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REGIONAL OUTLOOK

## Lonestar Limbo

**Apartment owners and investors in the Dallas/Fort Worth metro will have to muddle through to mid-2011 before fundamentals start to brighten.**

By: [Steve Fithian](#)



Like all things in Texas, Dallas thinks big, and the Dallas/Forth Worth (DFW) multifamily market is no exception.

In 2010, more jobs and more people will keep the future of this apartment sector looking bright. Population growth has historically been positive in the metro: Between 2004 and 2007, the Real Estate Center at Texas A&M University reports that the DFW area grew a whopping 8.1 percent, from 5.75 million to 6.22 million residents.

Still, after some decline in fundamentals, most experts believe that DFW metrics will stabilize in 2010. “Our expectation is that we will see about 40,000 jobs in Dallas/Fort Worth in 2010, allowing absorption to return to a significantly positive level, after a few net move-outs were suffered during 2009,” says Greg Willett, vice

president of Dallas-based M/PF Research.

Unfortunately, it may be 2011 before population growth and job creation push existing construction projects and nagging distressed assets through the system. Only then will apartment owners, investors, and developers be able to reap the benefits of their bright horizon.

## Metrics Meltdown

Rental and development fundamentals have seen a recent slip. Population growth in the mid-2000s helped rental rates increase, topping out at 4 percent year-over-year improvement in 2007. Following suit with the rest of the United States, however, DFW rents started to slide in 2008—a slight net of 0.3 percent for the year that continued into 2009. M/PF Research reports that rental declines reached 3.5 percent over the past 12 months. Currently, average quoted rents are \$772 per month in Dallas, \$686 per month in Fort Worth, and \$749 per month for the entire DFW market.

Although the Dallas area has outperformed most of the nation in job growth, demand has not kept up with supply when it comes to the construction of new units. It has been two years since the region has seen positive absorption, with year-end occupancy in 2007 hitting 94.1 percent (7,155 completions and the absorption of 1,095 units, creating an increase of 1.3 percent over 2006).

In 2008, there were 12,148 completions but a negative absorption of 5,580 units, leaving year-end occupancy at a respectable 91.4 percent, but none-the-less reflecting a decrease of 2.7 percent from 2007. Through November 2009, an additional 18,961 units were completed, creating a 3.5 increase in an overall inventory that now totals 534,418 units. This brings us to 2009 and its year-end occupancy that Willett has set at 88.8 percent, down 2.8 points on an annual basis.

“The market’s key challenge will be dealing with still-significant completions,” Willett says. “Whereas new construction has nearly wrapped up almost everywhere else across the country, there are about 12,000 units [still waiting] to be delivered in Dallas/Fort Worth during calendar 2010 and on into first quarter 2011.”

The M/PF forecast “calls for demand to be strong enough to allow occupancy to hold basically stable. But further rent cuts seem likely to be necessary to make that happen ... we’re calling for effective rents to fall between 3 [percent] and 4 percent during 2010,” Willett adds.

## Eyeing Investments

While the DFW metro thinks big, it has not been immune to the country’s overall decline in transaction volume. The peak in apartment sales in the DFW metro occurred in 2006, with a volume of \$4 billion. Volume remained healthy in 2007 at \$3.6 billion but was hit hard in 2008, falling 49 percent to \$1.8 billion. By third-quarter 2009, year-to-date volume had careened to an anemic \$651 million. Unless there are significant closings in the fourth quarter, 2009 year-end volume is projected at \$868 million.

In terms of returns, in 2005, DFW cap rates bottomed out at 6.6 percent. As transaction volume has decreased, cap rates have steadily increased, reaching a high of 8.1 percent in 2008. And although the volume of sales is still very low, it appears that average cap rates in 2009 have actually declined—down to 7.2 percent at the end of third-quarter 2009, according to Real Capital Analytics. Based on a typical market cycle, this decrease in cap rates should indicate that values are making a comeback.

## Fast Facts:

### Dallas/Fort Worth

**Population:** 6.6 million

**Median Age:** 32.8

**Median Income:** \$59,769

**Average Rent:** \$749

**Occupancy Level:** 88.8%

**Unemployment:** 8.2%

**Notable:** The Dallas/Fort Worth metro has one of the highest concentrations of corporate headquarters in the United States, with a particularly-high emphasis in IT. The metro's Silicon Prairie hosts companies such as Texas Instruments, HP, Perot Systems, i2, AT&T, and Verizon. The metro also knows how to have fun: Dallas has the largest urban arts district in the nation, and Cowboy Stadium, home to the NFL's Dallas Cowboys, features the world's largest domed stadium and largest HD video screen, which hangs from the 20-yard line to the 20-yard line.

