

Landlords face oversupply fallout

Lenders and investors have pulled back from multifamily projects in metro area

BY ALDO SVALDI

ASVALDI@DENVERPOST.COM

Metro Denver's apartment market, after years of robust construction, has swung solidly in favor of renters, and that is putting developers and building owners, and the lenders who fund them under increasing pressure.

Median apartment rents over the past year through August are down more than 5% in Denver, 7% in Thornton, about 8% in Aurora and Northglenn and nearly 9% in Glendale, according to the apartment search engine Apartment List.

Denver has the sixth weakest market for apartment rent appreciation among major U.S. cities and has a vacancy rate that was approaching 9% in August, which is well above the 5% to 6% vacancy rate range considered a balanced market, according to Apartment List.

"I would say my sort of one-sentence summary of Denver multifamily is that it's just difficult. No one wants to do anything right now," said Aimee Love, a principal with Essex Financial Group, a boutique commercial debt placement firm based in Denver, who spoke on a panel at IMN's Mountain States Middle-Market Multifamily conference in Denver last week.

Love said she has around a half dozen construction loan requests sitting on her desk, some ready to go for the past two years. But the projects can't find willing backers. Lenders who are still active often will lend only around half of a project's value, requiring developers to put in a large amount of equity.

The projects remain stuck on the drawing board, unable to move forward. Right now, that could be a saving grace in that the market has more supply than it can handle.

In the years since the pandemic, apartment construction in metro Denver has greatly outstripped the region's historical average of about 10,000 units a year, with about 23,000 apartments added in 2023 and 20,000 last year, according to the Apartment Association of Metro Denver.

While not as bad as the office market, which is struggling with an 11.7% delinquency rate nationally, borrowers in multifamily are finding it harder to stay current on their payments. Delinquencies on multifamily mortgage-backed securities surged 71 basis points in August to reach 6.86%, a 9-year high, according to Trepp, a data analytics firm.

About \$769 billion in multifamily debt is coming due between 2025 and 2027 and it will need to be refinanced in a market that has a greatly diminished appetite, according to a report from Newmark.

"You can't get a loan that works on construction. You can't (refinance) out of an existing deal," said J.C. Clemens Jr., chief production officer with Flagship Capital Partners in Houston, a firm known for being willing to invest when others won't.

Developers typically take out a short-term or bridge loan during construction, which they roll over into a longer-term mortgage at a much lower interest rate once a building is complete and takes on tenants. More and more of them are having to do what are called bridge-to-bridge loans, which used to carry a stigma, but have now become a necessity.

Capital providers will fund the short-term loans, which carry interest rates of 8% to 12%, but they represent a patch rather than a viable long-term solution. And they add to the overall costs.

Financing is even more difficult when it comes to purchasing older buildings and refurbishing them. Unable to compete with all the shiny new luxury developments, older urban buildings in places like Capitol Hill are struggling with higher vacancy rates and have become untouchable to traditional lenders.

"I would say it's a story of the haves and the have-nots. The extremely well-located newer vintage assets are receiving a lot of interest, but the not-so-well-located older vintage assets, there's almost no activity," said Craig Kalman, investment director with RedPeak, a Denver-based owner of 3,000 apartments spread across 52 buildings in the metro area.

That's a problem for RedPeak, which historically has targeted older buildings in central Denver. Rents on its new leases are down about 5% on average, Kalman said. The firm has shifted more of its purchasing focus to newer apartment buildings in the western suburbs, where operating costs are lower and less investment is needed in upkeep.

"I do think in the next year, maybe, maybe nine to 18 months, there could be a generational buying opportunity in central Denver," he said. But for now, RedPeak is looking elsewhere.

Clemens said his company focuses on deals in the \$10 million to \$60 million range, which in more normal times should be easy to find in the Mountain states. But lenders have stopped playing ball, and sellers aren't willing to acknowledge their predicament.

"It is a difficult story," Clemens said. "Sellers' expectations are not quite meeting buyers' desires."

Oversupplied multifamily markets like Denver might be at an impasse, but that could change next year as values drop low enough to draw in investment dollars.

High home prices and high mortgage rates continue to price many potential homebuyers out of the market, leaving them as renters. That provides a solid base of support to the market. That's different than in the office arena, where demand vanished when companies shifted to remote work arrangements.

Far fewer multifamily permits are getting pulled, which, over time, should bring the market back into balance, provided demand holds up, which it should barring a recession or outmigration.

Through the first half of the year, \$65.1 billion worth of apartments changed hands, up about 5.3% from the same period last year, but less than half the volume of \$150 billion in transactions that occurred in the first half of 2022, according to Trepp.]

Right now, owners of multifamily properties are increasingly focused on trying to get their operating costs down, although that has been hard to do given a surge in insurance premiums, property taxes and wages. Note

"It is an operationally-focused mindset right now," said Doug Elenowitz, a co-founder and principal at Trailbreak Partners in Denver.

Some of the ways property managers on another panel said they were trying to cut costs are by installing leak detection systems to catch damage early, bringing janitorial services in-house rather than relying on third-party vendors, and working with insurers on risk reduction strategies to reduce premium increases.]

Tenant attraction strategies are also part of the mix, and small things can give a development an advantage over its rivals. Some offerings include having a cafe on site with branded coffee or focusing on wellness amenities that go beyond offering an exercise room, such as fitness classes and rotating massage therapists.

Savvy tenants know that the market is in their favor, Elenowitz said, and they have become adept at playing landlords off each other when it comes to the concessions game.

Given the long lag between planning a project and opening one, Elenowitz said Trailbreak is trying to get ahead of what it expects will be shortages and rising rents once the market works through the excess supply. It is hoping to land its new units in 2027 and 2028 — just in time for an undersupplied market to gobble them up.

"We are developing right now," he said. "We're very bullish on it from a timing standpoint."

Clemens said his firm is buying older and well-located properties or buying brand new, higher-end buildings from developers who are being forced to get out for below replacement costs. Clemens expects sales activity to pick up in the remainder of the year and predicts that 2026 to be an active one for deals as more distressed assets come up for sale.