Apartment ReSources

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April Market Hotline!

Attitude Adjustment in Project Design

In our evaluation of overbuilt markets, we've begun to notice that some of the accepted beliefs in project design are beginning to show flaws. Suddenly, it seems, project designs that are normally popular are not achieving their usual success rates. The following* Hotlines! *contain important findings on project design and market impact.

- **Most developers have based their opinions of commercially viable designs on the performance of these designs in underbuilt markets. In years past, many apartment markets were so underserved in rental housing that almost any new product had excellent chances for success. Developers became enthralled with the product designs that were**

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Apartment Resources is a monthly publication designed for apartment developers, lenders, and builders involved in all forms of multifamily housing.

In This Issue:

achieving such high occupancies. However, the best time to evaluate the commercial potential of apartment design is now—when competition in some market areas is brisk. If you've accepted a design as an eternal verity, be aware that the true test will come when you enter one of these slightly overbuilt markets. (Or when the overbuilt market comes to you!)

- One of the first places we see weaknesses in a market area are in the lower levels of 2-1/2 story building designs. This type of design, which became quite popular 20 years ago, appears to be less attractive to tenants than previously believed. The next falloff in occupancy is quite often the third floor of the 3-story walkup design. In many of these projects, developers have begun increasing the quality of third-story units to make them more marketable, occasionally making the third-story units so attractive that the second-floor units begin to suffer.

- In many markets, we've also noticed that developers, banking on the "success" of these designs, have begun to cut corners in two equally damaging areas: construction quality and site selection.

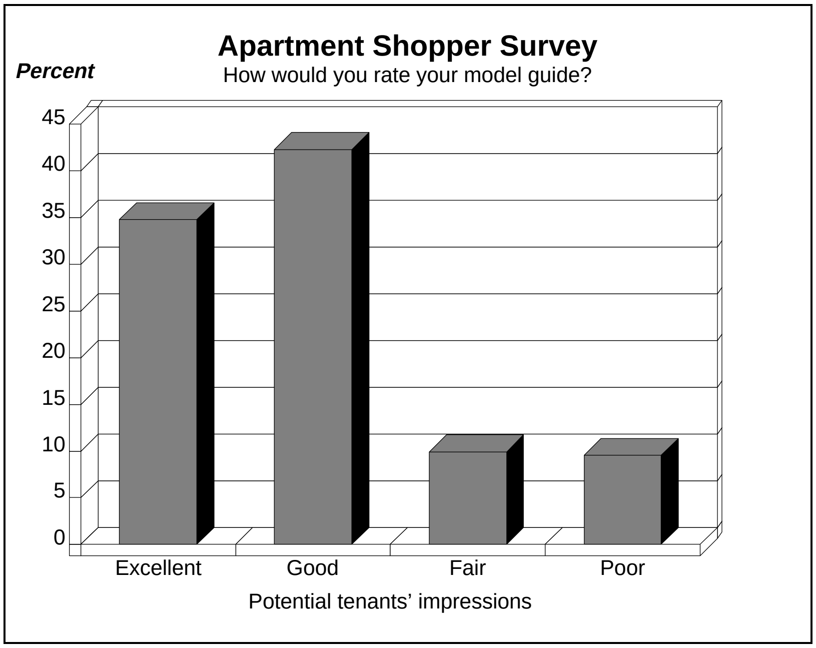
This is a dangerous path to follow in any development plan, but the problems are compounded when the development design proves to be less popular than believed. Developers must pay attention to three aspects of project planning: *site utilization, amenities*, and *quality*. Here, "site utilization" refers to the placement of the project in relation to natural site enhancements (lakes, ravines, wooded areas) that can work wonders in commanding premium rents. "Amenities" refers to unique or upgraded unit and project enhancements that can make your project stand out from the rest of the market. "Quality" refers to the use of better construction and materials, which has proven effectiveness in increasing tenant retention.

- It may seem like a simple point, but along with site selection, developers must also pay attention to "site integration." We are consistently surprised at the number of developers who, enamored of a specific design or layout, are content to reproduce them at each site regardless of the surroundings. The time it takes to ensure that the maximum number of units have ravine views or are integrated (through placement and landscaping) with an existing lake is nearly always paid off in premium rents.

