

Starwood Bets \$5.4 Billion That Apartment Rents Will Keep Rising

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Barry Sternlicht, chief executive officer of Starwood Capital Group LLC. Photographer: Patrick T. Fallon/Bloomberg

- ▶ Sternlicht says company is seeking 'fairly steady growth'
- ▶ Deal gives Starwood 23,262 apartment units in five U.S. states

With its \$5.4 billion purchase from landlord Equity Residential, Starwood Capital Group is making a big bet on the future of the U.S. apartment market -- and doing so at a time when both rents and property prices have never been higher.

Starwood, led by investor Barry Sternlicht, is adding 23,262 units in 72 multifamily communities across five states, expanding its reach into a part of the real estate market in which rents set records each quarter as young Americans face hurdles buying homes.

Sternlicht is joining the legions of investors who have been seeking to own apartments since the end of the recession, driving up prices and sending returns to new lows. For apartments bought during the third quarter, the average capitalization rate -- a measure of yield that drops as prices rise -- declined to a record 5.8 percent, according to research firm Real Capital Analytics Inc. And Sternlicht says returns could fall further.

“You look at the world and there’s no inflation and there are no yields anywhere,” Sternlicht said in a telephone interview. “We’re not underwriting massive rental growth, just fairly steady growth above inflation.”

Nationally, apartment rents have been breaking records almost every quarter since 2010, according to Reis Inc., which doesn’t adjust the figures for inflation. Annual rent growth has been greater than 3 percent since 2012, the real estate research firm said. Investors have been racing to capture some of that upside, buying more than \$30 billion worth of apartment buildings in each of the past five quarters, according to Real Capital.

‘Still Room’

“To make a deal like this, you have to believe that this is going to persist,” said Ryan Severino, director of research at New York-based Reis. “You have to believe that this is a more permanent than a cyclical phenomenon. From a macro perspective, you’re betting that the game is not over yet -- that there’s still room for the market to run.”

Investor demand for apartments, which has sent property prices up, had kept billionaire investor Sam Zell’s Equity Residential on the sidelines. The largest publicly traded apartment landlord in the U.S. has refrained from selling many assets this year because it had no plans to buy other ones at elevated prices, and thus had no need for cash, Chief Executive Officer David Neithercut said Monday on a conference call to discuss the deal.

Like other publicly traded landlords, Equity Residential has seen its shares trade at a discount to the value of its real estate, and considered paring its holdings to help remedy the situation, Neithercut said. As it chose what to sell, it concluded that properties in its more-peripheral markets might decline in value should the Federal Reserve raise interest rates or Fannie Mae and Freddie Mac curb their multifamily-lending programs, he said.

Special Dividend

It was those properties -- including 55 complexes in South Florida, 18 in Denver and three in Southern California's Inland Empire -- that Equity Residential sold to Starwood at an average price of \$230,634 a unit. That's about 73 percent higher than the national average in the third quarter, according to Real Capital. The deal also includes eight properties in Seattle and 10 in Washington, D.C., where an oversupply of new apartments has forced landlords to grant tenants concessions to keep units occupied.

Rather than buy properties with proceeds from the sale, Equity Residential plans to pay a special dividend of \$9 to \$11 a share.

"It was the best capital-allocation decision we could make for our shareholders," Neithercut said.

Equity Residential said it intends to sell an additional 4,728 apartment units next year, including all of its assets in Connecticut.

"We don't think Sam's wrong," Sternlicht said of Equity Residential founder Zell. "We just think he has a different hold period."

Denver, Florida

For Sternlicht, the purchase is a bet on the strength of the Denver and South Florida rental markets, both of which appeal to millennials, he said. Florida, with its lack of personal income tax, is drawing young job-seekers, who are most likely to rent their homes, he said.

"We went into markets that are more affordable," Sternlicht said. "These are not San Francisco or New York, which are stretching the imagination on rents, they're so high."

The purchase, being made by an affiliate of Starwood Global Opportunity Fund X, is Starwood Capital Group's biggest non-hotel property acquisition, the company said. It's purchased or agreed to buy 67,800 apartment units in the past 12 months, including the properties it's buying from Equity Residential.

Last month, another Sternlicht company, Starwood Waypoint Residential Trust, which rents out single-family homes, agreed to merge with billionaire Tom Barrack's Colony American Homes to create a company with more than 30,000 housing units.

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