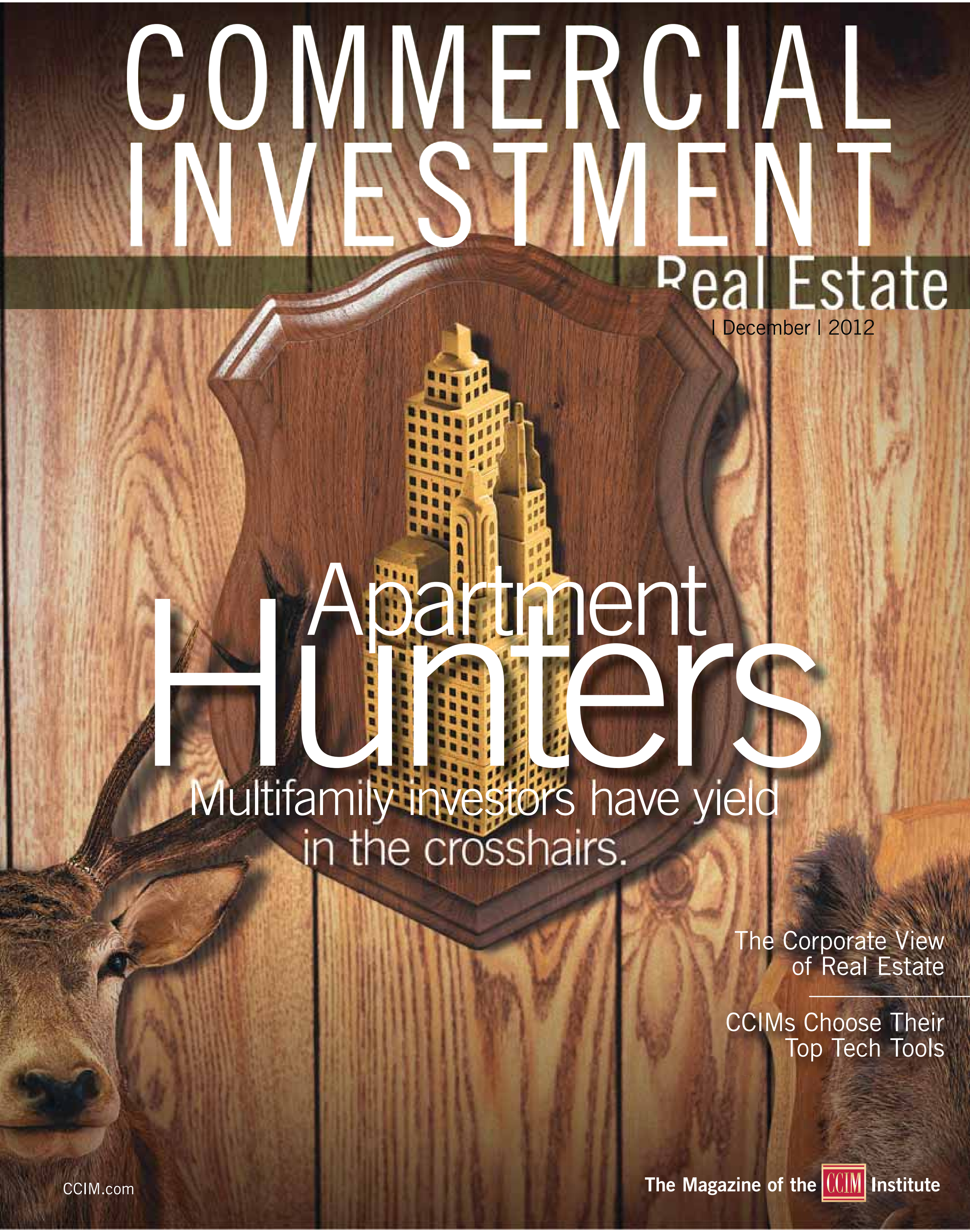
COMMERCIAL INVESTMENT Real Estate

| December | 2012



Apartment Hunters

Multifamily investors have yield in the crosshairs.

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Apartment Hunters

Multifamily investors have yield in the crosshairs.

by Rich Rosfelder

Apartment investors are on the hunt. And they're moving beyond trophy properties into unfamiliar territory in hopes of a rare catch.

In 1H2012, secondary markets posted a 38 percent year-over-year increase in multifamily transaction volume, followed by tertiary markets at 23 percent, according to Real Capital Analytics. Major metros saw only a 9 percent increase during that period.

