Multifamily Executive

February 22, 2018

Suburban Development

Suburbs Heat Up as Downtown Rents Cool

As rents in the urban core flatten, those in markets beyond are taking off. Developers and owners like Cortland, Bozzuto, and Kennedy Wilson are meeting the demand.

By Joe Bousquin

Courtesy Draper and Kramer Draper and Kramer's EVO Apartments in Richmond Heights is less than 10 miles from downtown St. Louis. The development's luxurious amenities include an outdoor saltwater pool, an on-site dog park, and a fully equipped fitness center. The nine floor plans range from 572 square feet to 1,203 square feet and rent for $1,225 to $2,225 a month.

When Mike Altman started looking for institutional investors to back Cortland Partners' multifamily push into secondary, tertiary, and suburban markets two years ago, he didn't find many takers.

With development going gangbusters in the urban cores of most cities nationally, looking for opportunities farther afield seemed anathema to the post-recession rallying cry of the apartment industry: to build new, luxury towers downtown while collecting ever-increasing rents. So when Altman and Cortland read the economic tea leaves and realized the next wave of growth was already starting to happen farther out, their prognostications fell on deaf ears.

“They couldn’t change the culture of their investment committees. Large capital was focused on the downtown core because it’s the cleanest Class A, institutional investment you can make,” says Altman, chief investment officer at Atlanta-based Cortland, which owns and manages approximately 45,000 units. “Even though their own research teams started talking about the suburban trade in 2016 and 2017, the shift in capital has been slower than the economic research and math that supported it.”

What a difference a couple of years makes. With downtown rents flat as those in the suburbs take off, Altman and Cortland in January unveiled a $550 million joint venture with the Canada Pension Plan Investment Board (CPPIB) and Singapore-based global investment firm GIC to acquire and renovate 8,000 to 10,000 Class B apartments in secondary and suburban markets throughout the U.S.

“GIC and CPPIB are very savvy, global investors, so I’d say this really validates the suburbs as a smart-money investment,” says Altman, who estimates that Cortland is currently renovating 800 units a month nationally.

Now Trending: Urban Overdevelopment

Cortland’s win in securing more than half a billion dollars of institutional money to rehab in the suburbs underscores a broader trend in both value-add renovation and ground-up development today; namely, whereas multifamily over the past decade has largely focused on developing or rehabbing properties within the central business district (CBD) downtown, apartment pros are now planting their flags on the edge of the farther-flung, suburban frontier.

Once viewed as a symbol of 1970s and ’80s urban flight, the outlying areas around America’s cities have suddenly become cool again. With more and cheaper land on which to develop from the ground up; plenty of 1990s apartment product that’s ripe for rehab; and lots of 1970s-era strip malls being redeveloped into mixed-use projects, walkable urbanlike pockets have been popping up in the ’burbs, and renters have followed.

Indeed, the fact that rent growth in the suburbs has outpaced what’s happening downtown isn’t breaking news. According to Los Angeles–based real estate investment firm CBRE Econometric Advisors’ 2018 U.S. Real Estate Market Outlook report, rent growth in the suburbs over the past two years has averaged 3.4% nationally, while downtown rents have grown at just 0.6% over the same period.

“The softest performance in multifamily right now is in downtown, high-end, recently built, luxury product,” says Matt Vance, an economist and director of research and analysis at CBRE. “And it’s because there’s a high concentration of new product that’s very homogenous and very Class A.”

Of course, it was the ever-increasing rents—CBD rents in many markets rose more than 35% during this cycle—that kept that development pipeline churning, even as opportunities got more and more expensive. Prices now range from $300,000 to $600,000 per apartment to develop downtown, and there’s a lot more competition when the units come on line.

“There’s a worrisome trend of overdevelopment in hot urban markets like New York, Los Angeles, Seattle, and Denver that’s pushed up the cost for developers and priced out renters,” says Ralph Orlando, division president at Torrance, Calif.–based Partner Engineering and Science. “That’s pushed development into the suburbs, exurbs, and less-prominent areas within cities themselves.”

The flip side of that trend is today’s suburban strength. “We’re seeing continued performance in suburban multifamily at a price where residents feel they’re either saving money or paying the same price but getting more space,” Vance says.

Kurt Zech, president of Beverly Hills, Calif.–based Kennedy Wilson’s multifamily investment division, says it’s all about the rents. “The renewed focus on development in the suburbs is a result of rent growth in the suburbs,” says Zech, whose firm has deployed $1.9 billion for acquisitions in suburban, secondary, and tertiary markets on the West Coast over the past three years. "Developers can now justify new suburban projects in some areas because rent growth has accelerated to close the gap with the urban core."