- There are positive aspects to the design/impact dilemma. When examining an area for market potential, you may want to take a second look at those areas that appear to be overbuilt. Those areas with high vacancies may in fact be demonstrating the commercial weaknesses of existing designs. You may uncover a potential market that is waiting for a more responsive design.

- Another attitude adjustment that the current market calls for is understanding the difference between counting occupancies vs. counting vacancies. So-called "overbuilt" markets, are typified by higher-than-normal vacancies. However, before you let such a market scare you off, remember that your aim is to score potential occupancies. If your project design and plan is such that the supportive Effective Market Area (EMA) yields a high number of profile-specific potential tenants, your project may have potential for success.

First Impressions—How Do Shoppers Rate Rental Agents?



A potential renter who sees an apartment for the first time can be overwhelmed by the number of features and drawbacks to assess. Further, each shopper tends to notice different features, depending on his or her needs.

During this process, it is important for project management to find ways to present the unit's very best features. Otherwise, the shopper may miss amenities that could sway his or her decision.

The traditional solution to this problem is the rental agent or "model guide." A guide who accompanies the shopper can provide immediate response to questions or concerns the shopper may have. Also, the quide can point out finer points that a typical shopper, concerned with overall features, may miss. For example, how many shoppers rate the quality of carpeting in each unit they visit? If the carpeting in your units is superior to that used in competitive projects, it can only be a selling point if potential tenants know about it.

The model guide should be knowledgeable about both the project and the neighborhood surrounding it. The shopper should come away from the tour not only knowing about unit and project amenities, but also locational attributes and proximity to community services.

Of course, the guide must also be sensitive to the amount of information the shopper must absorb. Trying to cram too much information about the project into the first visit can sometimes have the same effect as not saying enough.

In this survey, over 1000 apartment shoppers have rated the model guides in a number of modern, market-rate apartments. As the results indicate, most model guides leave a good impression on potential renters.

However, it is also the model guide's job to create a good impression of the unit. As part of the POP program, our analysts conduct on-site unit tours in which they rate the model guide instead of the project. In an upcoming issue, we'll present the results of these surveys. Also, we'll look at less-traditional methods of unit presentation that can increase the effectiveness of model guides.

The POP Results:

One of the real estate research services offered by Kenneth Danter & Company is the Project Opening Plan (POP)^{SM}, a 12-month study of an apartment project's rent-up process. The objective of our POP studies is to give the project's development and management team all of the necessary information required to fine-tune rents and marketing strategies during the first year. Among the analyses conducted are comparative shopping reports of the project and its competitors, an analysis of the Effective Market Area (EMA)^{SM}, an area advertising/marketing analysis, and rent-up tracking by unit type.

Another analysis conducted is an in-depth survey of all visitors who shop the project in its first 12 months. These surveys provide management with detailed shopper profiles within the EMA.

To produce **The POP Results**, we've aggregated the results of all of our POP surveys to provide the most accurate overall tenant profile available today.

We'll be bringing you more POP results in future issues of ***Apartment Resources***.

Eight Billion Dollars—The Hard Way

Last year, over 16 billion dollars were spent on new apartment housing. Although an even greater amount was spent annually from 1984 through 1986, this still represents an active, healthy market.

What is surprising about this housing investment is that fully half of it—*over 8 billion dollars*—was spent on tenants who would rather be somewhere else.

Over 50 Percent Want Single-Family Homes

As part of our real estate research, we routinely conduct both client-specific and proprietary surveys of tenant mobility. These surveys help us to understand tenant mobility patterns and to anticipate changes in apartment tenant demographics and lifestyles. During these surveys, we typically ask respondents what type of housing they expect to occupy after their next move. Usually, between 50 and 54 percent of the respondents in modern, market-rate apartments specify a single-family residence as their next form of housing.

Since the average duration of apartment unit occupation is 1.7 years, one could expect that losing over 50% of the apartment market to single-family homes every two years would wipe out the apartment industry in short order.

The Reluctant Tenant

But far from being "wiped out," the apartment industry remains vital and active each year. Reluctantly, these tenants remain in apartment housing, often opting to move to projects with newer and better amenities.