What's driving this migration? "It's primarily a search for yield," says Ben Thypin, RCA's director of market analysis. Private investors, equity funds, and some institutional investors have tired of the competition driving down multifamily capitalization rates in core markets.

"It's gotten to the point where inventory and competition is so tight that my San Francisco buyer is willing to look at higher cap markets such as San Diego and Fresno," says Davide F. Pio, CCIM, CRS, LEED-AP, a broker associate with BCRE in Pinole, Calif.

The search for yield among class B and C multifamily properties in these markets is less common, Thypin says, but it is happening. Just ask the government.

"Over the last two years, I've seen taxing authorities become more aggressive in their valuations of multifamily property," says Jamie Sieffert, CCIM, director of Thomson Reuters in Carrollton, Texas. "Last year it primarily affected class A product, but this year has been pretty much across the board."

The government is following the money. Multifamily cap rates in secondary markets fell only three basis points YOY in 1H2012, according to RCA, suggesting that investors are increasingly turning to reposition plays for better yields in markets like Austin, Denver, and San Diego. Marcus & Millichap notes that class C multifamily occupancy was up 100 basis points in 1H2012 — the largest increase among property classes during that period. Plus, class B and C cap rates were 520 bps higher than the 10-year Treasury rate in 2Q12, compared with a 400 bps difference between class A and the 10-year Treasury.

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Yield is in the crosshairs. But how will demand for lower class multifamily properties in smaller markets affect the future of investment and development?

Adding Value

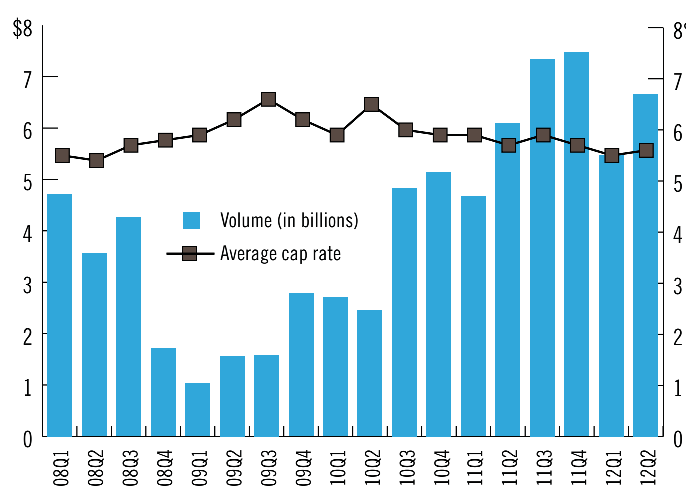
Today's multifamily investor is willing to compromise in search of the right deal. "Buyers are reconsidering their investment parameters to place capital," says Aaron Mesmer, of Block Real Estate in Kansas City, Mo. "That includes considering deals in second-tier submarkets, non-arterial locations, and other deal-specific complications that would have otherwise caused them to pass only 18 to 24 months ago."

This investor segment mostly includes private money, which comprised 65 percent and 66 percent of buyers in secondary and tertiary markets respectively as of 2Q12, according to Thypin. "Equity funds represent a bigger percentage in tertiary markets, and they're more likely to search among the lower asset classes," he adds.

Thomas McConnell, CCIM, associate director of Marcus & Millichap's National Multi Housing Group in Elmwood Park, N.J., recently sold an East Rutherford, N.J., apartment property built in 1979. The family owners had not pushed rents or made basic upgrades in many years. "I sold the complex at a going-in sub 5 percent cap rate to a private syndicate that was able to see the upside," McConnell says. "Within six months, the new owners had dramatically improved occupancy with simple upgrades and a very aggressive, hands-on management campaign." The property, which is located in a thriving transit-oriented community, is now stabilized at a 7.5 percent cap rate, he adds.

