The Apartment Report ™

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PLAYERS CHASE VALUE

Traditional value-add deals could be making an appearance on the acquisitions front, but it will likely be at least another 12 to 18 months before this niche regains some of its lost luster. In the meantime, **Cortland Partners** and **MRP Realty** show some muscle and swoop in on repositioning and distressed value-add plays. Firms such as **Bainbridge Companies** and **J.I. Kislak Inc.** keep an eye out for such deals but will take their time to sink in resources. Also, look for regional investment firms to pick up distressed value-add properties, especially ones located in secondary markets.

Value-add and rehab deals took a backseat over the past two years due to the glut of physically and operationally distressed assets available in the market. Such properties were trading for nearly 25% below value and promised much higher yields — in the 20% to 25% range — than traditional rehab plays that fetch returns in the 15% to 20% ballpark. But it looks like demand could be picking up for unstabilized, rehab opportunities displaying weaker occupancy rates. The value-add strategy today involves bringing such assets to economic occupancy and subsequently adding to NOI growth, as opposed to simply painting the walls and bumping up rents. A few years ago, most value-add deals were picked up based on in-place yields and 7% vacancy, with the potential of increasing rents by 3% to 4%. Now, properties with vacancies of 20% to 30% are considered a good pick because there is a lot of upside once occupancies are stabilized, and as long as the local job market shows signs of improving. Rents could eventually be pushed up by as much as 10% to 12%. However, such properties are rare in markets that deliver good returns on value-add like those in the Northeast and Mid-Atlantic.

There is a wide disparity of at least 100 to 200 basis points in cap rate spreads between A and B/C asset groups. In Florida, touted to be a good bet for repositioning plays, caps are around 6% for core assets, and 7% to 8% for B and C complexes. The delta gets wider in secondary and tertiary markets. But don't expect a flurry of activity in this arena simply because pricing seems favorable. Most buyers of unstabilized rehab opportunities prefer to sink in limited cash and use more financing, and we know that there is not a lot of financing going on today due to tight underwriting. Once the market rebounds, expect value-add deals to see as much as 10% to 12% return. Coastal markets along the Northeast corridor, from Boston to Washington, D.C., and parts of the West such as Seattle, Portland and San Francisco are probably the best bet today for rehab deals. However, investors willing to take more risks can look at more cyclical markets, where they can hope to receive higher returns — as high as 30% sometimes — once the local job scene picks up pace.

Cortland Partners acquires the 519-unit **Northchase Apartments** in metro Atlanta and intends to pour a little more than $4M in site and amenity improvements, as well as various soft costs. The cost of the acquisition, including the planned rehab, sums up to $15.2M. President **Steven DeFrancis** likes the configuration of this complex where about 75% of the units are townhomes, perfect for families that prefer to rent. The property has a mix of ones, twos and threes, averaging 1,300 s.f. Cortland picks up the asset from a special servicer that owned it after it was foreclosed on last year. Occupancy is 70% and DeFrancis believes there is great upside in the complex once renovations are complete, lasting about six months.

The value-add strategy for Northchase is twofold. The first part revolves around improving occupancy and bringing all units to market, as certain units were deemed unleasable because the interim-lender management didn't allow any capital expenditures. Once the property is full, Cortland will move revenues back to historic stabilized levels. The second part of the strategy outlines improvements that will reduce or eliminate certain operating expenses, for instance, replace carpeting in common areas with hard-surface vinyl flooring, which will in turn lower turnover costs. The firm will also convert buildings that supply hot water through a central boiler system to individual hot water heaters so that the owner doesn't incur natural gas expenses and the tenant pays for the water consumption.

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Cortland anticipates returns north of 30% on Northchase, surpassing the firm's typical IRR requirements on conservative underwriting. Watch for the firm to stay busy as it closes on three deals in the last 100 days, thanks to its relationships with brokers, special servicers and the lending community.