Our analyses of mobility patterns indicate that in spite of the survey responses, only 12% to 16% of tenants who move out of their apartment units actually move into single- family homes. (This ratio varies depending on the market area and project--it can be significantly higher in projects that are at the very top of the market because tenants in these projects no longer have a competitive alternative in rental housing.)

So what happens to the reluctant tenant? How does the 50+ percent of the market who intend to leave the market become the fewer than 16 percent who actually do?

The Step-Up Factor

When we analyze the market potential for a given site within a market area, one of the aspects we evaluate is "step-up" support. This support comprises those tenants within the area who will pay a certain margin of rent increase to obtain newer and/or better amenities. In the traditional interpretation, households moving through the housing continuum step up to better apartments several times, and then depart the apartment rental market for single-family housing.

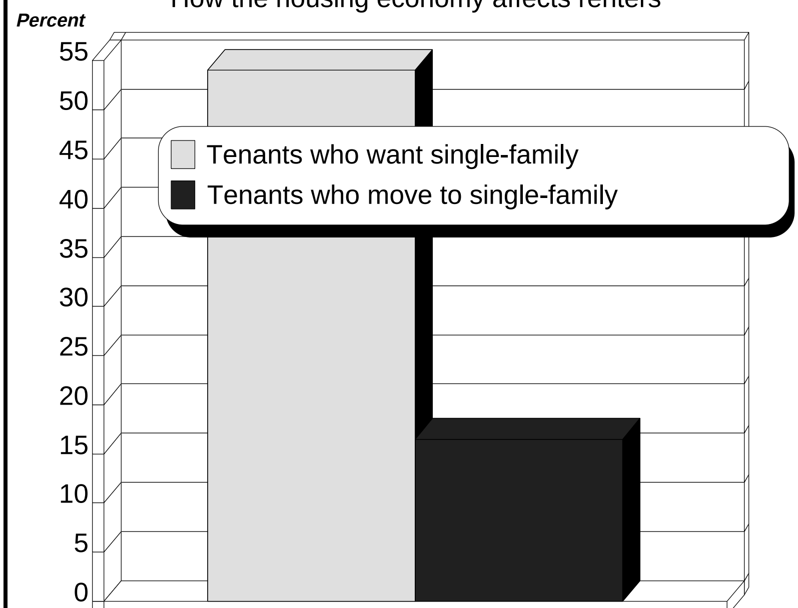
However, two things have happened in our current housing industry that have altered the traditional step-up pattern:

- ***Single-family homes have incurred large cost increases.***

- ***The quality of apartment development and design has improved greatly.***

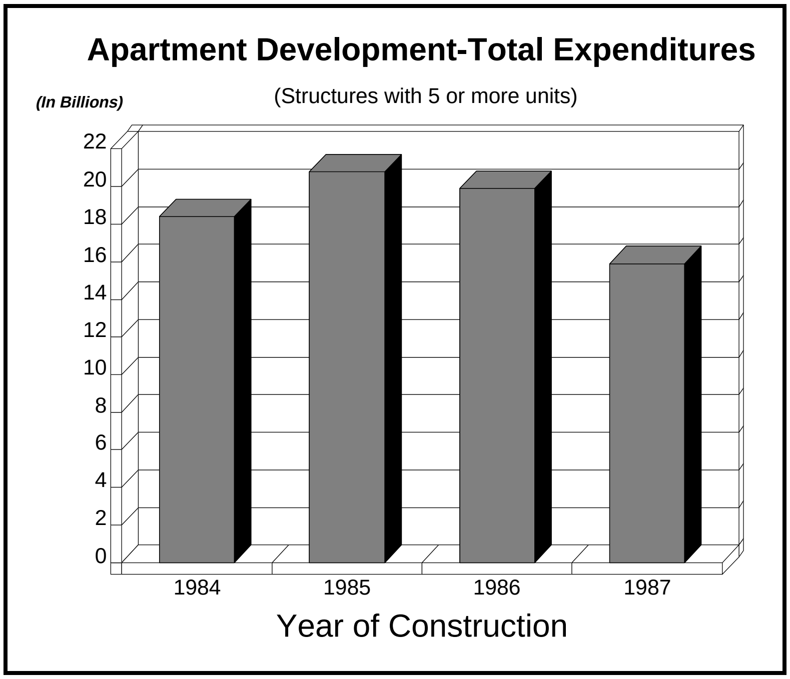
The Step-up Factor

How the housing economy affects renters



Tenant Mobility--Expectation vs. Realization

These two factors have created a bottleneck of sorts at the top end of the apartment market. Traditionally, apartment dwellers could step up into single-family homes that offered at least equivalent qualities by slightly increasing their housing payments. In other words, although some amenities available in their current apartment project would be lost, qualities available in home ownership would make a single-family residence a preferential choice for tenants in the step-up pattern.



