Multifamily Executive

Buy, Improve, Repeat: Value-Add Activity Reaches a Fever Pitch

Rising prices and falling cap rates are driving investors to far-flung markets for the next hot deal.

By Joe Bousquin

*Courtesy CARROLL*In 2021, CARROLL acquired the 282-unit 935M by ARIUM in Atlanta's West Midtown area.

Call it the HGTV effect on the multifamily market.

Late last year, San Antonio-based Lynd Living flipped an apartment building in just eight months for $15.5 million more than it paid.

After spending $4 million on renovations and upgrades at Aqua Villa, a 280-unit garden-style community in Margate, Florida, that it acquired in March 2021 for $51 million, the firm saw rents increase more than 20%.

That's when CEO David Lynd knew it was time to sell.

"We achieved our projected five-year net proceeds for investors and partners after just eight months," Lynd said. "We always keep our investors' goals in mind for every deal."

Atlanta-based CARROLL, which acquired 34 properties with a total purchase price of $3.35 billion in 2021 while successfully exiting 32 more to the tune of $2.4 billion, was the buyer.

CARROLL immediately renamed the community as ARIUM Coconut Creek to align it with its national portfolio brand and plans to keep enhancing the asset with even more interior and common area upgrades going forward.

The deal stands out as a searing example of the swift profits—and ongoing opportunities—available in multifamily's white-hot value-add market, where operators scoop up properties with the intent to better them, increase the rents, and then sell them.

But Lynd and CARROLL are hardly alone on this buy, improve, cash-in carousel.

A New Deal Every Week

Just look at Irvine, California-based SB Real Estate Partners (SBREP), which in January announced the sale of a two-property, 365-unit portfolio in Phoenix, just five quarters after acquiring it, for $96.4 million. That was $41.1 million over the price it paid in late 2020.

"While we continue to remain bullish as active buyers in the Phoenix multifamily market, we were also willing to adapt to the capital markets and round out a shorter-term business plan in order to deliver tremendous results to our investors," said Srijin Bandyopadhyay, founder and managing principal of SBREP, which has acquired more than 3,000 units since 2019.

Other examples abound, with the next faster, higher-returning deal seemingly emerging every week.

"On a scale of 100, the demand for purchasing value-add properties is as close to 100 as I've seen in my career," says Matt Jones, managing director at Norfolk, Virginia-based Harbor Group International, which operates 59,000 units and is currently making value-add

renovations to approximately 100 properties in its portfolio. “As a result, we are seeing unprecedented low cap rates.”

Indeed, according to Dallas-based real estate services firm CBRE, just three infill markets—Philadelphia, Oklahoma City, and Portland, Oregon—saw cap rates, which move in the opposite direction of asset sale prices, rise in the first half of 2021. Meanwhile, there was no cap rate increase in any suburban market nationwide.

“Tremendous investor demand, coupled with strong apartment fundamentals, is driving aggressive deal volume and rising prices in almost every market in the country,” says Matt Masinter, executive vice president of acquisition at Chicago-based Waterton, which counts 26,649 units in its portfolio. “The expectation is that the market will remain strong and pricing will continue to rise in 2022.”

*Courtesy Waterton*The Shoreham at Lakeshore East (pictured) and The Tides at Lakeshore East comprise 1,156 units in Chicago’s Lakeshore East neighborhood and were acquired by Waterton in December 2021.

Too Hot to Handle?

While Masinter is hardly alone in that bullish outlook on multifamily’s value-add activity, there are those who also point to signs of overheating.

At Austin, Texas-based real estate investment firm Palladius Capital Management, CEO Nitin Chexal notes a distinct change in the nature of investors seeking returns in tertiary markets.

"We see new entrants exercising a stock market momentum mentality just to get exposure to markets like Austin or Nashville, Tennessee," Chexal says. "They will pay any price and underwrite irrational rent growth to justify it."

In some markets, the value-add craze—and competition to snap up the best properties—already seems to be cannibalizing itself.

Take South Florida, where an influx of population during the pandemic has been ramping up the need for all types of housing.

"I'm seeing so much demand for value-add that there's not enough product out there to create a 'real' value-add anymore," says Matthew Jacocks, principal at Miami-based commercial real estate brokerage Lee & Associates South Florida. "The lack of current supply means the upside isn't what it used to be. There's just not enough supply of product that you can upgrade and raise rents at."

