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Scarcity Leads Small Apartment Properties to Outperform Large-Cap Properties

Small apartment properties - those with between five and 40 units - have smartly outperformed their larger-capitalization brethren.

Boxwood Means LLC, which tracks the sector closely, reported that effective rents at small-cap properties had increased by 1.7 percent during the year through September. That's driven by the relative scarcity of small-cap properties. An average of only 12,000 to 13,000 small-cap units have been delivered quarterly over the past four quarters, according to the Stamford, Conn., company, which relies on CoStar data for its analysis.

That dearth of supply is expected to continue as only 12,000 units are in the construction pipeline. That compares with the five-year quarterly average of 18,000 units.

In contrast, rents for units in class-A properties were unchanged during the 12 months through June, according to analysis by Berkadia. Class-A properties typically are large, meaning they have more than 100 units, and are managed by large regional or national companies. Small-cap properties, because of their size, often are owned and managed by local investors and operators.

Class-B and -C properties, meanwhile, had outperformed both small and class-A properties. Rents in those properties had increased by 2 percent and 5 percent, respectively. Scarcity plays a role as developers don't build class-B or -C properties. Inventory generally only increases as class-A prices age out of their classification.

Given the relative lack of construction of small-cap properties, the vacancy rate for the subsector was only 4.7 percent in the third quarter.

Contrast that to the large-cap sector, where the vacancy rate had jumped to 7.8 percent in the third quarter from 6.5 percent a year ago. That increase was driven by a near-glut of unit deliveries amid weakening demand. Cushman & Wakefield, meanwhile, expects the vacancy rate to increase further as the market gets hammered with new supply.

CBRE expects 440,000 units will be delivered next year. This year, nearly 490,000 units are projected to be brought online. Meanwhile, a total of 900,000 units are under construction. In 2022, 378,000 units were delivered, and in 2021, 439,000 units were delivered. To put those numbers into perspective, an average of 243,000 units have been delivered annually since 1973.

"Scarcity props up the smaller domain," explained Randy Fuchs, co-founder and chief executive of Boxwood Means.

That relative scarcity also has helped pricing. Small-cap property prices have increased by 2.7 percent during the year through September, whereas overall apartment prices, as gauged by the MSCI Real Assets Commercial Property Price Index, were down 8.73 percent during the same period.

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