Apartments 2009 ~ Panel Summary

Notes from the RealShare Apartments 2009 Conference in Los Angeles. These are notes I made from the presentations and opinions of the speakers, moderators, and panelists at the conference. They are meant to relate general thoughts, and should not be used as quotes.

Keynote Address: National Apartment Market Update

- The recovery from this recession will resemble a U-shaped curve. Home sales will begin to recover, but up to as many as 20% of the sales will come from foreclosures.
- Unemployment is higher in California relative to other parts of the nation, and will continue to climb in the short term.
- Rents will potentially decline another 3% depending on the level of current rents at a property.
- Questions remain as to whether lenders will continue to extend and pretend, or switch to foreclosures, and when the latter might happen. Currently, lenders are continuing to extend loans.
- Questions also remain regarding the government's decisions for Fannie Mae and Freddie Mac.
- It looks like the bottom will be in 2010.
- Senior Housing and Affordable Housing will attract more renters in the future.

Nowhere But Up – What does the apartment market look like post-recession?

- Rents have declined 4.6% over the past 6 months.
- Distressed property will become more prevalent in the market, and as a result values could decrease 25% more depending on the location and asset.
- We will continue to experience high unemployment until 2012.
- Currently we are experiencing "impaired pricing discovery" and as a result assets are not being marked to market which is causing very low transaction levels.
- The recovery is based on a political system gamble.
- More market indicators will appear and the market will improve when institutional players, such as REITs, who represent purchases at retail prices, get back into the market. Investors want transparency and REITs provide transparency and the ability to sell securities without disturbing the underlying assets.
- Unemployment will peak around 10-11% in 2010, and then start a slow decline.
- Supply will be limited over the next few years.
- The Coastal California market will continue to be depressed for the next 18 months, and then over the next 18-36 months it will continue to improve, and will improve faster than inland areas.
- In non-supply constrained markets, look for vacant properties and work to fill them.
- In supply constrained markets, look for rent growth and properties that are having operational issues.
- Apartments represent a better opportunity over the next few years compared with other product types because the shorter term leases will provide a better defense against inflation.
- Buying now will provide an opportunity to create a lot of value. If you're selling now, it's probably because you're unable to hold on.

Buy-Sell-Hold: What to do in Today's Investment Market

- Nationally, the average CAP Rate in 2007 was 6.00%; in 2008, 6.4%; so far in 2009, 6.9%.
- Transaction volume is down about 77% from 2008, and 2008 was significantly down from 2007.
- If you intend to hold for 5 or more years, now is the time to buy.
- The bottom might be reached in the next 6 months. Investors and capital are starting to come back in to the market, and investors should start thinking about taking more risk.
- Currently, FNME is helping to keep CAP Rates low. CAP Rates could climb 100-150 bps in the event of inflation, increased distress, or a government policy that eliminates FNME from the market.
- From the height of the market, panelists thought that at the end of the decline, values will have declined 10% to 40% depending on the specific market and job growth.
- Panelists think were are somewhere between the 5th and 7th inning of this cycle.
- The greatest risks to this recovery are jobs (and therefore consuming spending) and debt.
- There were mixed opinions about the amount of capital sitting on the sidelines.
- Panelists believe the national average CAP Rate is currently 6.5%.
- They foresee the most active sellers in the near future as being financial institutions and private owners, and the most active buyers being REITs and private investors.
- The lessons learned from this downturn are: invest with good, long-term debt; get out of the market when you know it's too crazy; don't get caught up in what the market is doing, stick to your own plan.

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- For apartments, the long-term demand is positive.
- There will be less distress in apartments, so the decline in value will be less than other commercial product types.
- Jobs have declined by 7 million since the height of employment, and it could take until 2014 to regain those 7 millions jobs back.
- Household formations are at historic lows.
- There has been a trend reverse of people renting verses buying. From 1994 – 2005, most people were buyers, and now the trend is returning to a historical norm of 35%-40% of the population being renters.
- Studies show that 60% of Echo Boomers (born between 1974 and 1984) prefer to rent.
- NOI growth won't occur until 2011 when rents start increasing again.
- The lender panel has seen about $9.9 billion in production so far this year.
- Average rates are about 5.3% for a 10-year note.
- Debt Coverage Ratios (DCR) are between 1.25 and 1.35.
- Loan-to-values (LTV) are at 70%-75% for a stable asset.
- Some 2-year interest-only programs are available.
- The number of properties owned, the ability to operate, and the borrower's strength all factor into the loan program and the ability to get financing.
- Lenders are looking for equity, large deposits, and recourse.
- Life companies are starting to get back in to the market, which is a good sign. Now we need banks to come back in to the market.
- For CMBS loans, 2-year extensions might be available.
- Banks will eventually have to dispose of product, so there will be opportunity there in the future.
- FNME currently has a 0.56% delinquency rate, which is up from 0.27%.
- According to REIS, the national vacancy rate is 7.8% and there is not a lot of oversupply, which is better than the last downtown and is part of the reason why people are starting to come back into the market.

Industry Leaders: The View from the Top

- The Bay Area is seeing CAP Rates between 5.75% and 6.25%.
- In a good market with supply constraint, there is question whether there is enough risk in the market to justify being 200-250 basis points (bps) above debt, at an 8% CAP Rate.
- We are in the era of deleveraging, possibly until 2020.
- One of the national apartment brokerage firms has experienced so far this year that 93% of transactions (out of 1,085) were for properties that are less than $10 million in value. And 41% of the sold properties under $10 million were less than $1 million in value.
- "A" class assets are doing well, but there is little to no movement in the market.
- "B" and "C" class assets are selling at 100-150 bps below list prices, depending on the market.
- Financing is not available for "C-" and "D" class assets.
- According to differing opinions on the panel, the investment market will return: mid-2010; between 2010 and 2011; 2012 after rents have come up; end of 2010 to the beginning of 2011 along with increases in the rental market.
- Current challenges for apartments: inflation; job growth, deleveraging, and property management.

The Word from the Street: Top Sales Brokers on How to Survive, and even Thrive, in Today's Market

- CAP Rates in desirable areas are less than 6%.
- CAP Rates in less desirable areas are between 7% and 8%.
- Northern California might end up with CAP Rates around 7%. There has been a 50 bps difference in CAP Rates between 2008 and 2009.
- With core deals, some brokers are seeing CAP Rates decreasing, such as a Class A apartment for under $10 million that traded in Santa Monica at 4% CAP Rate with long-term debt at 5.5%.
- Buyers are looking at replacement costs to help determine pricing.
- Rents have declined over the last 6 months, and won't climb as quickly as they dropped. There might be another 3-5% decline in rents through the end of the year, and they might stay low for another year until more jobs are created.
- Rents might spike again in 3-5 years.
- The market has not yet absorbed all the condo runoff yet.
- In 2007, 25,000 multifamily permits were pulled, but only 8,900 units were built.
- There will still be market turmoil over the next 3 years. People waiting for vulture opportunities, though, might miss the boat.
- Distress will be more apparent in land deals, failed condo conversions, and properties with short-term financing than in regular apartment transactions.
- According to the panel, motivations in the market will be influenced by the expectations of revenue, and by supply and demand factors which is currently out of balance.
- If interest rates start going up, that will affect CAP Rates especially if there is no rent growth.
- Now is the time to sell "B" and "C" properties.
- It's better to lease units at lower rates than to have units sit vacant.