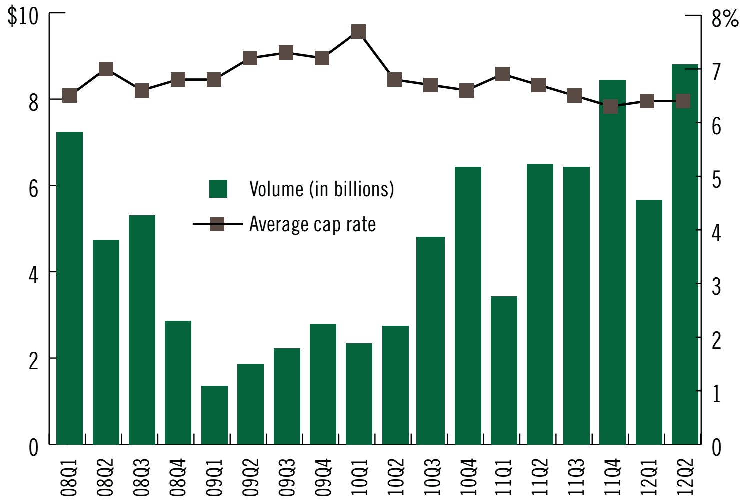
Multifamily by the Numbers

Major Metros



Source (all charts): Real Capital Analytics

Secondary Markets



Institutional investors remain cautious in secondary and tertiary multifamily markets, but they could begin to target some class B properties as class A opportunities dwindle. The Portland, Ore., area, for example, saw only five multifamily transactions greater than $10 million in 1H2012, says Anita D. Risberg, CCIM, principal broker with A.D. Risberg LLC in Salem, Ore. "The slowdown in this asset class has begun," she adds.

In the meantime, private investors are driven by what Solange Velas, CCIM, of Southland Realtors in Knoxville, Tenn., describes as a perfect storm: "You have prices that have returned to levels not seen since the 1990s, historically low interest rates, and a tightening rental market due to so many displaced homeowners competing with a steady increase in local population."

Conforming fixed-rate 30-year loans are "fueling the furor" among investors looking for apartment properties with two to four units in Velas' market. For Knoxville-area properties with five-plus units, local banks are offering five-year fixed loans with 20-year amortizations and 20 percent down requirements. "I tell my investors that there is a window of opportunity here that may last 18 to 24 months, or longer. It will be characterized by a firming of prices — no further decline, but no increases either." Velas says. "As long as interest rates stay down, this market will continue to rebound."

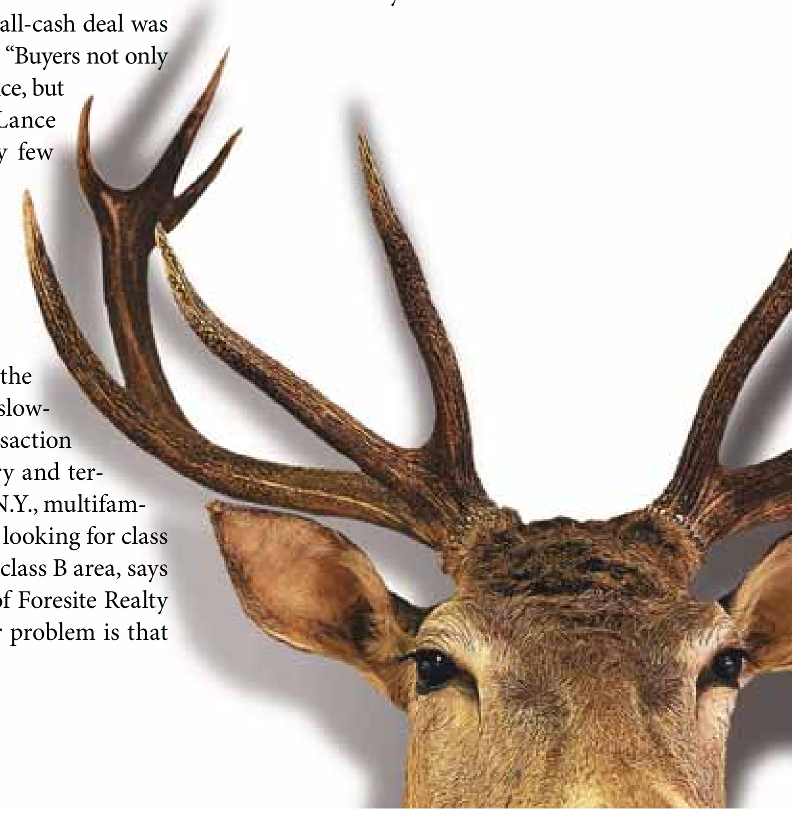
But a rebound also means increased competition in secondary and tertiary markets. T. Sean Lance, CCIM, managing director with NAI Tampa Bay in Seminole, Fla., recently represented a lender in the sale of a 600-unit class C multifamily portfolio in South Florida. His team sent out approximately 200 offering packages, led dozens of property tours, and ultimately received 17 offers that were at or above asking price. An all-cash deal was closed in less than 30 days. "Buyers not only have to be aggressive on price, but equally so with terms," Lance explains. "There are very few steals in the marketplace and most bottom feeders are coming up empty in their quest for deals."