MRP Realty and Angelo, Gordon & Co. purchase the 135-unit **Hampton Apartments** in metro Washington, D.C., for $33.5M in an off-market transaction. MRP plans to reposition the Crystal City complex from its B- status to B+ with a $3M to $4M renovation plan. Expect kitchens, baths, lighting and amenities to get significant upgrades. Rents are currently around $1.80/ft., but will go north of $2/ft. post rehab. Occupancy should reach the high 90s.

The south Arlington, Fairfax and Silver Spring areas are popular for value-add deals in metro D.C. Investors favor such deals but unfortunately they are pretty picked over in the area. Class A assets are trading for 5.5% caps, while Bs fetch 6% to 6.5% and Cs get 6.5% to 7.5%.

Value-add deals made up a sizeable portion of Bainbridge's core business, having done close to $1.5B worth of transactions in the years preceding the latest recession. But with the value-add business virtually having disappeared in recent memory, the company didn't believe the returns would justify its efforts in this niche. While demand for older properties was slow over the past three years, CEO **Richard Schechter** has been noticing that since the beginning of this year the market is re-emerging for comparatively newer assets built after 2000. However, he warns that this slight uptick in interest is only limited to certain locations and is not very prominent in a large part of the country. Buyers are very conscious about rehab deals and there is almost no interest from institutional capital. The only action in this field comes from astute, entrepreneurial investors.

Bainbridge expects to do about $500M worth of acquisitions over the next 12 months, including some value-add deals. Schechter will take a look at the Washington, D.C., to Boston corridor and core markets in Florida. Typically, the firm aims at a minimum 15% to 20% return on its rehab investments. Large portfolios are preferred but even complexes with a minimum of 250 units get the nod of approval. He prefers off-market transactions mostly. All deals are done with institutional partners such as pension fund advisers, opportunity funds and offshore capital, along with capital from Bainbridge itself. Its third-party management arm actively seeks value-add ops and can turn around units fairly quickly.

Armed with more than $200M in capital funds, J.I. Kislak will expand its footprint by acquiring multifamily properties across the Sunbelt region. As fundamentals begin to stabilize, the company wants to take advantage of the narrowing bid-ask gap in the marketplace. Value-add deals are favored, especially sizeable complexes that need an infusion of cash, either because the owners are over leveraged or the complex has bad management. Kislak doesn't typically get involved in expensive remodeling projects that need upward of $10K/unit. Its value-add strategy comes in the form of recapitalizing the properties and establishing operating efficiencies. Unlike bigger operators like REITs and hedge funds that have a lot of other people's money at their disposal, Kislak operates on a smaller scale with private funds and is accountable for every dollar spent. CFO **Dung Lam** targets cash-on-cash returns of roughly 8% to 9% on average and sticks to 70% to 75% LTV when underwriting deals. SVP **Stephen Braun** exercises caution when looking for deals in the marketplace and believes the bulk of the acquisition opportunities will hit the market in mid-2011. Until then, Kislak will keep an eye out for a bevy of property types, from recently constructed core assets to broken condo and distressed deals across Florida, Texas and Arizona.

Secondary markets such as El Paso, Corpus Christi and the Lake Jackson MSA in Texas witness a mix of both distressed and regular value-add complexes as well, and catch the eye of the more daring investor. Richwood, Texas, is part of the Lake Jackson MSA, traditionally a cyclical market, where the bottom lasts longer than most other markets, but once the local job scene picks up pace, yields could touch as high as 30% in a stabilized environment. Here, a Colorado-based regional investment firm picks up the 248-unit **Creekside Estates** with the intention of adding value to the distressed property that had a land-use restriction. The tax-exempt bonds were wiped out when the deal went into foreclosure and now the property is 100% market rate. In general, area prices are not too high and a similar complex would have fetched around $3M to $4M.

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The buyer plans to spend close to $500K in deferred maintenance, including upgrades to flooring, fixtures and the parking lot. Area occupancy is about 80% today. Occupancy at the complex is 70% and the new owner counts on that number to go up in the 90% range when the local market picks up and the property begins to stabilize. Average rent is about $500/unit or $0.65/s.f., however, when the market turns favorable, rents have the potential to go up by about $100/unit. However, the priority in the near-term is to implement upgrades and get more people in the door before bumping up rents.

