORTION OF THE POPULATION MOVING TO SUBDIVISION COMMUNITIES, A DIP IN RENTAL RATES, AND HIGH CONSTRUCTION COSTS, MULTIFAMILY DEVELOPERS AND INVESTORS ARE STILL BULLISH ON THIS SECTOR LOOKING AT LEAST THREE YEARS AHEAD. WHY IS THAT?

Wallace: Historically, California has been a top 10 market, and while we have experienced unfortunate circumstances because of the pandemic, people remain hopeful. Investors, tenants, and landlords alike are strategically thinking and planning ahead based on the historical market and anticipated trends and future returns. At some point, COVID restrictions will be lifted. It is imperative that multi-family developers and investors make calculated moves today.

Several factors play a significant role in the development of this sector – many of which include high barriers to entry, diverse employment, entertainment, weather, and a tenant base that has a high tolerance for increasing rents. Considering those, people are willing to invest and positively forecast based on California's track record of above-market appreciation. Although most of California is projected for flat net growth within the next year or two, in years to come, they are optimistic for the historical market setting increments of rent increases of year's past. What we will see once the economy fully reopens is a compelling place to 'park money and profit'. With the diversity we possess in our employment sectors, our population will see a sizable boom. This not only presents a beautiful opportunity for investors and developers to jump in, but also highlights several trends we are witnessing. Lumber prices have increased. There is also an escalation of labor costs. If you are going to build properties, it makes sense to build in areas where you will garner the best rents for your fixed costs, further driving the need to sow those development dollars in higher-end markets now.

Condas: A lot of data from experts support the contention that even with these above-mentioned factors, California still is way behind on the production of residential units. Our clients subscribe to this viewpoint; the creation of jobs has far outpaced the production of new housing units. We have seen a torrent of new activity, which appears to be driven in part by the reopening of California on June 15. Our clients believe that the worst impacts of COVID are behind us, and as we return to a more normal situation, the prior pent-up demand, pre-COVID, will return.

WITH A VAST MAJORITY OF SURVEY PARTICIPANTS STILL MOVING FORWARD WITH MULTI-FAMILY PROJECTS OVER THE NEXT FEW YEARS, PARTICULARLY IN SOUTHERN CALIFORNIA, WHAT ADDED OR NEW AMENITIES ARE DEVELOPERS CONSIDERING FOR THEIR PROPERTIES, EITHER COVID-RELATED OR OTHERWISE?

Wallace: We are seeing a continuation and enhancement of common trends such as automation and the installation of various technology types. From Nest thermostats to keyless entry and the expansion of Amazon lockers, developers are taking strides to ensure their tenants live in highly amenitized units. There are now advantageous additions like Stockwell, a popular smart store that provides a full range of services including lunch on-the-go or day-to-day retail supplies. Enhanced Wi-Fi options are now mandated. The inclusion of these types of additions not only offers a benefit to the tenant, but also provides additional income to the landlord.

Yoga studios and gyms have drastically expanded and are sometimes relocated outdoors. We recognize the value of health and learned through the COVID pandemic that in California, exercise outdoors is not only doable but preferable in many instances. Oftentimes, we are limited on space. In some cases, developers are re-inventing approaches by looking into other health and wellness options with the inclusion of pickleball courts and lap pools. The use of outdoor space has soared, especially because these spaces are hard to come by in main metropolitan areas. Tenants want user-friendly options in addition to fitness centers that include game areas with bocci or cornhole and homelike gardens with herbs and fruit trees. COVID-19 encourages developers to operate with a sharper focus on the tenant and their wellbeing. On the manufacturing front, new elevators include COVID filtration options to help keep our communities safer, with developers also looking to enhance airflow in corridors and common areas.

Condas: Our clients are incorporating amenities and changes to existing amenities to address COVID-related concerns. Such amenities include more outdoor areas, using Zoom to hold virtual cocktail tastings or cooking classes, reservable meditation rooms, and distanced workout equipment. They are instituting cleaning and sanitizing practices in on-site fitness centers and co-working spaces. Lounges, clubhouses, and other areas are now being repurposed for homeschooling and remote work. Our clients are investing in more movable furniture, which allows them to set seating, dining, and studying/work areas six or more feet apart. Dividers are being installed in co-working spaces to help tenants feel safe. Multi-bedroom units are now being advertised as one-bedroom apartments with home offices or remote learning spaces, instead of the traditional marketing for 2-bedroom or 3-bedroom apartments. Single-bedroom apartments are showcasing a creative space/working area where residents can earn a living in the comfort of their own home since a significant number of people are now working from home.

WHERE WILL BE THE NEXT "HOT SPOTS" FOR MULTIFAMILY DEVELOPMENT, IF NOT IN THE MAJOR MARKETS ALREADY SATURATED WITH HIGH-RISE CONDOS? WILL PEOPLE CONTINUE TO SEEK OUT LESS-DENSE LOCATIONS?

Wallace: While the hot spots will continue to be the regions that show high barriers to entry, the Inland Empire is set to flourish because of the port and logistics market as well as the increase in warehouse development. Institutional clients are now putting their capital toward this striking development concept. There is a plethora of population growth in the Inland Empire because of consistent rent growth. For the past 11 years, they have observed a steady 3% in rent growth. Historically, this market has seen only hundreds of new units coming to market. Now, it is expected that we will have close to 2,000 constructed units in the coming year. Though many rental markets in the state have been impacted by the pandemic, San Diego has been another hot spot, followed closely by the Orange County and Sacramento markets as these markets were more lenient with mask mandates, school openings, and the return to business.

Some tenants and investors are flocking to areas out of state to Montana, Idaho, Colorado, Arizona, or even Utah. Some due to the cost of housing development, but many because of the restrictions in the state of California. As some have left, many are returning because there are improved opportunities here; growth prospects are better. It is certainly a changing of the guard now with our tenant and investor demographics, but we will see investors utilize their capital because of the profit potential. Our markets have steadily maintained a 5% vacancy rate, which means our rents are mounting. In the next three years, it is expected to skyrocket. Right now, many rental markets are tight, so we are witnessing unrelenting interest in those pockets.

Condas: Our clients are especially bullish on developing multi-family projects in suburban, less-dense areas, such as the Inland Empire. One reason the Inland Empire has allure for our clients is due to the tremendous job growth which has occurred there, driven by the number of warehouses and logistics facilities which have been developed. Land prices also are lower there than in more urbanized areas. These projects are being developed at lower densities than in urban areas, allowing cheaper types of construction to be used. Also, we have seen a lot of new development activity in Orange County, outside of coastal areas. Our clients also understand that the regulatory pendulum has swung towards a more pro-housing bent, due to the California Legislature's adoption of SB 330, and the extremely high Regional Housing Needs Allocations (RHNA) which local governments have been assigned by various associations of governments. State law requires cities and counties to demonstrate that these local governments have adequate land, zoned at appropriate densities, to meet their RHNA obligations. These high RHNA obligations will compel local governments to upzone or rezone properties to accommodate their respective RHNA obligations, which will make the entitlement process more certain and somewhat less risky.

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