In World of 'Distressed New Construction,' These Apartments Sell for Almost Half of Cost To Build New

High-End Nevada Complex Shows How More Building Creates Discounts in Some Cities

The Deco at Victorian Square apartment complex has suffered from declining rents and high vacancy rates as the Reno, Nevada, market struggles with a supply glut. (CoStar)

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When the 209-unit Deco at Victorian Square outside Reno, Nevada, finished construction a few years ago, apartment rents were rising in the double digits. But as apartment construction later surged in some secondary cities across the country, supply outpaced demand and drove down prices.

In February, the property sold for $43 million. That amounts to $205,000 per door, well below the $350,000 to $400,000 per unit it is estimated the project would cost to build these days.

"There's an opportunity to buy these deals well below replacement cost," said Tyler Pruett, the co-founder and principal of real estate investment and management firm Tower 16 Capital partners, which bought the Deco, in an interview.

Reno shows how some metropolitan areas where multifamily construction took off after the worst of the pandemic ended up with too many new apartments. That ended up stifling rent growth, making good deals more likely not only for renters but for multifamily property buyers — and leading to occasional pain for sellers.

The number of new apartments becoming available in Reno, the self-dubbed Biggest Little City in the World, has outpaced move-ins for nine straight quarters, sending vacancy rates into double digits and pushing rent growth into negative territory in 2023. A number of those projects were financed with terms underwritten when analysts were touting record-high rent growth as national prices surged 16% from the beginning of 2021 to the end of 2022.

During that time, the acceleration of U.S. multifamily construction to take advantage of that demand peaked at over 200,000 unit starts across the country in the first quarter of 2022, the most starts in at least two decades. That construction surge resulted in the opening of 583,000 units in 2023, a 40-year high. In 2024, 460,000 additional units are expected to open to tenants. Most of these new units are concentrated in the southern half of the United States, a region that has attracted an outsized number of new residents looking for warmer weather and lower rents.

Those factors have led Pruett to rethink how he approaches acquisitions in the Sun Belt. Pruett said his company has been focused on a strategy he calls "distressed new construction."

While Tower 16 has traditionally targeted older properties in need of upgrades, these days the company is looking to buy construction projects that began when rent growth peaked and are now in lease-up, or completed buildings that have recently reached near-full occupancy levels.

Fitting the Strategy

That opportunity materialized with the Deco, at 955 Avenue of the Oaks in Sparks, Nevada. Construction began on the 10-story, Class A multifamily complex in 2018 and was completed in 2021. The property built atop a parking garage includes a mix of studio, one and two bedrooms averaging 742 square feet.

Deals meeting Pruett's preferred strategy are few and far between, he said, as lenders ignore declining valuations and rework loan terms for longer periods in a classic "pretend and extend" scenario.

The Deco at Victorian Square apartments in Sparks, Nevada, was completed in 2021. (CoStar)

But the Deco was different. "This was a unique situation where the seller group," had some issues, Pruett said. "Ultimately the equity partners just wanted out and wanted to clear the market with the asset."

That desire to exit led to Tower 16's recent announcement that it purchased the property for only $43 million.

"Rents just weren't what developers had projected when they underwrote those deals," he said. "It creates a pretty challenging environment to lease up a project and stabilize it."

While Tower 16 scored a discount, investors around the country might not get so lucky if supply and demand come more into balance in various markets and send rent growth, and property prices, back up.

Jay Lybik, the national director of multifamily analytics for CoStar Group, said these types of deals are rare. "They are the exception not the rule," he said in an email.

The seller was Quarry Capital, according to CoStar data. The company didn't respond to a phone request for comment.

Construction Boom

Reno and its surrounding area have shown strong fundamentals in recent years, including positive job and population growth. Going back five or six years, Reno was benefiting from the "outpouring of people out of the Bay Area into Nevada," Pruett said, including "the Tahoe Reno Industrial Center, which has been a huge windfall for that economy. All the major tech names are out there."

Electric vehicle maker Tesla operates one of its massive gigafactories about 20 miles east of Sparks.

The flood of people, jobs and businesses into Reno caused property values and rents to surge. When construction of the Deco began in 2018, yearly rent growth hovered around 7% each quarter, according to CoStar data.

By the time it was completed in 2021, annual rent growth in Reno had ballooned to 11%. But the run-up in rents didn't last, and from those 2021 peaks began a steady decline that led to negative rent growth in 2023 and a 25-year high in vacancy rates.

Reno, a microcosm of the larger Sun Belt market, had become a victim of its own success. Soaring rent prices unleashed a construction boom that drowned the market in new supply. Since 2018, there have been 1,000 new units entering the Reno market annually, according to a CoStar analysis, and the pace has only grown. The second quarter of 2022 saw 4,700 units under development, an all-time high. An additional 2,500 units are under construction, representing another 5.6% expansion in inventory.

A recent flood of new residents into Reno, Nevada, caused property values and rents to skyrocket. (Getty Images)

In that environment, the Deco has struggled to fill its units. Recent vacancy rates recorded by CoStar topped 36% even as rents have declined more than 10% over the past year, far more than similar properties in the same area that fell 2.7% over that time.

"These deals were underwritten with rental growth rates priced to perfection," Pruett said. "So when these developers finish their deal from a construction standpoint [and] start the lease-up, they've got pressure to kind of come out of the gates" with high prices.

But that prospect is difficult when market-level rents have been declining, particularly at top-tier properties like the Deco. Even with discounts on rent, the lease-up period can take well over a year, meaning efforts to land new tenants at reduced rates can end up competing with renewals, according to Pruett.

"It ends up being a vicious cycle," he said.

Look Ahead

Working with a new property management company hired by the seller toward the end of its ownership, vacancy rates at the Deco have declined through a combination of improved operations and rent discounts, according to Pruett. He said occupancy had reached 80% by the time the deal closed and has since climbed to 97%.

The turnaround was an encouraging sign for Pruett, who still likes the fundamentals backing Reno's growth and is confident that foundation will allow the market eventually to work through its glut of supply as construction begins to tail off toward the end of this year.

"It's going to be choppy, just operationally in terms of softness and rents over the next … 12 to 24 months," he said.

In the meantime, Tower 16 is getting to work on $1 million of planned improvements at the Deco, which include adding outdoor seating and fire pits, upgrading the gym equipment, and replacing the clubhouse common area's furniture.

"It's been a while since we've acquired anything," Pruett said, "so it's great to … get things rolling again."

For the Record

Jonathan Merhaut of Eastdil Secured represented the seller in the transaction. Eastdil also helped secure financing for the buyer, led by Lee Redmond and Greg Stampley.