Courtesy Kennedy Wilson The purchase of the 343-unit Atlas in Issaquah, Wash., on the outskirts of Seattle, highlights Kennedy Wilson's suburban push.

In the end, the shift has come down to how much capital it takes to turn dirt, and the availability of space to build on.

"There are larger swaths of land in suburban markets," says Kyle Peterson, director at San Diego–based architecture firm Carrier Johnson + CULTURE. "A lot of large-scale malls with acres of surface-parking lots are being repositioned as 24-hour, mixed-use lifestyle centers. We're seeing more of an urban vibe being created that attracts a similar rental profile as core urban locations."

And the scope of the opportunity could be even bigger than what developers saw downtown. For instance, while just under 1 million new apartments were built between 2012 and 2016 nationally, according to apartment analysis site RENT*Café*, Altman says Cortland estimates there are 1.4 million units that fit his criteria for rehab alone. "There have been a lot of apartments built in the last five years," Altman says. "But the truth is, there are many, many more in the existing housing stock."

While the trend of heading back to the suburbs represents a reversal more than two decades in the making—downtown development really started taking off around 1997, according to Vance—the elevated tastes and expectations residents acquired for over-the-top amenities while living downtown have proved quite portable. That means today's successful multifamily suburban properties are anything but a carbon copy of what came in outlying areas before.

The "Surban" Mix

"When you hear the term 'suburb,' you tend to think of cookie-cutter home subdivisions that are an overwhelmingly single-family environment," says Vance. "But that's really not what apartment developers are after. Instead, we're talking about areas like Tysons Corner in the metro D.C. market or Cherry Creek in Denver. What we're seeing is a continuous spectrum of urban to suburban where you have the densest pockets downtown, and then similar, but slightly less dense urban pockets cropping up in the suburbs."

In other words, developers aren't just moving to the suburbs from downtown; they're actually bringing downtown to the suburbs. And they're doing it in locales that often haven't seen a lot of redevelopment in recent years.

Suburban NIMBY Blues?

How open suburban communities are to developers varies by market. While some actively court development, others want no part of it. In fact, while Bozzuto's experience with Aperture Apartments, its 421-unit luxury rental in Reston, Va., was a win, another development nearby has recently been blocked due to residents' protests.

Mike Altman, chief investment officer at Cortland Partners, says backlash toward building in the suburbs can be intense, an advantage rehabbers have over ground-up developers.

"NIMBYism is alive and well, especially for developers trying to build in the suburbs," Altman says. "Entitlements are difficult everywhere in the world."

Chuck Reed, former mayor of San Jose, Calif., who now serves as special counsel in Silicon Valley law firm Hopkins & Carley, says in many areas apartments still aren't welcome with open arms.

"One way to tone down the opposition and generate some support is through high-quality, well-designed, mixed-use projects that will bring retail and service amenities to areas where they're lacking," Reed says.

That's especially true when it comes to redeveloping outdated retail or repurposing light-industrial areas.

"There's a lot of opportunity out there to repurpose sites that previously were developed for other purposes," says Ed Polich, senior vice president and chief development officer for Chicago-based Draper and Kramer, which is currently developing a residential mixed-use project on an infill site in St. Louis that previously housed an 1890s industrial complex. "Assembling and entitling these types of sites can be challenging and time-consuming, but we feel the end result is worth the time and effort."

"Many suburban areas were left with older supply as people flocked to solve the demand for the urban core," says Rob Bond, president of Chicago-based Bond Cos., which currently has 1,300 units under construction, including Inspire, a 369-unit project in the South Park area of Charlotte, N.C. "A correction is occurring to fulfill those unmet needs in those cities that are benefitting from employment growth."

Renters, meanwhile, are meeting developers where they're increasingly choosing to live. Part of the push comes from an organic component of this cycle, as the oldest millennials, born in the early 1980s, begin bundling and having families or start living a more subdued lifestyle.

In fact, suburban areas are outpacing urban areas for renter household gains in 19 of the 20 largest markets, according to RENT*Café*. Suburban gains in renters in Atlanta, Phoenix, Riverside (Calif.), Minneapolis, Washington, D.C., Seattle, Chicago, Boston, and San Francisco outpaced renter gains in urban markets by 50% to 100% from 2011 to 2015.

“The customers in the suburbs are more millennial today than they were even two or three years ago,” Altman says. “Their lives have slowed down a little. They’re not just out of college anymore. So you have couples who might still be pre-kids, but they’re trying to make better choices economically.”

