

PSRST STD  
U.S. Postage  
PAID  
Minneapolis, MN  
Permit No. 31515

# ILLINOIS REAL ESTATE JOURNAL

REjournals.com

VOLUME 9, NUMBER 4

©2006 Law Bulletin Publishing Co.

April 2006

## Conversion slowdown boosts apartment market



By  
Douglas Imber  
Contributing  
Writer

Chicago's apartment market has experienced a dramatic, yet seemingly unheralded transformation in the past six months.

Specifically, there has been a profound rebound in the rental market, an ebbing in condo conversion activity and a record level of transaction velocity. These forces are quickly changing the landscape and are requiring investors to reevaluate their strategies for a new apartment market.

### Record activity

To begin with, 2005 was a record year for transaction velocity in Chicago's apartment market. In the city of Chicago, there were 417 closed apartment transactions of more than \$1 million with an aggregate volume of \$1.8 billion. By comparison, in 2004, there were 386 sales with an aggregate volume of \$1.3 billion. Similarly, in 2005 the average price-per-unit jumped to \$111,346 from \$90,634 just one year earlier.

This heightened velocity is in contrast to a more typical year such as 2001 when only 171 sales occurred and the average price per unit was just \$66,585.

Obviously, this increase in velocity is correlated to an increase in values. As prices increase, so too is an owner's willingness to sell. Less obvious, however, is that since 2001, there has been an inverse correlation between net operating income (NOI) and values. NOIs declined dramatically between 2001 and 2005, yet values increased dramatically. This created further incentive for owners to sell.

Not only were prices skyrocketing, but incomes were dropping severely. While interest rates deserve much of the credit for these price increases, it was the condo converters who most exploited these low rates, increasing values and ultimately accelerating velocity.

### Conversion aversion?

Now condo converters are working on thinner margins than at any time in recent years.

First, lenders are starting to tighten their terms in response to the increasing inventory in a number of submarkets. Second, construction costs have substantially increased. Third, there is an ever-growing competition among converters competing for fewer and fewer prime conversion properties. Fourth, according to the Multiple Listing Service, marketing times have in-

creased by as much as 35 percent since last fall in most sub-markets, thereby increasing carrying costs. These forces are all cutting deeply into converters' profits.

Since mid-2001, condo converters have been outbidding apartment investors, in general, from 10 percent to 20 percent on properties that have strong conversion potential. This is in contrast to the period from 1997 through early 2001 when apartment investors frequently outbid condo converters.

It is highly unlikely that condo converters will disappear from the landscape, but a compression on developers' margins may dampen the premiums which they can pay to sellers.

Initially, this has already been noticed in marginal conversion deals. That is, properties in weaker locations or properties with below average unit layouts that in recent years have been successfully converted due to strong end user demand.

This in turn begs the question, "Will a slow down in conversion activity lead to a slow down in velocity?"

If owners cannot obtain the same premium pricing, will they be as inclined to sell?

Of course, this presumes that future premium pricing would come as it has in recent years, from converters. It may well come from apartment operators seeking to take advantage of the new apartment market.

### Rental rebound

In early 2005, many apartment owners were battling physical vacancies of 8 to 12 percent, depending on the submarket.

In addition, rental concessions, renewal concessions and bad debt expenses were adding an additional 6 percent to 10 percent in economic vacancy, depending on the submarket.

Beginning in mid-2005, however, physical occupancies began rebounding and have been steadily improving since. Most submarkets are reporting physical vacancies today of 4 to 7 percent, with virtually no remaining rental concessions. The speed of this rebound is astounding and seemingly unheralded.

In addition, there has been a noticeable improvement in the quality of rental applicants. This appears to be as a result of an improving entry-level employment market.

Beginning in 2001, qualitatively the top tranch of the rental pool became first time homebuyers. This tranch represented as much as a third of the rental market in many submarkets. Apartment operators not only had to recover from the economic impact due to vacancy loss, but also had to adjust their management and marketing strategies to account for this qualitative change. In recent months, however, it appears that the rental rebound has positively affected both the quantity and quality of income stream.

Rent increases, a term nearly forgotten in apartment circles, have sparingly reappeared in a few submarkets. If this rebound continues, owners may soon be able to pass thru rent increases to offset the rising operating expenses that have been eroding NOIs in recent years.

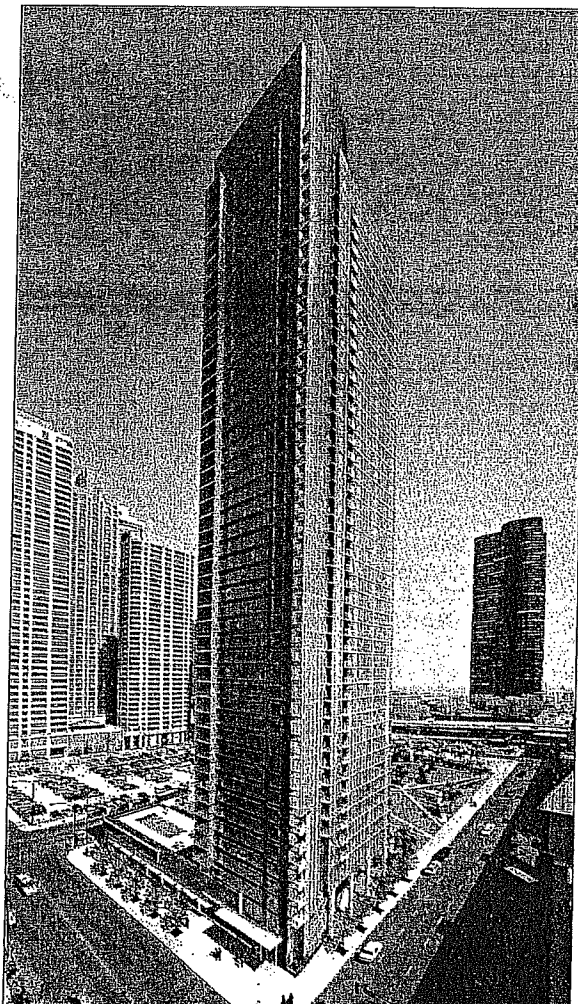
In a related vein of relief, the Cook County Board just approved a plan to reduce tax assessment levels for buildings with seven or more residential rental units from 26 percent to 24 percent starting in 2006. By 2008 the assessment level will be 20 percent.

### The new apartment market.

What does the new apartment market look like? There will be less pricing differential between condo converters and apartment investors, stabilized occupancy rates, no rent concessions, rent increases and operating expense relief.

After five years of challenging buying opportunities and disheartening NOIs, Chicago's apartment investors are on the verge of a new market.

Douglas Imber is president of Essex Realty Group Inc., a Northbrook-based real estate brokerage company specializing in the sale in Chicago area investment properties.



RENDERING SUPPLIED BY HCL COS.

In 2005, the 417 closed transactions in the Chicago apartment market surpassed the 386 sales in 2004 and greatly surpassed the 171 sales in 2001. In addition, new projects have been sprouting up. ParkView, a 47-story tower (pictured above) at the corner of McClurg Court and Illinois Street, will bring 3,000 residents to the area.