Furthermore, tenants could even continue the step-up pattern by increasing their housing payments by a greater margin, thus acquiring single-family housing that offered superior qualities.

This is no longer true. Apartment dwellers in the high rent ranges are offered a broad range of service and physical amenities (from housekeeping services to health-club memberships) and a quality of construction and design that makes lateral (or modest step-up) moves to home ownership difficult. In fact, tenants in premium developments often find that equivalently priced single-family housing is a step down in perceived quality of housing.

To make matters worse, the increase in housing payments required to attain single-family housing of better or equivalent value is often too great to consider.

Home, Sweet Unit

Multifamily developers and managers must recognize that this year they'll be spending literally billions of dollars on an unwanted product. Fewer than half of the tenants in the average project will be content with an apartment lifestyle, while the remainder will be anticipating the move to a single-family home.

Although most of these tenants will find that anticipation unfulfilled, it does not mean that they will cease to improve their quality of housing. In fact, it is this population segment that will quite likely continue to drive the upscale market. If this market cannot step up into single-family housing, it will probably continue to seek newer and better apartment housing.

What the apartment industry needs to remember, however, is that "newer and better" to this market means "like a single-family home." In the past, many of the perks that attracted tenants included physical amenities, such as microwave ovens and saunas, and intangible attributes, such as a singles lifestyle or household services for busy young professionals.

Courting the Reluctant Tenant

Many of those perks will remain attractive in coming markets, but as acquiring single-family housing becomes more difficult for tenants, other project attributes will become excellent selling points. The "buzz-words" you should be considering to appeal to this market include *privacy*, *quality of construction*, *security*, *personal space* (as opposed to common space), *independence*, and *neighborhood.* Tenants who have traditionally turned to single-family housing to attain these attributes will increasingly tend to seek them out in apartment housing.

Further, when considering unit amenities, keep in mind that you are competing with single-family projects as well as other apartment projects. Amenities such as garages, private entrances, and secluded or scenic patios can help make your project a pleasant alternative to a single-family residence. Finally, project designs that give each unit the appearance of a private space or lot are preferred.

As home prices continue to rise, you can expect to see increasing numbers of reluctant tenants in your projects. Preparing for them now may be your best chance for continued success in the apartment market, since, for a number of reasons, the reluctant tenant market may become your most important one. Last year, there were about 8 billion reasons. This year, there may be more.

