Milwaukee CRE Summit Challenges are Many, but Milwaukee's Apartment Market is Weathering Them

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The Milwaukee apartment market remains strong, even during the COVID-19 pandemic. And when it comes to commercial sectors in the region? Only industrial is outperforming it.

That was the takeaway from a panel of apartment experts during the third annual Milwaukee Commercial Real Estate Summit held Nov. 5 by Midwest Real Estate News and REjournals.com.

This year's summit was an unusual one, of course. Because of the pandemic, the event was held virtually, with panelists speaking from their offices and homes. It also took place shortly after the presidential election, which, during the event, had yet to be decided.

But speakers expressed plenty of optimism regarding the Milwaukee commercial real estate market and economy. Those speaking on the apartment panel predicted that Milwaukee will see an increase in renters as people move from bigger cities such as San Francisco, New York City and Chicago to smaller, tier-2 and -3 cities like Milwaukee.

The mood, then, was a positive one on the multifamily panel, one moderated by Tracy Johnson, president and chief executive officer of CARW, the Commercial Association of REALTORS Wisconsin. Other panelists, all with years of experience in the multifamily market, were S.R. Mills, chief executive officer of Bear Development; Patrick Gallagher, executive vice president of CBRE; Ralph DePasquale, managing director of Berkadia; and Jason Korb, principal of Korb & Associates.

Korb kicked off the optimism by stating an important fact: Even during the pandemic, investors are looking for a place to put their money.

"And multifamily is a good place," Korb said.

DePasquale agreed that multifamily remains an attractive CRE asset class. Yes, COVID has impacted the apartment market. But what remains equally important? Jobs, DePasquale said.

"It is jobs," DePasquale said. "Jobs are always, always the key factor in the apartment business. Where there are jobs, there is usually apartment development and better occupancy rates. Where jobs go is where apartments go, in terms of the market."

Mills said that one of the bigger challenges the apartment market faces – in addition to the pandemic – is that there is a lack of housing inventory. This makes it more difficult for renters to find apartments in the communities they desire.

“There is a lack of inventory at all housing levels, from the starter home all the way up to the more expensive properties,” Mills said. “If people can’t move out of that starter house because they can’t find a home costing $350,000, we never make that starter home spot available. That then constricts some of the supply in the apartment market. It creates a lot of pent-up demand from people who can’t find apartment units.”

The challenge of COVID, of course, is a more immediate one. As Korb says, the commercial real estate market has slowed because of the uncertainty brought by the pandemic. There are just two exceptions, Korb said: multifamily and industrial. Those two sectors remain strong if not impervious to COVID’s effect.

“What we like in real estate is that certainty,” Johnson said. “What is interesting with apartments and industrial is that so much of the construction in these sectors has been planned. So much of those sectors has already been established pre-COVID.”

Now that there’s been a change in the presidency, will the country’s new leadership have any impact on the multifamily market?

DePasquale said that there has been talk in the past about eliminating or changing the 1031 exchange rules.

“That could have a huge impact on the overall market,” DePasquale said. “That might cause people to rethink the timing on dispositions. If something does go through on 1031 exchanges, that could have an impact.”

DePasquale also said that interest rates could have an impact on the future of the apartment market. Rates today, of course, are at historic lows. This is something that can’t last forever, DePasquale said.

“The interest rate environment right now is almost unheard of,” DePasquale said. “That can’t last forever. That’s another actor that will impact everything from investment sale prices to development to everything else in between.”

When will the country see interest rates rise? That’s uncertain.

“If we knew the answer, that would be great,” DePasquale said. “But we don’t see them rising in the short term. Over the next year, you’d think rates would be moving. But I have spent the last three or four years saying that this is the year rates go up. They never did. I think we’ve all become spoiled with the rates being at 3-and-a-quarter. There aren’t many who remember when a good rate was 6-and-a-half.”

Gallagher with CBRE said that while COVID-19 has hurt Milwaukee’s economy, the city is actually performing better than many others. As Gallagher said, many major metropolitan areas – places like Chicago, New York City and San Francisco – have seen their downtowns and their economies decimated by the pandemic.

