The Crucial Role of Submarket Selection

ARA Research

AMERICAN REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT

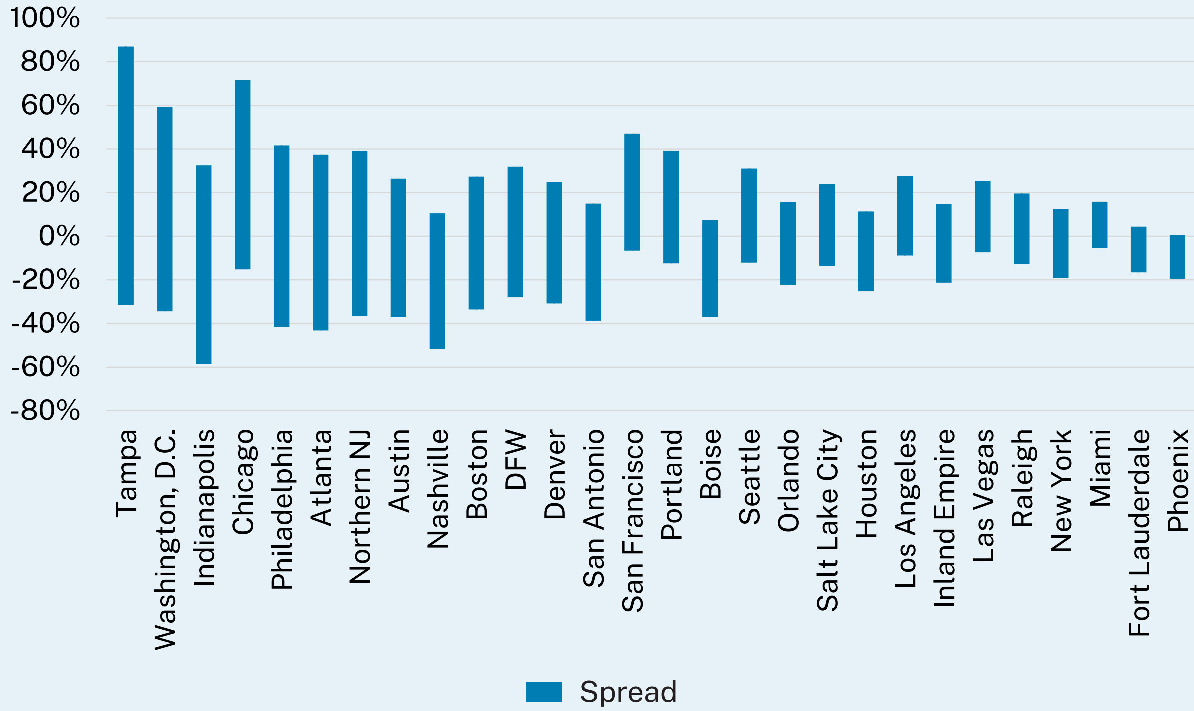
The recent wave of new apartment deliveries has downshifted fundamentals across most markets. However, supply exposure varies significantly among – and even within – markets, meaning that some areas are feeling the pressure more than others.

We believe the new real estate cycle will be one where evaluating markets at a more granular level will be the key driver of outperformance. Why? Because sector-level total returns are expected to converge over the next few years (absent office), offering less differentiation than before. As a result, outperformance should hinge less heavily on weighting portfolios toward any single sector but more on driving value through a more granular approach.

In this environment, an ability to peel back the layers on market-level narratives to uncover underappreciated nodes of strong performance is especially helpful.

FIGURE 1

Spread Between Best- and Worst-Performing Apartment Submarkets' Annual RevPAF Growth Through Q3 2024



Note: RevPAF Growth = Revenue per Available Foot Growth, calculated as the change in rents multiplied by the change in occupancy.
Source: American Realty Advisors based on data from Costar as of October 2024.

One way to do this is by looking at variation in performance between the best and worst submarkets. In Figure 1, we can see that over the past 12 months, the spread of rent and occupancy growth between the best and worst performing submarkets in Tampa is substantial. This suggests that making the right call on which neighborhood to invest in is more impactful in this market than in one like New York, where submarket variation shows a tighter spread. In other words, less variation and a tighter spread means there is less potential for outperformance from submarket selection, whereas a greater spread means there's more potential upside.

Even in a short span of time, the importance of selecting the right submarket is evident. Over just 12 months, the spread between the nation's best and worst submarkets has reached a remarkable 218%, meaning the best-performing submarket saw annualized RevPAF growth of 152% versus the worst, where collectively rent and occupancy declined 66%. This shift suggests the start of a new cycle, marking a departure from the five-year trend, where the average spread was 145%.

With volatility in interest rates – and our prediction of "higher for longer" – income is likely to regain its importance in real estate total returns going forward. This means that an ability to pinpoint localized dynamics that are supportive of rent and occupancy growth is likely to be rewarded.

At ARA, we monitor performance of 1,400 submarkets using a proprietary method that incorporates long term rent and occupancy trends in order to determine stickiness and momentum simultaneously.

Connect with us if you'd like to learn more.

Disclaimer

The information in this newsletter is as of November 11, 2024, and is for your informational and educational purposes only, is not intended to be relied on to make any investment decisions, and is neither an offer to sell nor a solicitation of an offer to buy any securities or financial instruments in any jurisdiction. This newsletter expresses the views of the author as of the date indicated and such views are subject to change without notice. The information in this newsletter has been obtained or derived from sources believed by ARA to be reliable but ARA does not represent that this information is accurate or complete and has not independently verified the accuracy or completeness of such information or assumptions on which such information is based. Models used in any analysis may be proprietary, making the results difficult for any third party to reproduce. Past performance of any kind referenced in the information above in connection with any particular strategy should not be taken as an indicator of future results of such strategies. It is important to understand that investments of the type referenced in the information above pose the potential for loss of capital over any time period. This newsletter is proprietary to ARA and may not be copied, reproduced, republished, or posted in whole or in part, in any form and may not be circulated or redelivered to any person without the prior written consent of ARA.

Forward-Looking Statements

This newsletter contains forward-looking statements within the meaning of federal securities laws. Forward-looking statements are statements that do not represent historical facts and are based on our beliefs, assumptions made by us, and information currently available to us. Forward-looking statements in this newsletter are based on our current expectations as of the date of this newsletter, which could change or not materialize as expected. Actual results may differ materially due to a variety of uncertainties and risk factors. Except as required by law, ARA assumes no obligation to update any such forward-looking statements.

Authored by:

Stanley L. Iezman
Chairman & CEO
siezman@aracapital.com

Sabrina Unger
Managing Director,
Research & Strategy
sunger@aracapital.com

Britteni Lupe
Assistant Vice President,
Research & Strategy
blupe@aracapital.com

AMERICAN
REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT

www.aracapital.com