Location Matters: Multifamily Market and Submarket Selection

ARA Research

There are many elements that go into portfolio construction – sector selection, location selection, and asset selection. While sector selection was notable in the last cycle due to the extreme outperformance of industrial and residential properties, as we look to the next cycle, we believe a spotlight will be shined on the importance of location selection – at both a market and submarket level.

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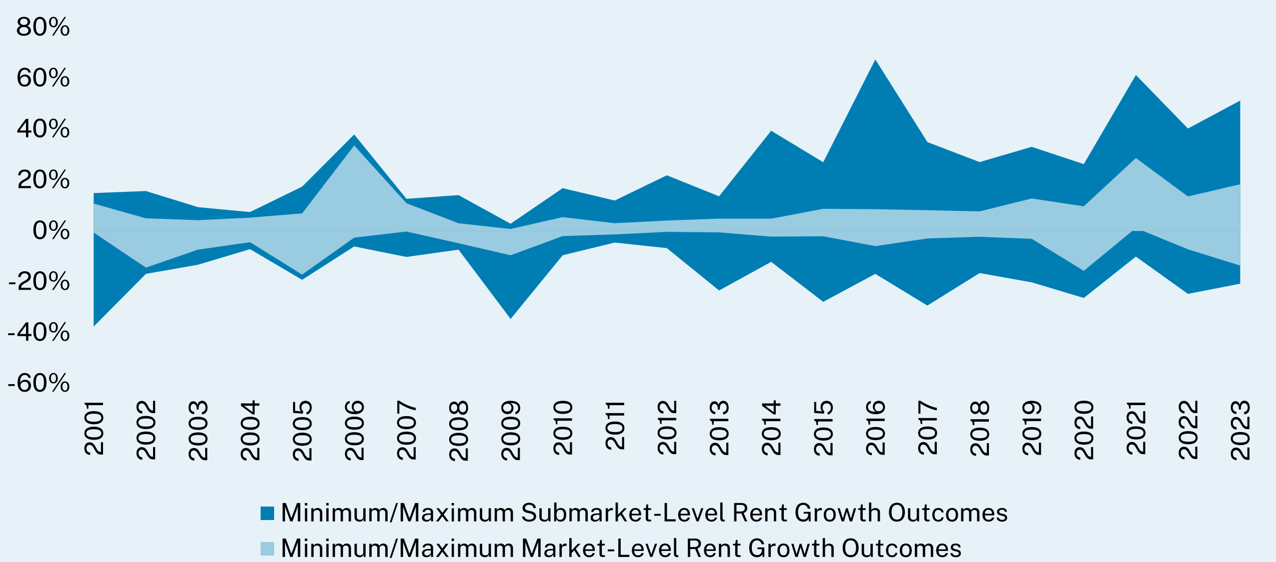
Does Market Selection Matter?

It goes without saying that some markets are winners, while others offer far less in performance when it comes to fundamental balance and rent growth. Historically, significant differences between the best- and worst-performing multifamily markets have typically occurred during periods of adjustment, such as the Global Financial Crisis, the supply surge in 2016, and the pandemic. During these times, the delta between the best- and worst- performing markets is more pronounced. Outside of these adjustment periods, rent growth in most markets tends to cluster more closely together (Figure 1), a tendency reflected in third-party forecasts for the next two years suggesting a more modest, but still meaningful, 270-basis point delta from the top to the bottom-performing markets. Though market selection still remains a key lever, as it can add a meaningful difference in outperformance, the sweet spot becomes even more pronounced when compounded with a more granular strategy, amplifying potential returns and providing a strategic edge.

FIGURE 1

Spread Between Best and Worst Apartment Rent Growth, Market vs. Submarket Level



Source: American Realty Advisors based on data from CoStar as of June 2024.

Digging Deeper: Submarket Selection

While market selection can lead to outperformance, we have found that digging deeper may offer investors even more benefits. Where markets trend closely, submarkets offer more variability and higher potential rent growth relative to their broader markets, as seen in the darker band in Figure 1. On average, there's an 870-basis point spread between the best and worst performing multifamily submarkets. This higher reward potential underscores the importance of selecting the right submarket within a broader market, as it can significantly move the needle on overall performance.

For instance, in 2016, the best-performing submarket achieved ~60% more rent growth than the best-performing market did. Investors who mindfully select consistently outperforming submarkets can tap into these greater opportunities for rent growth and returns.

How Can We Predict Submarkets Primed to Outperform?

While historical performance isn't a crystal ball, it does give us a good sense of the natural patterns within a submarket, which usually persist unless significantly disrupted by an external force. A recent case study by CBRE has highlighted the effectiveness of considering historical performance as an indicator of future performance. Using the Seattle market as a proxy, CBRE found that those submarkets that performed well in the 2010s continued performing strongly, even despite disruptions from the pandemic. This consistency shows that past performance can indeed be a useful guide for targeted selection.

With that in mind, to get the best view of historical performance from both a supply and demand perspective, we use revenue per available foot (RevPAF), which takes rent levels and supply into account. This dual perspective helps us identify not just which submarkets have high face rent growth (perhaps by virtue of new supply delivering at considerably higher price points to the existing buildings surrounding them), but also which ones maintain occupancy and attract consistent demand. We then look at that historical performance and rank it relative to its peer set to see which submarkets have consistently outperformed. For instance, Figure 2 illustrates a condensed example of this process.

Of the five Miami submarkets represented, we can see that Submarket E frequently ranks at the top, making it the strongest choice for investment:

FIGURE 2

Miami Submarket-Level RevPAF Growth Ranking

Ranking	'01-'05	'02-'06	'03-'07	'04-'08	'05-'09	'06-'10	'07-'11	'08-'12	'09-'13	'10-'14	'11-'15	'12-'16	'13-'17	'14-'18	'15-'19	'16-'20	'17-'21	'18-'22	'19-'23
1	D	E	A	E	E	E	E	E	E	A	E	E	E	D	E	E	D	E	E
2	E	D	E	B	D	B	C	D	C	E	D	A	B	B	B	B	E	D	A
3	A	A	C	C	C	C	B	C	B	C	B	B	A	E	D	A	A	C	D
4	B	C	D	D	B	A	D	B	D	B	C	C	C	C	C	D	C	A	C
5	C	B	B	A	A	D	A	A	A	D	A	D	D	A	A	C	B	B	B

Note: RevPAF is calculated as rent per square foot x occupancy rate. All submarkets are ranked relative to all national submarkets.
Source: American Realty Advisors based on data from CoStar as of June 2024.

While choosing the right sector and market is and will always be important, we believe digging deeper into submarket performance can give disciplined investors even more of an edge. By focusing on trends at the submarket level, investors can identify areas with the highest potential for growth and resilience, even in fluctuating economic conditions. This approach can help mitigate risks and maximize returns, ensuring a well-rounded and strategic investment portfolio.

Disclaimer

Forward-Looking Statements

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