LENDERS BANK ON SECTOR

Available lending prospects will keep multifamily afloat, and the niche could even outperform its commercial counterparts for the foreseeable future. Lenders such as **NorthMarq Capital**, **Arbor Commercial Mortgage**, **Hudson Realty Capital LLC** and **Avant Capital Partners** help keep the sector humming with business, allocating at least 50% of their total originations to apartments. Look for **Bond Street Capital Companies** to originate smaller apartment loans. Although the appetite for apartment deals is adequate, lenders will place greater emphasis on asset location, quality improvements and sponsorship value, with the latter becoming more important than ever before. Larger players tend to opt for high net worth borrowers, while smaller suits prefer liquidity.

Expect fundamentals to strengthen lender interest in multifamily this year, which will give way to higher production volumes compared to 2009. Activity is on the rise — though modestly — but bet on greater velocities come Q4 2010. Short-term bank financing, typically two- to three-years floating rate with a LTV of around 70% for non-stabilized apartments, already rears its head. Freddie Mac, Fannie Mae and HUD will service at least 70% of all apartment loans this year, which is good news for agency lenders. However, this group will start to see nominal competition as life companies, regional and community banks look to place their dollars in healthy apartment deals. Life companies tend to be more flexible with regards to prepayment penalties and may not participate in global underwriting, taking into account the entire portfolio rather than just the single asset. Life loans bear LTVs in the 60% to 65% range and favor good quality deals, which are difficult to come by these days. Meanwhile, banks see LTV/LTC hover in the 70% to 80% range. Despite more lending sources re-entering the playing field, the GSEs will still be the first in the pecking order with low rates and LTV/LTC ranges from 60% up to 80%, on average. HUD will go north of 80%. Overall, commercial real estate spreads have fallen this year to a point where today they are in the 220 to 270 bps range depending on LTV and asset type.

About 60% to 65% of NorthMarq Capital's total loan production will come from apartments, and the lender's overall commercial real estate production should beat last year's figures of around $3.5B to $4B. NorthMarq is a major champion of the agencies and HUD, which should make up 85% to 90% of its total apartment production. For 2010, its apartment lending activity can be broken down into 40% acquisition, 55% refinance and 5% construction. According to **William Ross**, EVP, regional manager of NorthMarq Capital, the company's multifamily loans are typically less than 80% LTV with at least 1.25x DSC. Spreads are in the 180 to 230 bps range for terms of five to 10 years.

NorthMarq arranges a $25.4M first mortgage note for **Jefferson at Carmel Mountain Ranch** in San Diego, Calif. **Carmel Mountain Apartments Inc.** was the borrower and the loan was based on a five-year term, interest only. The non-recourse financing is through NorthMarq's affiliate AmeriSphere Multifamily Finance LLC, a Fannie Mae DUS lender. Jefferson at Carmel Mountain Ranch is a Class A complex with 277 units.

VP, National Sales Manager **Ken Fazio** at Arbor Commercial Mortgage expects 2010 originations to be comparable to last year, with an increase in appetite for multifamily acquisitions and refinances. Already a heavyweight in the apartment space, refinancing will likely dominate its books this year, accounting for about 80% to 90% of production. The balance will be split between new construction and acquisition. Arbor keeps a keen eye on the experience and liquidity of each borrower and typically does not favor properties below eight units because of higher volatility. The national lender offers fixed and floating rate notes and will do five- to seven-year deals.

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Arbor funds a $3.37M loan under its Fannie Mae DUS® MBS product line for the 228-unit complex dubbed **Spring Hill Apartments** in Houston. The 10-year loan has a 25-year amortization schedule, priced at 5.67%. Proceeds refinance the well-occupied property.