Plight of the Hunter

The bottom feeders aren't the only ones to blame for a slowdown in multifamily transaction activity in some secondary and tertiary markets. In Albany, N.Y., multifamily investors are primarily looking for class B property, or class C in a class B area, says Robert Giniecki, CCIM, of Foresite Realty Advisors in Albany. "Our problem is that it's very difficult to locate owners who are willing to sell, and, if they are willing to sell, the cap rate may be below what a buyer is willing to accept," Giniecki explains.

Faced with a lack of available product, some multifamily investors are considering alternatives. In Philadelphia, for example, the few companies that control most of units are reluctant to sell as they can't replace the returns on their current holdings with other opportunities in the market, says Adam Gillespie, CCIM, senior vice president with SSH Real Estate. "One trend that we've noticed is owners buying out their equity partners instead of chasing new product to purchase in the marketplace," he adds. "These returns are usually at substantially higher rates than those achievable by purchasing new properties through a competitive process."

Smaller multifamily investors are turning to single-family opportunities. "The supply of single family in Knoxville far exceeds the multifamily supply and there is a great deal more choice in location and style," Velas says. A multifamily investor in her market recently liquidated most of his holdings and began purchasing single-family foreclosures. "He is the proverbial kid in a candy store," Velas says. "He told me recently that he bought a home sight unseen — unless you count the Internet



Tertiary Markets

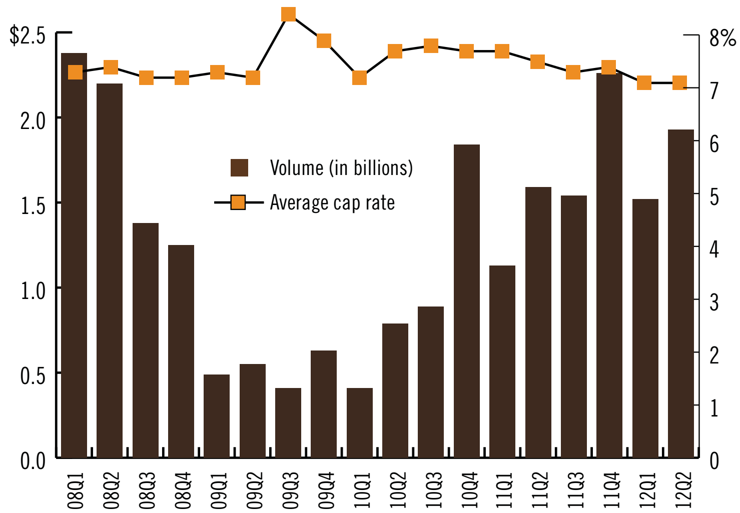


photo — at auction for $10,000. When he showed it to a local Realtor, he was told it was worth $30,000 or more."

There is hope, however, that multifamily deals will surge before year-end in these and other markets. McConnell says that reluctant sellers, who otherwise might not have considered selling until next year or beyond, could be spurred on by the potential capital gains tax increase. And some uncertainty remains about just how long this seller's market will last.

Fresh Units

Owners of existing multifamily product might also be motivated by the new supply that's poised to come on line during the next few years. New multifamily construction increased 45 percent YOY in July, according to the Associated General Contractors of America. In addition, developers acquired more than $2 billion in multifamily development sites in 1H2012, nearly double the volume for all of 2011, according to RCA. However, much of this activity is still concentrated in major metros and strong secondary markets such as Seattle and Raleigh, N.C.

Research firm Axiometrics is tracking 800,000 multifamily units that are still in the planning stage, but new deliveries are expected to total only 87,000 units and 129,000 units in 2012 and 2013, respectively. What's the holdup? Part of the problem is that developers are focused on more-difficult sites.

"We are seeing more gravitation toward infill sites with much more density than the typical three-story garden-style walk-ups that peppered suburban markets in the last 20 years," Lance explains. "We think this trend will continue as the demand for infill is strong with prospective tenants, and most equity groups prefer it over suburban right now." Lance has participated in the sale of six South Florida multifamily sites since 2010, and several similar deals are in progress.

Investors are probably wondering: What will happen when these units eventually come on line? Consider New Jersey, where builders are delivering 2,412 units this year, according to McConnell, a nearly fivefold increase over 2011. "With the influx of new starts, investors are keeping a watchful eye on their older, existing product," Mc Connell says. "On the flip side, I believe the new developments will cater to the folks who would have been home buyers a few years ago. The tenant going into the new product is in a different income bracket than the tenant going into the older garden community."

