The Apartment Report™

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CAP RATES ON THE RISE

Cap rates inch closer to historic norms and open up the marketplace for deals priced at 2% to 3% higher caps from 2007 peak levels. While many previously active buyers are comfortable on the sidelines, **KJO Investments LP**, **Capital Assets Inc.**, **Campus Habitat**, **Olympus Property**, **Wesley Apartments** and JV partner **Westplan** snap up deals bearing 6% to 8% cap rates. However, even though sizeable funds are available for opportunistic deals, rising cap rates will not necessarily equate to a shopping spree as many buyers still exercise vigilance in the volatile capital market with weakening renter demand.

The higher the cap rate, the lower the implied value of an asset. Market trends suggest cap rates that increase to 7% implies a nearly 15% value decline, an 8% cap a 25% value reduction and a 10% cap rate a 40% cut in value. A few years back, these rates were at historical lows due to inflated appreciation expectations, cheaper debt and high LTVs, all of which marred the actual performance of the property. However, now that the equity pool is gone and property values depreciate between 20% and 35% on average since 2007, caps are on the rise and are expected to move up at least 100 to 150 basis points by year-end. On many deals, rates may need to increase 200 basis points before settling at historicals. Expect higher caps in tertiary markets (high-7% to low-8%), nearly 7% in secondary markets and 6% in primary areas. Class C assets in tertiary markets see the greatest cap rate adjustments in the last 12 months at 2% because of a 30% price decrease over the same period. Pricing drops about 12% for a Class A property in a primary market resulting in a 65 basis point cap rate jump. Core assets typically demand no less than 6.5%, while equity managers target at least 7% for value-added and opportunistic deals. On the development front, lender resistance does not provide a lot of incentive to developments, in spite of the potential to sell the asset at a lower cap.

KJO Investments buys the 172-unit **Buckner Village** complex in Dallas for under $3M and a sub-6% cap rate based on pro formas, in an all-cash transaction. List price was $3.2M. Buckner Village was built in 1972 on an eight-acre site. It was foreclosed on about 18 months ago. Almost 90% of investors originally took notice of the 60%-occupied property because of the HAP contract associated with 38% of the units. HUD lifted the HAP contract prior to closing. Buckner Village has 141,5000 s.f. of rentable space at about $0.80/s.f. The current market-rate complex's annual rent is $1.342M. NOI comes in at $350K. Cash-on-cash return is above 16%.

Capital Assets picks up 984 units in Tulsa, Okla., in a four-property buy: **Arbors of Southern Hills**, **Lakewood Park**, **Hunter's Creek** and **Sand Dollar on the River**. Capital Assets currently manages about 5,050 units in Oklahoma, of which nearly 3,300 are owned. The seller is NVHF, a non-profit that was over-leveraged at the time of purchase a few years ago, likely paying at least $30M, prompting the owner to sell. Capital Assets teams up with equity partner Moriah Real Estate Company and uses four loans to finance the $24M transaction. The trailing-12 cap rate is just under 8%. Fannie Mae provides loans to Hunter's Creek and Lakewood that are stabilized at above 90% occupancy, while **SpiritBank** finances Arbors and Sand Dollar that are more distressed below 80% occupancy. Expect Capital Assets to hold four to five years and execute about $3M in portfolio rehabs.

The four properties were built between 1972 and 1982. Arbors has 226 units in ones, twos and threes on 12 acres. Projected rent increase is around 5%, post rehab. Units measure an average of 947 s.f. and collect approximately $1.45M in annual market rents. NOI is $233K. Hunter's Creek includes ones, twos and threes ranging from 690 s.f. to 1,400 s.f. in a total of 206 units. Annual rent collection is $1.4M and NOI is $660K. Lakewood Park counts 224 units in only ones and twos. Rents average $431/month, tabulating $1.16M annual market rents. Sand Dollar has 328 units that generate $1.76M in annual market rents and $564K in NOI.