Construction Up With Steady Absorption

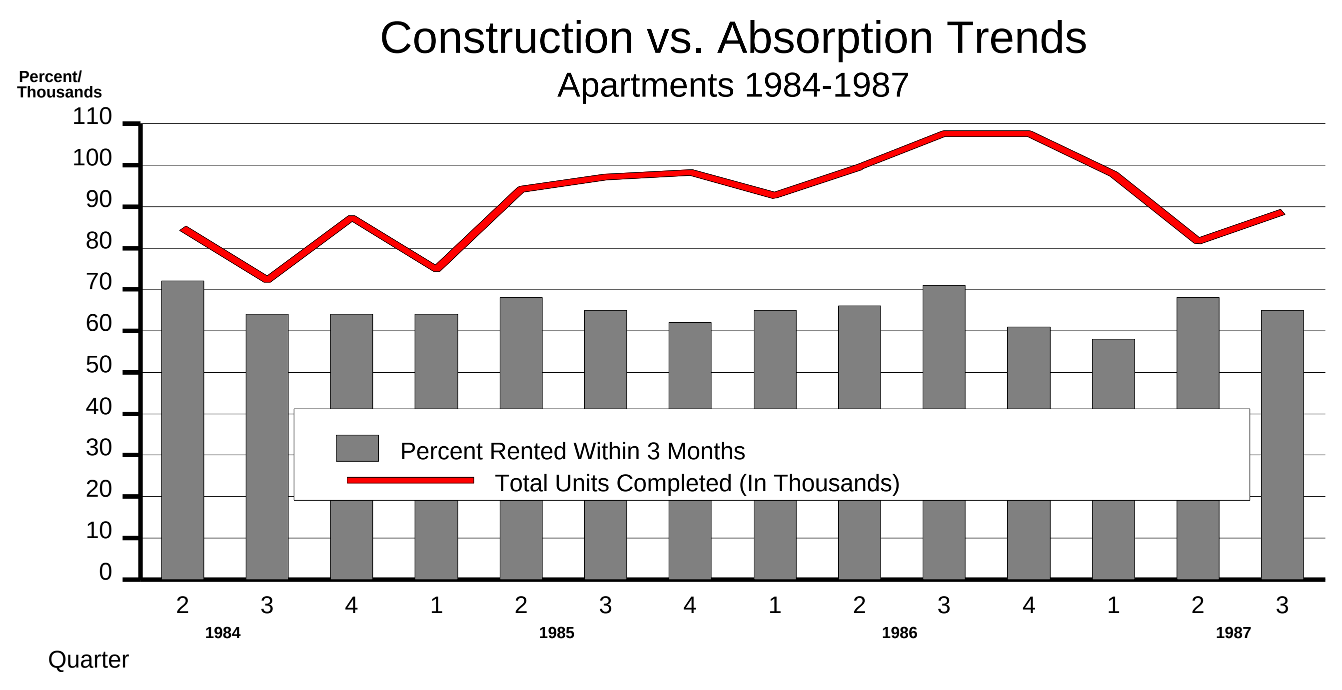
This month's **Apartment Absorption Update** covers the latest absortion trends among non-subsidized, privately financed apartments.

- Construction rates turned upward in third quarter 1987, causing a slight decrease in the three-month absorption rate. The third quarter 1987 national construction rates for apartment units rose from 81,600 in the previous quarter to 88,700. Although third quarter construction was one of the lowest in three years, this may indicate a trend toward stabilization in the market.
- Although absorption decreased slightly from the previous quarter, it remained the second highest in the past 4 quarters.
- Median rents rebounded from $496 in second quarter 1987 to $520 in the third quarter. Higher priced apartments ($550 or more) accounted for 44% of all new construction. This is an increase from the previous quarter, in which higher priced apartments accounted for 38% of all new construction.
- Forty-six percent of the units built were one bedroom and 50% were two bedroom. Four percent of the units built were three bedroom or more. In the previous quarter, only 39% of the units built were one-bedroom, indicating a shift in emphasis away from two-bedroom construction. This also indicates an increase in construction of units larger than two-bedroom.
- Forty-four percent of the units completed during the second quarter of 1987 were renting for $550 or more. Of those units, 66% were rented within three months of completion. Only 26% of the units completed were renting for $450 to $549, and 70% of these units were rented within 3 months of completion.

Comparison of Construction to Absorption Trends

This graph compares levels of apartment construction to absorption trends from the second quarter of 1984 through the third quarter of 1987. The bar graph indicates the percentage of units rented within three months of completion since 1984. The line graph indicates (in thousands) the number of new units constructed each quarter.

Not surprisingly, as the construction rate has declined from its peak in the middle of 1986, absorption rates have begun to return to previously established absorption rates.



And They're Off!

Since only January data was available for our last month's building permit update, we omitted that column to make more room for our special *congregate care* issue. This month, with February data available, we can take a first look at how our ***What's Hot*** cities are progressing in 1988.

Caution is the byword for the top 19 cities in our ***What's Hot and What's Not*** ranking. Of these 19, 14 are experiencing decreased construction compared to last year at this time. Of the remaining 5, only New York is experiencing a significant increase, with nearly 200 more units in the planning stage this year than at the same time last year.

The following cities are experiencing the largest cutbacks in development:

Anaheim-Santa Ana, CA
Birmingham, AL
Chicago, IL
Detroit, MI
Los Angeles-Long Beach, CA
Louisville, KY-IN
Miami-Hialeah, FL
San Francisco, CA
San Jose, CA

Since deficit construction has already placed these cities high on our ***What's Hot and What's Not*** list, this cautious start for 1988 indicates that they will probably continue rank highly on our upcoming 1988 analysis.