Those better choices might include rents in the $1,200 to $1,800 range versus $2,000 to $2,500 or even $3,000 downtown. In fact, on average, living in the ’burbs saves renters one month of rent per year, according to RENT*Café*.

The other wave of renters invading the suburban shores is millennials’ baby boomer parents, many of whom are nearing retirement and looking for housing that promises less maintenance but can still offer space for the material possessions they’ve acquired over the years. Suburban apartments, with their typically larger footprints, help meet that demand.

“There’s demand at both ends of the barbell,” says Ed McGovern, managing director, capital markets, at Seattle-based Security Properties, which has acquired or developed nearly 80,000 units at a cost of $5.3 billion across 530 assets. “You’ve got millennials who are moving up and out of downtown, and you’ve got the boomers who are coming in and want to downsize for simpler maintenance.”

Indeed, while multifamily has tended to focus almost myopically on millennials in recent years, that may be changing.

“What seems to have everyone salivating currently is the downsizing, active-adult boomers,” says John R. Kirk, partner at architecture and urban design firm Cooper Robertson in New York. “The numbers are staggering, with Florida, Arizona, and Southern California projected to capture most of them. But not all boomers want to live in a gated golf-cart community. A lot are looking for a more stimulating, active, and urban-suburban lifestyle.”

Living, Developing on the Cheap
Renters aren’t the only ones saving in the suburbs. For Altman and Cortland, the suburban market has an almost perfectly inverse correlation to the costs of developing downtown. For instance, whereas buildings in CBDs can trade for $300,000 to $600,000 per apartment, depending on the market, suburban properties go for just $120,000 to $200,000 per unit.

Altman points to the Attis, a 304-unit, garden-style property in Roswell, Ga. Cortland acquired the project in 2015 for $120,000 per unit before putting another $30,000 into renovations. With an all-in cost of $150,000 per unit, not only was Altman well below the cost of what it would take to build downtown, he was also below the replacement cost of $165,000 to $175,000 for that submarket.

The result? He was able to raise rents by $250 to $300, to reach $1,200 to $1,450, while providing a product that’s essentially new to his residents and has a sustained, 96% occupancy.

Ray Cavicchio KTGY designed Aperture Apartments in Reston, Va., to bring a city feel to the suburbs outside Washington, D.C.

“We’re inside of replacement costs, so there’s not an economic motivation to buy or build new product in this location, and our gross rents are still much more affordable than the high-rise units downtown,” Altman says.

And while the returns on rehabs have driven up prices for 1990s properties like the Attis—ones built after 1996, when the Americans with Disabilities Act passed, are prime candidates—Altman explains that cap-rate compression can be allayed by blending all-in costs post-renovation.

“Yes, we’re all buying 5 and 5½ caps, which feels thin relative to 2013, when it was a 6½ cap,” Altman says. “So it’s a compressed market, and yields are down. But if I’m buying at a 5 cap, and then put a 25% increase in capital for renovation, I do the rehab portion at a 12 cap. So when you blend it all together, you’re back at a mid-6 cap, which is very attractive to our partners.”

From the Ground Up

Lest you think the math of suburban versus urban works only for rehabs, keep in mind suburban ground-up development can benefit from a lower cost basis as well.

Take Aperture Apartments, a 421-unit luxury rental community in Reston, Va. Because the building is only five stories, Greenbelt, Md.–based Bozzuto Group, which developed the property and manages 47,000 units nationally, was able to employ standard wood-frame construction, versus the steel-beam construction required for taller downtown builds. The end result was $50-per-square-foot savings. “Generally speaking, anytime you can build in wood frame, combined with the land, your costs are going to be lower in the suburbs,” says Rohit Anand, principal of KTGY Architecture + Planning, which designed the community.

Millennials, Boomers Wanted

Some small municipalities are capitalizing on the turn from downtown to the suburbs to capture a larger share of residents and businesses, says Ben Donsky, vice president of New York–based Biederman Redevelopment Ventures, which focuses on revitalizing public spaces. He points to communities like Stamford, Conn.; White Plains, N.Y.; and New Brunswick, N.J.

“These areas are developing arts facilities, waterfront parks, and restaurants to complement new multifamily,” Donsky says. “These locations were [once] considered peripheral at best but are now competing with more-established destinations for young professionals and active older adults. They can offer a mix of suburban comforts like larger units and garage spaces, but with urban convenience.”

The desire to draw those kinds of residents means more communities may be willing to deal than during previous cycles.

