

## **ABQ apartments: Why investors chase low CAP rates**

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An investor client of mine taught me a new acronym the other day: BLUF – Bottom Line Up Front. So here is the BLUF: 5.5 percent cap rates, 10 percent rate growth, 21 percent unleveraged returns, 43 percent leveraged creates phenomenal interest in Albuquerque from out-of-state investors.

A more in-depth review of the sales of the apartment communities with more than 100 units indicates that in 2006 there were 18 sales, ranging in condition from grade “A+” down to “D” and with a price per unit from \$18,750 to \$143,000, while the advertised CAP rates average hovered in the mid-six-percent range.

That is twice as many sales as occurred in 2005, which ranged from \$34,000/unit to \$65,000/unit, with CAP rates averaging 7.9 percent and is similar to the number of sales occurring in 2004, with pricing per unit ranging from \$32,000 to \$114,000, and average CAP rates of 8.0 percent.

Confused? SO are most investors. It’s hard to tease out the trend of the past three years, which is why most investors base their offers on an investment’s future prospects.

Any investment has two components- the return earned from its operation (known as cash flows) and the net sales price from a sale of the investment in the future,. The value an investor applies to any investment is influenced by factors such as the stability of the cash flow, the volatility of the market, and the chances of obtaining appreciation in the marketplace.

The stability of cash flow of an investment is impacted by internal and external factors. Internal factors are usually management- and resident-cased issues, often influenced by the property management company. External factors are unforeseen increases in vacancy rates, insurgence rates, property taxes, utility rates and other expenses.

Assuming a property is well maintained, New Mexico has lower insurance rates compared to states that suffer natural disasters year after year. Increases in property tax values are capped at three percent a year, and utility expenses are being pushed from the landlord to the resident, all of which minimize external influences on cash flow.

Market volatility has a large impact in how investors value a market. Many cities across the country depend on oil, technology or manufacturing for their employment base – sudden changes in these sectors (think dot com bursts, Enron and GM) lead to wild fluctuations in demand and values for real estate.

Albuquerque has diversified into a multi-pronged economy with businesses that are cushioned from many of these external global shocks.

Investors price appreciation in most apartment markets by analyzing two demand/supply relationships: the number of buyers/number of properties for sale and number of units to rent/number of tenant looking to rent.

The latter trend is fairly easy to determine. Take the current multifamily renter population (about 25.6 percent) factor in job growth (thanks to Albuquerque Economic Development, 3.0 percent++, and subtract out current supply (80,248 units) after adding any new projects coming on line, and then make an adjustment for a reasonable vacancy factor (4.5 percent).

Based on this, Albuquerque has demand for about 2,500 new apartment units a year, 1,900 more than the city can supply due to the lack of multi-family zoned land, sales tax on construction, increasing construction costs, and increasing development taxes, which have pushed the cost of developing an apartment to \$125,000/unit, up to 67 percent from the early 2000s.

So our fair city isn't producing enough apartments to match resident's needs, and as supply continues to decrease, rents will continue to rise (3.5 percent in the past quarter, forecast at 10 percent for 2007).

Once rent increases are factored into the model, the investors yield during the duration of the investment is significantly higher in Albuquerque than in a market with a higher CAP rate.

As long as Albuquerque continues to offer stable cash flows, low volatility, and the possibility of appreciation, it's a market to which investors will continue to flock.

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