Nearly 30% to 50% of Hudson Realty Capital LLC's business volume this year will be focused on multifamily. The balance will take into account office, retail, industrial and some hospitality. Hudson Realty, a middle market fund manager, sees a lot more opportunity in the multifamily space and works on its fund five to issue loans. It is essentially a bridge lender and will do acquisitions, buy debt and do recapitalizations, and also get involved in rehab and renovation deals. Loan sizes are typically between $12M and $20M. Managing Director **Spencer Garfield** will lend up to 80% in cost and 65% to 75% LTV upon stabilization. Rates are typically at least 11%. He does not believe in ground-up developments and does not underwrite based on significant cap rate compression. Non-recourse deals are also considered.

Look for Avant Capital Partners to provide between $200M and $300M this year, with apartments making up about 50% of the total volume. The lender sees activity in two primary apartment loan segments: distressed or REO purchases and recapitalization of assets. Avant typically likes market-rate deals, however, as more opportunities come knocking it may add tax-credit productions to its books. Avant will lend on multifamily, office, retail, industrial and hospitality, in that order of preference. Its footprint primarily spans the Northeast, Southeast, Texas, Oklahoma and Chicago.

Bond Street Capital Companies, primarily a mortgage broker, does some private lending and multifamily accounts for about 25% of that segment. Its loans are priced in the double-digits, typically between 10% and 12%, and ranging between $2M and $10M. Preferred transactions involve deals that require some renovation, have some credit impairment or involve the purchase of a loan. The lender is active primarily in the Southern California market.

REITS EXPERIENCE NOMINAL OCCUPANCY INCREASES

Occupancy rates in top U.S. markets came in about 2% higher in June compared to the end of 2009, and REITs such as **Equity Residential Properties Trust**, **AIMCO** and **AvalonBay Communities Inc**. have new visibility into the balance of this year, with some retreating to normal or somewhat favorable exposure levels. Expect these players to keep a keen eye on key drivers such as resident turnover, net effective new lease prices and renewal prices to dictate year-end physical and economic occupancies, which most predict will be a few points higher than originally estimated.

Indicators suggest a continued recovery in apartment fundamentals throughout the primary leasing season, yielding steady, and in some cases, improving occupancy. The brave at heart even increased rents during Q2 2010. Among markets experiencing significant vacancy declines in the first half of 2010: Phoenix (down about 175 basis points), Jacksonville, Fla., (down nearly 110 basis points) and San Jose, Calif., (down about 100 basis points). However, those that continue to see weakening vacancy include the likes of Oklahoma City (up about 25 basis points) and Detroit (climbing nearly 20 basis points). Turnover is a major factor for the majority of owner/operators, and while most companies experienced a lot of turnover in the summer leasing season, occupancies are beginning to recover as high as 6% in some REIT markets.

Limited new supply across most major locations no longer threatens REIT occupancies, and many players think that residences are not as concerned about losing their jobs anymore, which will give apartment occupancies a boost. Overall it looks like the apartment market absorbed 215,000 units in Q1 and Q2 of this year, and stands to absorb a little more than 300,000 units by year end. These numbers will positively affect occupancy levels in upcoming months, which could allow companies to implement more aggressive rent increases.

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Equity Residential (EQR)

Lower turnover and growing demand allows EQR to recover its occupancy to normal and sustainable levels in virtually every market, especially in the Northeast where demand is high. By the end of Q2, annualized turnover rate was 52.1%, 520 basis points below this time last year. July renewals are up 4.9% over the entire portfolio, and the REIT expects this month to see a 6.2% renewal increase. This not only reduces expenses, but also provides a base for occupancy gains, which in turn gives the REIT pricing power over new, as well as renewal leases. Select markets are poised for a small increase in turnover, partly because of aggressive rents, which will add pressure on occupancies. Looking ahead, EQR expects turnover rates to continue slowing down, which will help sustain occupancy levels near 95% by year end.

