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THE BIG CHILL

Multihousing brokers are certainly feeling the pinch. During a panel discussion at the Apartments 2008 conference in Los Angeles, hosted by Real Estate Southern California and GlobeSt.com on October 2, brokers from CB Richard Ellis (CBRE), Hendricks & Partners, Marcus & