Apartment market inches back

But challenges remaim in form of interest rate questions and popularity of condo living

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Vacancy rates in Twin Cities apartments continue to fall, and it is music to the ears of apartment building owners and investors. GVA Marquette Advisors reports third quarter rental vacancies at 5.6 percent — down more than a full point from the 6.7 percent reported last fall.

In recent years, apartment vacancies have climbed as low interest rates drove more people to buy homes — or condos — rather than rent.

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But now the lowering vacancy trend seems to have taken hold. "It's been trending that way, the general trend of vacancy has been a decline, and we expect that will continue," said Brent Wittenberg, vice president with GVA Marquette Advisors. "The recovery is more widespread. Even the high end of the market is showing improvement over a year ago. What jumps out is that the improvement is more widespread between the urban and suburban markets."

Most of the submarkets tracked by GVA Marquette posted improvements during the third quarter.

Minneapolis has a 4.3 percent vacancy rate across the city, contrasted with 5.8 percent in St. Paul. Little Canada is the tightest local market, with a 1.8 percent vacancy rate. Cottage Grove/Newport has the highest area vacancy rate at 18.7 percent.

Rental rates, at an average of $848 per unit, haven't really budged in the last four years. They stood at $836 in 2001. "The job growth has improved, the demand fundamentals have strengthened. The fact that apartment construction has slowed down has also helped. Condo conversions are actually outpacing new construction," Wittenberg said.

But good news for apartment owners doesn't necessarily translate into good news for all.

"The majority of renters are what we call 'renters by necessity' rather than renters by choice," Wittenberg said. "The majority of the job creation seems to be at the low end, and that's putting more and more renters in the market who are renters by necessity."

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Wittenberg also sees lingering challenges for apartment owners. "The majority of our apartment product in the Twin Cities does not compete very well with modern condominium projects," Wittenberg said. "The fact of the matter is that the condos are here to stay, and apartment owners are going to have to learn to compete."

The looming unknown for Wittenberg is what will happen to interest rates and what impact that will have on the rental multi-housing market: "That's key, and I don't know that anybody has the answer," Wittenberg said.

Notably, even as vacancy in apartment buildings climbed in the last few years, investor demand has remained robust, even amid falling yields — or cap rates — to investors. "It's still really strong. We continue to see aggressive pricing from buyers, low cap rates," said Abe Appert, an apartment broker and principal with the Fransen Appert Real Estate Group.

Appert said institutional investors are buying buildings at cap rates of as low as 5 percent.

"If you exclude condo [conversion] deals, we're between 5 and 7 percent," Appert said.

Times have changed from a mere decade ago.

"In 1994, when I got into the business, in the apartment sector only, the cap rates were 10 plus. The good product was trading at 10 caps, and the bad product was trading at 12 caps. I would say that in 2000, five years ago, cap rates were probably between 7 and 9," Appert recalled. "It's just been in the last couple of years that caps have dropped below that 7 percent level. But now it's almost as if they could go lower. They are lower in other markets."

Keith Collins, vice president with CB Richard Ellis, agrees that investor demand has remained strong.

"The interest from the pension funds, the institutional investors has been very strong. I think they're bullish on the Twin Cities. These investors certainly seem willing to accept lower yields, and a lot of that's tied to the 10-year Treasury [bond]," Collins said. "They view the Twin Cities as a supply-constrained market, meaning that it's difficult to build here. It's tough to find land. It's expensive to build here."

Collins said the current range of cap rates on multi-family projects is 5.25 to 5.75 percent. On Monday, the 10-year Treasury closed at 4.49 percent. While yields or cap rates on real estate are at a low ebb, many still see those returns as better than other potential investments.

But Collins wonders if the breaking point is approaching when it will become cheaper for investors to build new, rather than buy existing assets.

"On some of this stuff, on the high end, we are getting closer to replacement costs," Collins said. "When stuff starts trading for $120,000 to $140,000 per unit, you're getting closer to that replacement cost."