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Cap Rates On The Rise

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Capital Assets VP **Greg Wright** keeps his eye out for C+ to B- properties with at least 160 units, between $6M and $10M and generating at least 10% returns. The value-add buyer is currently in Tulsa and Oklahoma City and may add a third market in the future. Areas like Wichita, Kan., and Kansas City are likely. To date, Capital Assets doubles its 2008 acquisitions, already snapping up 1,256 units. Wright hopes to eventually manage 6,000 to 7,500 units.

Campus Habitat adds the **University Club at Howard** in Kalamazoo, Mich., to its growing portfolio. The buyer assumes an existing loan with **Wells Fargo Bank, N.A.** The Class A property sold for $17.5M back in 2004. The student-housing complex has 484 beds and sits across the street from Western Michigan University. The 2001-complex is 97% occupied. Units average 1,400 s.f. and rents are $330/bed. University Club will be rebranded under the Campus Habitat umbrella. VP of Acquisitions **Oliver Swan** hopes to acquire another three to four properties (and adding its eighth state by year-end), possibly touching the 4,500- to 5,000-bed mark. The portfolio currently stands at about 3,000 beds. Campus Habitat also starts raising its first equity that should be wrapped by the end of the year. Look for about $50M in equity commitments that will be deployed over 12 months.

Olympus Property bumps its portfolio to 3,300 units through the $19M purchase of the **Rancho Mirage** complex located in the Dallas/Fort Worth Metroplex. The cap rate was a little above 8% based on actuals. Principal **Chandler Wonderly** uses a 10-year fixed Fannie Mae loan at 5.67%. BlackRock was the seller. Rancho Mirage has 310 units and is about 95% occupied. The Class A property charges about $1/s.f. in rents. Expect one and two bedrooms. The acquisition fits perfectly with Wonderly's expansion plan of adding an additional 2,000 units in the next nine months. The company hires a new director of acquisitions to spearhead expansion.

In a 50/50 JV play, Wesley Apartments and Westplan acquire the **Dunwoody Station Apartments**, formerly known as Post Dunwoody Apartments in Atlanta for $47.4M with a cap rate between 7% and 7.5% based on actuals. A nearly 70% Freddie Mac loan through a local lender finances the deal. The 530-unit community was constructed in two phases in the 1980s and 1990s and is 91% occupied. Dunwoody has ones, twos and threes, measuring 1,026 s.f., on average. The partnership plans to invest about $2.1M in rehabs, including roof replacement. Wesley currently owns more than 6,000 units in the Atlanta area, while Westplan is a Dutch equity fund. Wesley typically likes value-added deals, over 200 units based on a five- to seven-year hold.

REFINANCE ON THE UPTICK

For lenders still engaging in financing, business is essentially thriving. The decline in mortgage rates trigger a flurry of refinancing activity to almost peak levels experienced in early 2000. **AFC Realty Capital Inc.**, **Alliant Capital LLC**, **Housing & Healthcare Finance** and **Biscayne Capital Partners Inc.** see multifamily refi transactions triple in some cases in the last six to 12 months, tapping the GSEs for most deals. **Ironwood Apartments, LaSalle Investment Management, J.C. Hart Company, Connecticut General Life Insurance Company** and **Deerbrook Garden Apartments Ltd.** ink Freddie Mac and Fannie Mae loans priced between $5M and $23.28M. Typical expected refi loan parameters: 5% to 7% interest rates, mid-70% leverage, five- to 10-year terms and 1.20x to 1.35x DCRs. Notes are typically non-recourse with adjustable rates.

More cracks will appear in the multifamily credit realm this year as total loan delinquencies notch up at least 40 basis points since Q4 2008. Maxed out existing debt, declining property values, revenue haircuts at least 5% and tighter underwriting pose a significant threat to apartment loans maturing in the next five years. Of loans payable between 2009 and 2012, less than 40% will qualify for refinancing. Floating rate CMBS notes issued between 2005 and 2007 that are due in 2010 to 2011 are especially at risk. Nearly $35B in CMBS loans mature in 2010, across all sectors. For apartment investors not maxed on credit lines, now is the best time to refinance. Facilities with 30% to 40% of available powder are the sweet spot for refinance deals.

