Class B Offers Choice Investments

They may not be the prettiest of properties, but B and C developments can yield attractive returns.

By Ryan Severino

Would you rather have a B or a C than an A? Not likely in academics. Probably not likely in restaurant sanitation grades either. But how about in apartment investing?

While B and C properties are often not the most aesthetically pleasing, there are compelling reasons why they present excellent investment opportunities, possibly even better than does Class A, for the next few years.

Affordability
Let's start with the most obvious reason B and C properties perform well—affordability, or the lack thereof.

Most households living in B/C apartments are doing so out of necessity, not preference. If they could afford something better, they'd likely choose it. However, with median real household income falling over the past two decades, many households have limited ability to spend on goods and services, especially housing. This situation relegates them to B/C apartments and essentially excludes these households from purchasing a home. That's especially true these days, with residential mortgage underwriting standards remaining so stringent. Indeed, it's tremendously difficult for many households to obtain a mortgage, even an FHA loan. Although FHA loans are ideal for lower-income households, many of these households have impaired credit that puts even this option out of reach.

The "A" Team
What about the potential for moving up into a Class A apartment? It doesn't require the same stringent underwriting that a mortgage does. Moreover, if you look out at the swelling construction pipeline, the overwhelming majority of new properties being developed are Class A. Could the intense competition between Class A properties cause rents to fall enough that they'd be affordable for Class B or C residents?

As I've heard stated by a number of individuals over the past year, "Yesterday's Class A is today's Class B!" Yet, this, also, is a highly unlikely scenario. While the pipeline is robust for Class A, the difference between A and B/C rents is too large to be narrowed enough to put the A rents within reach of most Class B/C renters. For example, the national Class A rent premium over Class B/C is an astonishing 41%. The narrowest margin is in Syracuse, N.Y., at 29%, and the widest is in Westchester, N.Y., at 69%.

Lack of Competition
With the majority of the pipeline focused on Class A, there's little to no competition from new Class B or C apartments. In fact, in recent years, Class B/C inventory has actually been

declining, due to conversions, demolitions, etc., which are not adequately being replaced by either new construction or Class A properties sliding down into the B/C category. This presents an ample opportunity for Class B/C rent growth to accelerate.

Although apartment rent growth is surely constrained by income growth, household incomes are projected to keep growing, which will enable B/C landlords to continue to increase rents. Meanwhile, Class A rent growth will slow and compress toward the inflation rate, weighed down by all the new competition in the market. Additionally, the lack of new competition in the B/C space will continue to put downward pressure on an already incredibly low vacancy rate.

The Class B/C vacancy rate is now 220 basis points lower than Class A's. This wasn't always the case, but the hundreds of thousands of new Class A units that have been added over the past few years have pushed Class A vacancy well above Class B/C's. Therefore, it's highly likely that NOI growth for Class B/C properties will exceed that for Class A properties over the medium term.

Investment Outlook

Beyond the fundamentals, there's also a capital markets argument for B/C investment. Class B/C properties typically trade at a discount to Class A properties. On the cap rate side, the discount is currently equivalent to about 100 basis points. And while higher cap rates usually reflect greater risk or worse NOI growth prospects, that doesn't look to be the case now.

Obviously, each property will differ, but from a macro perspective, at the moment there appear to be more risks associated with Class A than with B/C, and Class A is likely to have slower NOI growth than Class B/C.

A higher cap rate and faster NOI growth? Looks like B/C will be making the grade while Class A is sent to detention.