NOI and Factors that can Accelerate Growth in the Multifamily Sector

Over the long term, real estate investment performance is driven by cash flow and growth in net operating income (NOI). Through the power of NOI, owners of commercial real estate have the potential to increase a property’s value year after year.

NOI is income generated by a property after expenses. The capitalization rate (cap rate), the percent of return expected if a property was purchased for all cash (unleveraged), is a common calculation used to estimate an investor’s potential return. Divide NOI by the purchase price to get the cap rate. For example, if a property produces $800,000 dollars of NOI annually, and you paid $8 million for the property, the cap rate would be 10 percent.

Properties with potentially increasing annual revenue may be better positioned to improve NOI and market value. And according to Marcus & Millichap’s Premium Yield Index, apartments in secondary markets currently are providing the highest yields (yield is the dividend you receive per share divided by the stock’s price per share.)

Rents are Increasing

Increasing rents are a cornerstone component of NOI growth. Short-term leases allow owners of multifamily properties to regularly raise rents to align with current market conditions. As an example, asking rents for multifamily grew by 0.6 percent in the first quarter of 2015. Over the previous four quarters, asking rent growth rose 3.3 percent. For perspective, in 2014, asking rents grew by 3.5 percent, its strongest showing since the apartment sector started recovering in early 2010.

Marketwide, average effective rents jumped 12.1 percent in the 12-month span ending in the second quarter 2015 to $1,260 per month. Over the same time period last year, effective rents rose 9.6 percent.

With the multifamily vacancy rate hovering at or around 4-to-5 percent, the market is relatively tight, which allows landlords to continue to increase rent in excess of inflation. Other ways to raise revenue besides increasing the rent include application fees, pet deposits, pet rents, parking garage rental, washer and dryer fees, and more.

Net Operating Income (NOI) = Cap Rate

There has been a compression in cap rates over the past three to four years, as the value of real estate has increased. Take that same property that’s producing $800,000 of NOI, and sell it for $16 million instead of the original $8 million, and the cap rate would be 5 percent. This inverse relationship shows that as the real estate market gets stronger, cap rates decrease as property values increase.

Overall, the multifamily sector has posted the strongest long-term return performance among all commercial real estate sectors. Apartments, for example, exhibit the lowest capital requirements, which results in a higher dividend payout ratio. Apartment tenant turnover is more frequent than commercial tenants, so it is easier to re-lease apartment units than it is to re-tenant an office building or warehouse facility. In addition, multifamily’s shorter lease terms allow for more frequent increases in rent, which directly supports NOI growth over time.

Sources:
1 TIAA-CREF Asset Management, U.S. Commercial Real Estate Outlook, March 2015.
2 BlackRock Special Commentary: Long-Term Income Opportunities in U.S. Real Estate, June 2013.
3 National Real Estate Investor, May 19, 2015.
4 Apartment Research Market Report, Marcus & Millichap, Third Quarter 2015.
Active Property Management to Cut Costs

Active property management is an equally important strategy to decrease expenses and increase cash flow. Some of the areas management can rein in are repairs and maintenance, utilities, insurance, personnel, property taxes, equipment and office supplies. In addition, negotiating fees, keeping an eye on contract services, and minimizing turnover costs serve to positively impact a property’s financial return.

Every tenant that renews a lease with an increase in rent contributes to NOI growth. Property owners and managers have many strategies they can employ to increase tenant retention. Examples of amenities that may keep residents loyal and interested in renewing their lease are minor capital improvements such as upgrading appliances and lighting, adding amenities such as movie nights and free wi-fi, and even giving tenants the option to rent month-to-month, to name a few.

The continuing strength of apartment demand in 2015 creates positive NOI growth potential. This is particularly due to Millennials, the children of the baby boomers. Around 80 million strong, they remain a huge untapped reservoir of demand for apartments. Most of them are in their 20s, an age where they’re looking to establish their own households.

As a result, high quality, well-located multifamily real estate assets are expected to continue to see growth over the foreseeable future, as owners focus on maximizing value at the property level through growing revenue and decreasing expenses.

An investment in commercial real estate can provide portfolio diversification and the potential for capital appreciation. Nonlisted REITs specifically are not priced by the equity markets, which also may help improve long-term investment performance. However, nonlisted REITs are not liquid investments and are appropriate for investors with longer time horizons and who do not need liquidity over the life of the investment.

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**Year-Over-Year Multifamily Rent Growth – As of April, 2015**

Source: Yardi Matrix. Data provided by Pierce-Eislen. Matrix Monthly, April 2015

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