Improving fundamentals prompt EQR to revise its 2010 guidance to reflect occupancies 0.7% higher than originally stated. Other guidance amendments include revenue change of (0.5%) to 0%, versus the original (3%) to (1%). Expenses remain the same, while execs now predict a (2%) to (0.5%) NOI change, compared to the (6%) to (2%) forecasted at the beginning of the year. EQR's Q2 occupancy is 95.1%, up about 1.5% year-over-year. All of its markets have above 94% occupancy, with the Washington, D.C./Northern Virginia and New York MSAs boasting the strongest figures of 96.2% and 96.1%, respectively. In weaker markets such as southern Florida, EQR sees a 1.3% positive change in occupancy, and expects that to spill into Q3 and Q4 as the market is making good strides in selling and clearing the condo inventory. Also, jobs are starting to come back there. The REIT sees increasing occupancies for high-end units, and commands $7/ft. in rents in New York again.

AIMCO

The REIT experiences increased tenant demand that led to better occupancy and stronger pricing in Q2. New lease rates turned positive in several of its markets for the first time in five quarters. Overall, AIMCO's average daily occupancy remains at an approximate high of 96% and should settle at 95% to 95.5% by year end. Q2 conventional same-store occupancy was 95.6%, a 2.8% increase year-over-year, which offsets the year-over-year rental rate drop of nearly 4%. On the affordable side, occupancy was stable at 97%, with rents increasing 1.5% for the quarter. Its original guidance pegged occupancy levels of 94.5% to 95.5% for the year, and 95% to 96% for Q2.

AIMCO focuses on the 20 largest U.S. markets, primarily coastal spots, some Sunbelt cities and Chicago. The REIT believes these markets are relatively liquid and possess desirable long-term growth characteristics. Some of its highest-occupied markets include Seattle (97.4%), the East Bay in California, (97.6%) and Nashville, Tenn., (98.1%). New leases account for about one-third of its overall business.

AvalonBay

The REIT maintains a flexible operating position in response to the economic shift that affects occupancies. It seems the company was less focused on occupancies this past quarter, and instead concentrated on driving the top line through rental rate growth. This is partly because execs believe that mid-year is the best time to push for rents. With this carefully mapped out strategy, even if AvalonBay experiences some loss in occupancy mid-year, it still has the capacity to adjust pricing before the lower traffic sets in. As a result, select markets experienced a drop in occupancy. In fact, AvalonBay was willing to tolerate additional occupancy loss, however, execs maintain that virtually all of their markets are pushing back, as turnover rates remain in the high single-digits, lower than the previous year.

Overall, AvalonBay's occupancy seems to be stabilizing around 95% with turnover remaining favorable and solidifying conversion ratios. All of its markets experienced positive occupancy growth from this time last year, with Southern California and the Pacific Northwest seeing the greatest gains of 2.5% and 2.4%, respectively. Year-over-year, economic occupancy increased 1.2%, which help offset the 3.3% decrease in average rental rates.

AvalonBay's redevelopment projects are also poised for healthy occupancy. The REIT looks to start around $125M this year, and many of these deals will be able to be redeveloped between 90% and 92% occupancy level.

REVISED PLANS DRIVE PROJECTS

Rent growth and a better dynamic between supply and demand lift some new projects off the ground, allowing **Post Properties**, **Wood Partners** and **Alliance Residential** to move forward on new developments. Post bets on the Washington, D.C., submarket for a near $100M development, while Wood will spend $85M on two new communities in Georgia and Northern California, bringing a total of 432 units. Also keep an eye on Alliance that counts on projects near the nation's capital, with one in early development and one that will cost almost $60M. While select projects are on the move, things continue to be at a standstill in markets that have high vacancies and unemployment. Another problem has also been the lack of available land, as most landowners opt to wait out the recession and decide not to market it.

New construction is at an all-time low with just 50,000 to 65,000 units forecasted to come aboard by December. But the renter pool is expected to grow as mortgage standards remain tight and former homeowners transition into renting. This prompts many of the big developers who took last year off to jump back in with the hopes of bringing their projects online just in time for the 2012 to 2013 expected apartment lease growth. Also, many of the big banks are starting to consider construction lending but underwriting and approval take much longer than they did two years ago.

New development will be a bit different than during the boom years. Condo components are now a thing of the past and developers are even scaling back on condo-like finishes and amenities such as granite countertops that just do not make sense in the current environment where people do not want to pay for extras. Many sites where condos were originally in the cards are now being developed into apartment-only complexes.