In those cities, residents are struggling with reduced income, a loss of jobs and a loss of confidence in earning future income. Gallagher said that there are now more 18- to 29-year-olds living at home than at any time since the Great Depression.

“Demographically, there is a lot going on in the major cities that will benefit Milwaukee,” Gallagher said. “In the bigger urban areas, people are fleeing to the suburbs or tier-2 or tier-3 cities. If you can work from anywhere, you can live wherever you want. The limited availability of entertainment or other urban amenities makes the cities less attractive.”

Gallagher said that people remain uncomfortable taking public transit during the pandemic. Many are looking for more living space as they spend more time at home.

“Milwaukee, technically a tier-3 city, is benefitting from these trends,” Gallagher said. “Milwaukee is the kind of city that people move to when they are leaving downtown Chicago or New York City. I am still bullish on Milwaukee.”

Those renters who do come to Milwaukee might struggle to find an apartment depending on their economic situation. Korb referred to barbell development in the local multifamily market. Affordable units and expensive, luxury apartment units are being built. What’s missing in the market? Moderately priced apartment units.

Korb said that renters who have incomes in the 80 percent to 100 percent range of the area median income will struggle to find units targeted toward them.

"There is a hole in the market," Korb said. "Demand is really strong for apartments. But there is a hole in the multifamily space that people are trying to figure out how to fill."

Mills agreed that this middle area of the barbell has been a challenge in Milwaukee. As he put it, it's difficult for renters who make more than $30,000 a year but less than $60,000 to find an apartment in their price range in the Milwaukee area.

"There is a significant and not an easy gap to fill," Mills said.

Mills said that income averaging has helped alleviate this problem. The Consolidated Appropriations Act of 2018, also known as the Omnibus Spending Bill, boosted the effectiveness of the Low-Income Housing Tax Credit program by adding income averaging.

Under the new guidelines, properties qualify for the Low-Income Housing Tax Credit if the income and rent limits for at least 40 percent of the units in a multifamily development average 60 percent or less of the Area Median Income. National professional services organization Novogradac gives a good example of how this works: Under income averaging, a property could have 25 units at 80 percent of the AMI, 25 at 40 percent of this median and the rest of the units at 60 percent to qualify for the Low-Income Housing Tax Credit.

Mills said that income averaging has made it easier for developers to qualify for the Low-Income Housing Tax Credit, an essential incentive that makes it financially feasible to develop apartment buildings that don't charge top-end rents.

"We can now cater to that many more people who didn't have an option prior," Mills said.

And demand for multifamily remains high in the Milwaukee area, despite the pandemic, Mills said. He said that Bear Development routinely has waiting lists of 200 people for the new developments they've opened in the area.

"The need is insatiable and it's not going anywhere," Mills said.

The lack of moderately priced rental options isn't the only challenge facing Milwaukee's apartment market. Mills also pointed to rising construction costs.

"Every year we comment on how costs are going up," Mills said. "Lumber costs this year have tripled. We have had to get real creative."

Gallagher pointed to the flat rental rates in the Milwaukee market as another hurdle in the multifamily market. For the last 15 years, monthly apartment rents had risen about 1.9 percent to 2 percent each year in the Milwaukee area. In the center of the city, rents rose at a rate closer to 2.5 percent to 3 percent each year.

Now rents are flat, Gallagher said. And that poses a challenge for multifamily owners.

"Having flat rental growth is actually good news when you compare us to what is happening in the rest of the nation," Gallagher said. "But still, when you project flat rent growth for a year, it's a struggle to make the formula work, especially when you look at rising construction costs. If doesn't help to have flat rental growth while construction costs are going up. That adds a layer of difficulty.

DePasquale said that most suburban apartment markets are performing better than urban ones today, thanks to the pandemic. Urban apartment owners have to offer more concessions and their effective rents are seeing more of a dip, DePasquale said.

The hope, of course, is that the pain downtown Milwaukee is feeling today is only short term and that the center of the city will see a big rebound once the country gets the pandemic under control.