That dynamic, and a winnowing supply of good candidate buildings in many markets, means that some properties are being bought and sold multiple times, with each new buyer adding their own incremental improvements. Once they do, they're still sure to have multiple options for exiting it again.

"Now is a great time to sell because cap rates are low, and there is a lot of equity and debt capital," says Jones at HGI. "There's great liquidity in the market, and, when there's great liquidity, it's never a bad idea to sell."

The pace of activity in the space, of course, could be reason for pause, and some outlooks see prices moderating in 2022, at least partially in light of expected interest rate increases later this year.

"We think everything is priced extremely high," says HGI's Jones.

Seller's Remorse?

Then again, demand has been so strong, sellers who made tidy profits on quick flips last year are already questioning whether a holding strategy could have been even more lucrative.

"People who sold six months ago probably felt they were selling at the top of the market, only to watch valuations continue to increase substantially," says Casey Barber, senior vice president of investments for CARROLL. "Just about any deal that sold six months ago would sell for more today."

Observers say the frenzied pace of the value-add market is the result of a confluence of events. Out-migration from large cities during the pandemic is one, which subsequently drove housing demand in secondary, tertiary, and even farther afield markets.

The Robinhoods of Multifamily?

The flood of cash looking to invest in the space—both institutional and retail—is another.

For example, Lynd's original acquisition of Aqua Via in South Florida only happened when the firm turned to crowdsourced funding after its original institutional equity partner pulled out at the start of the pandemic.

Now, with echoes of how consumer-focused investment platforms like Robinhood have helped retail investors move markets that used to be the sole purview of institutions—the short squeeze and ramping up of GameStop's stock in early 2021 is the most salient example—observers say the continued emergence of crowdsourced funding in multifamily over the past decade is now apparent in the market, if to a more subtle degree.

"Crowdfunding sites and registered investment advisors are becoming increasingly sophisticated and garnering meaningful success investing directly with operators," says Chexal at Palladius Capital, who notes that retail investors often have lower return thresholds and require less hand-holding. "There are hundreds of billions of dollars in pent-up demand from retail investors sitting on the sidelines that want single-asset exposure."

The high level of demand has also fueled competition for the best value-add candidates—those increasingly rare shaggy dogs in Class A, B, or even C locales that can be groomed into show hounds with some exterior and common area upgrades, and a few enhancements in the units themselves, before being sold on.

"Much of the low-hanging fruit has been picked over," says John Sebree, senior vice president and national director of commercial brokerage Marcus & Millichap's multifamily housing division.

*Courtesy Castle Lanterra Properties*Castle Lanterra Properties acquired Overlook at Stonemill, a 216-unit garden-style community in Lynchburg, Virginia, in 2019.

A Two-Flight Investing Approach

That competition has led to a “second city” effect for some multifamily pros. Namely, as competition for assets surges nearly everywhere across the country, more acquisition vice presidents are finding themselves on two-flight connecting routes to find the next up-and-coming areas.

Just listen to the strategy Elie Rieder, CEO of Suffern, New York-based Castle Lanterra Properties, which operates 6,660 units, has adopted today.

“I am a believer in pursuing assets in geographical locations that exhibit long-term stability, growth, job creation, coordinated efforts between local education and governments to retain talent upon graduation, and have favorable tax and business environments, but are also two flights away from gateway cities,” Rieder says. “You may be able to limit your competition from institutional players if it’s not as easy for them to travel to.”

He also likes to time his shopping trips on a contrarian schedule to the seasons. “Pursue assets in colder states in the winter and hotter states in the summer,” Rieder advises.

Looking Within

Coupled with COVID-induced geographic migrations for many renters, that means the traditional metrics for finding prime value-add locales, which had focused on high barrier-to-entry markets along the coasts for most of this century, have swiftly pivoted toward the inward.

“It’s important for buyers to look in new locations. We’ve seen competitive groups enter new markets, especially in the Midwest,” says Christine Espenshade, vice chairman, multifamily capital markets, at New York-based commercial real estate firm Newmark. “Value-add players should also consider office or hotel conversions to multifamily for yield.”

Value-add has even started to emerge in build-first-oriented areas. Just look at Phoenix, where John Kobierowski, co-founder of real estate crowdfunding company Neighborhood Ventures, says value-add is now the dominant force in the market.