Keep an eye out for Post Properties to begin its second and final phase of **Post Carlyle Square** in Alexandria, Va., this summer. Total project cost is expected to be $95M. This phase will include 344 luxury units in one 14-story high rise and one four-story mid-rise. Phase I was done in the early to mid 2000s and brought in 205 apartments, 105 condos and some retail. The biggest change now is that Post plans this phase to be 100% apartments, reflecting the market. Count on construction to start by end of the summer and the first units should come online Q2 2012. Construction will commence by Q4 2012. Expected absorption should be around 25 +/- units a month and the average unit size will be 906 s.f. Rents should be $2.60/s.f. to $2.65/s.f. Tenants will be late-20s, early-30s young professionals or married couples. Post tends to be a long-term holder and most new developments are luxury.

The development will be financed out of a $400M line of credit with lead banks **Wells Fargo** and **J.P. Morgan**. Post President and CEO **Dave Stockert** notes this is the typical way Post usually finances development unless a joint venture partner is involved. This will be the first development for Post since 2007. Post owned this land for 10 years and decided now was a good time to build because the Washington, D.C., market has remained pretty strong even through the downturn, with job growth and solid asset performance. The company also has land in Orlando and Tampa, Fla., Houston, Dallas and Austin, Texas, and Atlanta, but Stockert does not think they have recovered enough for new construction. This will most likely be the only new development from the company this year.

Look for Wood Partners to break ground on **Alta Glenridge Springs** in Sandy Springs, Ga., an Atlanta suburb. The project will cost $30M and is expected to open by summer 2011. Alta Glenridge will have 175,000 s.f. of residential space and 20,000 s.f. of retail. There will be 168 units with a mix of one, two and three bedrooms. The company bought the 2.5-acre site last month. Director of Development, Southwest, **Bennett Sands** believes this will be a successful project because the market has high barriers to entry, little new construction, a good job base and proximity to all the major Atlanta office markets. Tenants will be professionals working in the area and medical professional working in one of the many nearby medical facilities. Sands notes that in Atlanta there has been relatively little new construction activity and interest for new deals is limited to infill sites. The company is pursuing deals in all of its markets with several starts expected next year.

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Wood Partners also resumes construction on **City Walk** in Oakland, Calif., which sat partially completed for three years following a bankruptcy filing by the original contractor. Wood bought the site last September. City Walk is expected to cost $55M and be completed in one phase. Four seven-story mid-rise buildings are planned to bring 264 Class A apartments that will range from 570 s.f. to 1,700 s.f. Deliveries are forecasted for next summer. Primary debt was done through **American National Insurance Company** and there is a secondary loan through the **City of Oakland Redevelopment Agency**. Project Manager **Brian Pianca** anticipates a medium-term hold, probably three to five years. Absorption should be around 20 units a month. Wood's joint venture partner on the project is Berkshire Property Advisors, LLC. This project aligns with the company's expertise in developing urban, infill locations.

Alliance Residential works on a new project under contract and in entitlement for Odenton, Md., while simultaneously breaking ground on **Broadstone Laurel Highlands** in Lorton, Va. Broadstone will cost $59.3M and will bring 289 garden-style apartments and 11 townhouse units. Condos were originally planned for the 10.9-acre site but the builder abandoned those plans and disposed of the property. Alliance then contracted to buy the land from the bank. Average unit size will be 1,083 s.f. and rents will be $1.74/s.f. Absorption should be around 20 units a month.

Count on construction to be finished in 21 months all in a single phase. Alliance got a construction loan with **US Bank** for 60% of the cost and the other 40% will come through equity. Alliance Managing Director **Dean Wilson** notes that this will be part of the Base Realignment and Closure (BRAC) activity that is relocating jobs to the D.C. area. He also notices that there is a mad scramble for land in the market because of the lack of available sites. Wilson would love to bring a total of 250 to 500 new apartment units to the market every year. The company did zero new development last year. Alliance typically holds products for five years.

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