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BUILDING VALUE

Apartment-Rental Market May Pick Up This Year

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Low interest rates have turned thousands of renters into home buyers, driving down profits for many apartment-building owners.

At the same time, though, investors have paid ever higher prices for some of these very same apartment buildings.

That left longtime apartment investors struggling with what to do. Real estate investment trusts, which control about a third of all apartment units, last year took advantage of the high prices and sold buildings -- the second year in a row that they were net sellers. But some apartment-building investors took a different path, venturing into beaten up markets such as Atlanta, San Francisco and southern Florida, hoping for a rebound.

Most notable was **Morgan Stanley**'s U.S. Real Estate Investing division. According to a report from the National Multi Housing Council, an apartment trade group based in Washington, D.C., Morgan Stanley bought 46,473 apartment units last year, boosting the size of its portfolio by 87%. That made Morgan Stanley one of the top 10 owners of apartments, ranking seventh, up from 12 the prior year.

Morgan Stanley spent 2004 acquiring apartment assets mostly in "opportunistic" or "value-added deals," as they are known in the industry.

BIG LANDLORDS

Sales of rental apartment buildings set a record in 2004, but the top owners didn't change much. Below, the biggest owners of apartments and their rank last year.

	2003 Ranking
CharterMac Apartment Investment and Management	1
Equity Residential	3
MMA Financial	4
SunAmerica Affordable Housing Partners	6
Boston Capital	5
Morgan Stanley	12
United Dominion Realty Trust	8
Archstone-Smith	7
Lefrak Organization	9

Source: National Multi Housing Council

"We had been selectively buying core investments but found that difficult given the high prices," says Dave Hardman, U.S. head of real-estate investing at Morgan Stanley. Last year Morgan Stanley bought lower-quality "very opportunistic" assets, and entered into joint ventures to develop apartment properties, he says.

The plan with the opportunistic assets is to upgrade them and improve the income they generate. The firm's focus is "high demographic-growth markets with limited supply of land," Mr. Hardman says, and it continues to selectively invest in the Northeast, from Boston to Washington.

The U.S. apartment market was hurt by low mortgage rates turning some would-be renters into home buyers, a weak job market that cooled tenant demand and oversupply in some areas. The national apartment vacancy rate rose to an average of 6.7% in 2004 from 3.1% in 2000, according to Reis Inc. In recent months, however, average rents and occupancies have been rising slightly in some areas.

It appears more firms are making bets on a recovery in the rental-apartment market this year. As of the end of February, apartment deal volume totaled about $3.53 billion, up from $2.86 billion in the fourth quarter, according to real-estate research firm Real Capital Analytics Inc. Just last week an investment company controlled by the ruler of the Persian Gulf emirate of Dubai agreed to buy 21,000 rental apartments in the Sunbelt for $1 billion, the largest acquisition of apartment buildings in the U.S. in four years.

Morgan Stanley's Mr. Hardman says the firm is bullish on the apartment sector for this year and the next few years to come. "We see the demographics at work as the echo boomers start their household formation years and generally are renters versus homeowners and as job growth improves," he says, referring to the children of baby boomers.

Mr. Hardman also says the firm believes higher mortgage rates and rising prices will cool home buying. "We think there'll be a return to rental versus home ownership," he said.

Many REITs decided not to wait around for the market to improve. As a result, last year apartment REITs owned 31% of the apartments owned by the top 50 owners of apartments in the U.S., down from their peak of 35% in 2003 and the lowest level since 1998.

Instead, private investors, including condo converters, took advantage of historically low interest rates, leveraged up and gained buying power.

"It was not difficult for any private investor to leverage up to 70% to 80%," says Yougou Liang, managing director of research at Prudential Real Estate Investors, the real-estate investment arm of Prudential Financial Inc., of Newark, N.J. "All institutional investors have a hard time matching that," as they have to be mindful of shareholders and credit-ratings companies.

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