**Sources:** Texas A&M University, M/PF Research, Texas State Demographer

It is also important to note that the spread between the average Dallas cap rate and the average national cap rate of 6.9 percent during the third quarter stood at just 0.3 percentage points. Considering that this spread normally ranges from 0.9 percentage points to as much as 1.6 percentage points, a spread of just 0.3 percentage points is historically very low. This cap rate decline has been pinned on DFW's significant number of distressed sales, with multifamily properties purchased more on a "per-square-foot" or "per-unit" basis as opposed to a "cap rate" purchase. The buyers of these properties are anticipating significant upside as they improve operating results.

However, a larger chasm exists in pricing expectations. Institutions and private investors are flush with investment capital, but they are still waiting to see "blood in the street." While there have been significant sales of distressed assets in '08 and '09, it has not been at the level that most investors anticipated for the market. There are some who expect a major change in 2010, with lenders foreclosing at a higher level and prices decreasing to a point that satisfies the vulture funds waiting on the sidelines.

In analyzing reports from DFW's Foreclosure Listing Service, 62 apartment properties in the DFW market went into foreclosure in 2009, with a total assessed valuation of \$257 million. But in a declining market, this valuation did not equate to market value. Lenders bid a combined \$191 million at foreclosure sales, representing 74 percent of the assessed valuation. Even though vulture funds had ample investment funds to commit to these opportunities, they evidently did not see sufficient promise in said foreclosures. Only four were purchased on the courthouse steps, leaving 58 to revert to lender ownership.

One example of this trend of lenders acquiring foreclosed properties occurred in January 2009 when LaSalle

Bank foreclosed on the 160-unit Regal Brook Apartments in the White Rock Lake submarket of Dallas. The property was built in 1978, is located on 6.2 acres, and has 146,142 square feet of improvements. Unfortunately, it is located in a submarket that has seen its share of foreclosures. Area occupancy is at 83 percent and, in the past 24 months alone, rents have declined 6.78 percent. In April 2006, LaSalle financed \$4 million for Regal Brook, when the property sold for \$5.3 million. At the time, the assessed valuation on the tax roll was \$5 million. LaSalle submitted the only bid (totaling \$3 million) at the foreclosure sale, then subsequently sold the property to Wind Properties RB in March 2009 for \$3.3 million, or \$20,625 per unit. The new owner renamed the property Castle Rock and is working on renovations valued at \$900,000. For 2009, Castle Rock is assessed on the tax roll at \$3.3 million.

George Roddy Sr. of Roddy Information Services and longtime publisher of DFW's Foreclosure Listing Service expects foreclosure postings in 2010 to increase. "What started as postings of C and D product has changed over the past two-and-a-half years, and evolved to B and sometimes A product," Roddy says. "The softness in the housing market will provide additional demand for apartments as homeowners continue to lose homes due to foreclosure and as people downsize and double-up."

### **Planning for the Future**

With the current DFW unemployment rate at 8.2 percent, the expectation of positive job creation and projections of a steadily increasing population, the future for the metro looks guardedly optimistic. But to get to that horizon, the industry will have to wade through 2010.

Developers face competition from plentiful new construction in the face of weak demand, and likely have months of soft occupancy and declining rents ahead. But assuming builders refrain from new project commitments, the Dallas multifamily development market should stabilize by mid-2011.

Investors will look for buying opportunities as the foreclosure trend continues, though they should not expect deep discounts. To avoid a deep recession in commercial values, the FDIC appears to be propping up banks and adopting a policy of "extend and pretend" for commercial notes that are maturing in the near future.

While owners of quality assets might be able to worry less about their position in the fundamentals pecking order—since the majority of foreclosures represent non-institutional-grade product—there are two issues that could continue to stall the investment market for more traditional, non-institutional-grade properties. These are competition from lenders reselling REO properties and buyers who expect a larger discount than most owners are willing to give.

If they are able to do so, owners are best advised to hold off until 2011. That's when the market in Dallas should be fully recovered and, once again, thinking big.

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