Demand for new properties is also driving multifamily development in Knoxville. "Though we already have some nice older

Statement of Ownership
Commercial Investment Real Estate Publication Number 1524-3249 Filing Date: 10/1/12
Published bimonthly by the CCIM Institute, an affiliate of the National Association of Realtors, 430 N. Michigan Ave., Suite 800, Chicago, IL 60611-4092.
Publisher and Executive Editor: Sara Drummond
Annual Subscription Price: $45 for nonmembers, $55 for Canada/Mexico

Extent and Nature of Circulation	Average No. Copies Each Issue During Preceding 12 Months Date	No. Copies of Single Issue Nearest to Filing (Sept./Oct. 2012)
Total Number of Copies	13,714	13,871
Paid and/or Requested Circulation		
Paid/Requested Outside-County Mail Subscriptions	12,421	12,446
Paid In-County Subscriptions	0	0
Sales Through Dealers and Carriers, Street Vendors, Counter Sales, and Other Non-USPS Paid Distribution	0	0
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Total Paid and/or Requested Circulation	12,442	12,451
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Other Classes Mailed Through the USPS	23	6
Free Distribution Outside the Mail	692	888
Total Free Distribution	1,169	1,250
Total Distribution	13,611	13,701
Copies not Distributed	103	170
Total	13,714	13,871
Percent Paid and/or Requested Circulation	91%	91%

complexes with typical amenities such as pools and tennis courts, we are seeing a pent-up demand for upscale, luxury-laden, well-located projects," Velas says. "The younger crowd likes the newer styling that's hard to replicate in buildings built in the 1960s and '70s." The vacancy rate for these new projects is under 5 percent and rents are approaching $1 psf. "I know this doesn't sound like much compared to the major metros, but up to this point, our most expensive rentals in the best locations topped out at 75 cents psf," Velas adds.

Potential tenants are looking at the price-to-rent ratio, according to McConnell. And in some markets, including New Jersey, effective rents are closing in on the max point. "When the rents max out, the tenants will be redirected back toward homeownership," he says.

But this scenario is a distant dream for many secondary and tertiary markets, and developers know it. Still, pursuing multifamily construction projects in smaller markets requires extra care. "Understanding the pipeline is critical," says Drew Dolan, president of Titan Development in Albuquerque, N.M. "In bigger markets, you might just need a great site."

Titan Development recently broke ground on the first phase of a multifamily development project totaling more than 460 units in Albuquerque. The first phase is being financed by a regional bank that had long-standing relationships with Titan and its project partner, Alliance Residential Co. And that's just the beginning. Titan currently has six more Albuquerque-based multifamily development projects in the queue.

After several years of developers and investors chasing 6 percent cap rates on multifamily in major markets, Dolan is beginning to see the first signs of change as those markets become overbuilt. "Dollars here can buy a lot more return than dollars in bigger markets," he says. "But by the time investors recognize the stability of markets like Albuquerque, they'll be too late."

Rich Rosfelder is associate editor of *Commercial Investment Real Estate.*

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THE TENANT OF THE FUTURE

Generation Y members are ready to leave their parents' house and find apartments that fit their needs. What does that mean for owners and investors? *CIRE* asked Todd Clarke, CCIM, CEO of NM Apartment Advisors in Albuquerque, N.M., to discuss how Generation Y is shaping the future of the multifamily market.

CIRE: What is Generation Y looking for in an apartment?
Clarke: Basically, they favor smaller, connected spaces in urban locations. Between college and age 40, this generation will likely hold a dozen different jobs, so they pack very light. Unlike Baby Boomers, who collect things like baseball cards, antiques, or jewelry, Generation Y collects digital things. ITunes is a great example. Plus, a higher percentage is single. They want their smaller personal space and larger communal space.

CIRE: What steps are owners taking to attract younger renters?
Clarke: They're adding more outlets with built-in USB charger ports in kitchens and bedrooms. Open storage spaces are also popular because Generation Y likes to see their stuff. And a Formica countertop in a cool color attracts more attention than a granite countertop. I recently made some of these changes to an apartment I renovated to chase Generation Y, which led to a 50 percent rent increase over the former tenant.

As for marketing, you can sell experiences. For example, tenants might not cook for themselves but offering them a map showing hundreds of nearby restaurants helps them create an urban adventure.

CIRE: What factors will shape the future of the multifamily investment market?
Clarke: The key demographics are Generation Y and Baby Boomers who choose to cash in houses and rent. On a micro level, both groups share a desire for urban, walkable neighborhoods with transportation access. On a macro level, both coasts and cities near the 30th parallel north are attracting renters. There are exceptions like Chicago, of course. And some markets, such as Tulsa, Okla., are adding cool amenities like skate parks in an effort to rebrand and attract younger residents. Access to airports will also be an important factor.