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REFINANCE ON THE UPTICK

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LIBOR and prime rates artificially depress capital conditions and because bonds are not government guaranteed, private lenders are likely to charge higher interest rates in the 7% to 8% range — about 300 to 400 basis points higher than the GSEs. Prepayment rates also see a shift this year. While yield maintenance typically is unfavorable for refinances, borrowers are willing to accept the prepayment option. This is because interest rates are expected to increase in the future — one of the principal reasons to refinance now. If the loan is paid off when the prevailing rates are greater than the contract rate, it's easier to replace the investor's yield, and in some cases their yield may actually increase. However, if the prevailing rate at the time of maturity is less than the contract rate, it's harder and more expensive to provide the same yield to the investor. Prepayments typically have two-year lockouts with a 5% to 10% penalty in the third year that reduces by about 1% each succeeding year.

Refinance deals account for almost 100% of all of AFC Realty Capital's multifamily lending activity. Deal size is between $2M to $30M compared to $5M to $80M a few years ago. Majority of the private lender's loans are hospitality driven, and about 25% to 30% are multifamily related. The company typically does 10 to 20 multifamily deals a year, compared to 60 to 80 deals in hospitality. Principal **Paul M. Fried** spends most of his time on loan restructuring.

Alliant Capital's multifamily refinance activity stands at about 70% and aims to take advantage of the market share left behind by busted lenders. The $15.2M refinance loan for the **Villages of Royal Lane Apartments** in Dallas is an example of a typical Alliant transaction. The loan bears a 10-year term with a 30-year amortization. In 2008, the company funded about $430M in loans and hopes to do substantially more going forward.

HUD also gains the attention of borrowers seeking financing, and interest more than triples in recent years. Lenders like Housing & Healthcare Finance typically see approximately 20 FHA deals each year, averaging $8M. Refinance and acquisition make up the bulk.

Biscayne Capital Partners Inc., a real estate advisory firm specializing in senior debt, structured debt, bridge capital, mezzanine debt and joint venture equity, does about 20 to 25 deals a year, split 50/50 between refinance and acquisitions. Managing Partner **Scott Marchand** sees a lot more acquisitions in the marketplace because borrowers are still gun shy to jump on refinance deals, even though volume is greater than 2008. Biscayne's cash-out refi rates see little change in recent months with DCRs at 1.17x and LTVs up to 80%. All deals are HUD.

<u>Recent deals</u>

Ironwood Apartments in Rancho Cucamonga, Calif., refinances using a $23.28M. A non-recourse seven-year, adjustable-rate loan with Freddie Mac. Proceeds pay off an existing loan. Ironwood is a 260-unit complex with ones, twos and threes averaging 920 s.f. The property is 94% occupied.

The 408-unit **Harbor at Lake Howell** in Casselberry, Fla., gets $18.25M refinancing through Freddie Mac. The seven-year adjustable rate loan was made on behalf of LaSalle Investment Management, a subsidiary of Jones Lang LaSalle. The complex has ones, twos and threes and is 90% occupied.

J.C. Hart Company and its affiliate Payne Road Associates secure $8.45M to refinance the **Oak Lake at Crooked Creek** community in Indianapolis. The Freddie Mac loan bears a seven-year term, with a capped adjustable rate. Proceeds pay off an existing first mortgage. Oak Lake has 192 units.

An investment management subsidiary of Connecticut General Life Insurance Company inks a seven-year, adjustable rate refinance loan with Freddie Mac, totaling $18.5M. The non-recourse loan retires a construction loan for the **Mallory Square Apartments** in Tampa, Fla. The 383-unit complex was constructed in 2006.

Deerbrook Garden Apartments Ltd. refinances **Deerbrook Garden** in Humble, Texas, with a $5M non-recourse loan through **Wachovia Multifamily Capital**. The Fannie Mae note is priced at 5.83% fixed and replaces an existing CMBS loan. Deerbrook Garden Apartments Ltd. affiliated with The Angel Group.