“Value-add used to not be so common here, people would just build new,” Kobierowski says. “Now, we’re moving from properties that need their first wave of renovations to those that are candidates for a second or third round.”

Keeping Investors Happy

With many value-add deals purchased at compressed cap rates, observers note that keeping investors in the loop on exactly what you’re doing, and how you’re doing it, is critical to a mutually beneficial outcome, especially given the continued challenges of COVID-19 and supply chain snarls today. For experienced operators, that dictates an underpromise, overdeliver approach.

“The risk right now is the labor shortage and construction costs. COVID is delaying getting materials into the market and causing delays and cost overruns,” says Jacocks. “We’re sometimes putting 10% contingencies in pro formas because of these unknowns. If you account for that properly, everyone will understand that this is the world we live in.”

Indeed, Kobierowski has even put his own investor relations team in place to keep his crowd funders up to date on project progress.

“They answer questions from investors all day long over the phone or online,” Kobierowski says. “People need to understand what the plan is, what you’re doing to execute it, and that you’re doing what you say you will do. You can’t assume investors are happy because they’re not calling you. You need to stay involved and be proactive.”

Complete (Apartment) Home Makeover

While market dynamics, investment timelines, and geographical parameters for a successful multifamily value-add strategy have evolved, operators note that the basics of property enhancement once you find your asset—if you can—have largely remained the same.

“Dramatically improving curb appeal goes a long way toward making a rent raise palatable for existing tenants and new move-ins alike,” says Shawn Wolfswinkel, co-owner with wife Joni of Houston-based Real Property Management Preferred, a manager of approximately 600 units.

If those exterior improvements can also help update operational efficiency of the property, so much the better.

“Transformative measures that boost curb appeal and also bring operational benefits such as enhanced energy efficiency and building performance—for instance new windows, exterior coatings, or façade recladding, as well as upgrades to plumbing, lighting fixtures, and other appliances within individual units and common areas—can help improve rent rolls, too,” says architect Gary Kane, principal at The Architectural Team, based in Chelsea, Massachusetts.

In Phoenix, Kobierowski targets buildings that still have a few items left on their beautification punch lists. “A building that was renovated fairly recently but didn’t get washers and dryers, new windows, balconies, and patios would be a great candidate,” he says.

Indeed, the National Multifamily Housing Council and Grace Hill 2022 Renter Preferences Survey Report ranks washers and dryers in the unit as the top dollar-adding amenity renters want, tied with air conditioning. Other high-ranking upgrades include high-speed internet access, dishwashers, and soundproof walls.

While improving common areas is also a tried-and-true value-add tactic, there have also been subtle revisions to that approach since the pandemic.

At CARROLL, vice president of marketing and communications Noah Echols, says the firm has a keen eye toward amenities that cater to individual uses, rather than large social gathering spaces.

“Due to the ongoing pandemic, the traditional way to approach value-add projects needs to be handled more thoughtfully,” Echols says. “We’re investing in fiber-speed internet, smart home technology, health and wellness programs, and resident services like dog walking, dry cleaning, and housekeeping.”

*Courtesy CARROLL*Ariza Forest View, a 283-unit community in Santa Rosa Beach, Florida, has been rebranded as ARIUM Santa Rosa Beach.

Rebranding First, Renovating Second

Finally, to successfully reposition and make ready a value-add property to either boost internal rent rolls or attract its next owner, operators say the time to start branding a community’s new features is before the ink has time to dry on the sale documents.

“It is important to rebrand at the beginning of a value-add program so that you tell the story through the process, rather than rebranding at the end in a grand unveiling,” Echols says. “Word of mouth is arguably the most important marketing channel for any multifamily

community, but it takes a lot of time to build the right reputation. Start early, tell a compelling story, and bring residents and the wider community along the journey with you."

Despite the stiff competition for properties in all markets, seasoned vets say value-add's simple philosophy of finding an underperforming asset and making it better are inherently fused to the fundamentals of multifamily, and will continue to be.

"No matter the condition of the overall apartment market, there will always be undermanaged and undercapitalized properties to acquire," says Waterton's Masinter. "We look to avoid the herd and leverage our relationships to find interesting opportunities and situations that result in discounted pricing to recent sales and replacement cost."