“Sophisticated suburban municipalities are more willing to rezone land to higher-density multifamily, something they may have shied away from in the past,” says Ken Outcalt, president of development at Cleveland-based NRP Group, which has developed more than 28,000 units. “They want to attract those higher-earning millennials and well-heeled baby boomers, just like everyone else does.”

That holds true even though, on average, apartment sizes in the suburbs are going to be larger—think 725 square feet for a one-bedroom versus 600 square feet downtown—while rents are less. For instance, rents in Reston go for around $2.50 per square foot, whereas those in DuPont Circle in downtown D.C. might be $3.50 or higher. “But because land costs and other elements tend to be cheaper in the suburbs, the numbers work themselves out,” Anand says.

Indeed, John Thatch, director of design at Pleasanton, Calif.–based architecture firm Dahlin Group, says construction costs are at least 10% cheaper in the suburbs versus downtown in the Bay Area, but he says the real savings come from the compressed time frames it takes to get suburban jobs done.

“In the suburbs, you can do three- or four-over wood frame for a project that’s got 30 to 36 units per acre, which means you’re not waiting on the concrete. You don’t have to frame it, pour it, and then wait for it to cure,” Thatch says. “That’s going to save you three or four months on the build, which is going to have an even bigger savings on your loan and construction timing.”

In South Florida, the cost difference is even starker. “Because we’re geographically constrained, urban projects are 30% to 35% more expensive to build,” says Dominic Mazza, director of acquisitions at Boca Raton, Fla.–based Altman Development Corp., which has developed over 25,000 units. “That’s despite the fact that those downtown units are 25% to 30% smaller in terms of square footage than their suburban counterparts.” In other markets, observers say the downtown–suburban spread can be as high as 50%.

City Living in the Suburbs

Yet, while the calculus of building, buying, and rehabbing in the suburbs is different, what renters want there really isn’t. Even though residents are showing a willingness to move away from CBDs, they’re not willing to give up the amenities they grew accustomed to while living downtown.

Security Properties’ McGovern points to grocery-anchored developments in the suburbs where luxury apartments are built atop a gourmet market, with other boutique-type retail nearby. In his market, that includes Seattle’s University District, as well as Columbia City, both of which, he notes, are along the region’s light-rail line.

"Suburbs today are a state of mind," McGovern says. "People still want to mix things up so there's less segregation between work and home, and they still want lifestyles that are urbanlike. They just want them in less-dense neighborhoods."

Or, as David Kessler, managing partner of Bethesda, Md.–based CohnReznick's real estate industry practice, puts it, "The key to ultimate success is still self-containment. You've got to have the living, shopping, and dining experiences of the new 18-hour live–work–play lifestyle."

From a management perspective, you still need to engage those residents too.

"It's about differentiating yourself beyond amenities and into the service space, too."

—Derek J. Olszanowski, vice president, Chesapeake Realty Partners

"Obviously, you've got to have the amenities, but it's about differentiating yourself beyond the amenities and into the service space, too," says Derek J. Olszanowski, vice president, asset management, at Owings Mills, Md.–based Chesapeake Realty Partners, which operates 4,000 units. "Residents want a place to gather, a healthy lifestyle, and a place where they can give back. It's all about building community, first and foremost."

It's also about highlighting what's around your development, as well, and developing relationships with other businesses or job centers in the neighborhood.

"Marketing the strengths of your community in relationship to workplaces, schools, and access to transportation are some ways we attract that suburban renter by choice," says Diana Pittro, executive vice president of RMK Management Corp. "Having strong relationships with companies where people work can become a really valuable referral source."

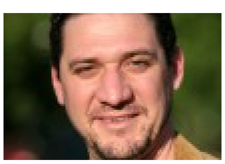
The apartments going up in the suburbs today are different inside, also.

"People still want to be closer to the amenities, in a higher-density area, but they also like the feel of a single-family home, so the goal is to make these spaces more open, and have as little of an apartment feeling as possible," says Dahlin Group's Thatch, referring to for-sale multifamily units in places like Southern California that are following the suburban trend.

He notes that having a kitchen that opens to the living room in great-room style on the window side of the unit is paramount, even if that means sleeping areas are on the interior wall, without windows. Situated at the back of an apartment, those "double studios," as opposed to bedrooms, can be accessed with a barn door, on the other side of a 7-foot-high divider wall with a clerestory at the top to let light in from the window side of the unit.

From the neighborhoods around them to what's on the inside, today's suburban apartments are taking center stage in multifamily's focus. Getting a toehold in this new frontier beyond downtown—in 2018 and beyond—will be a key to operators' success.

About the Author



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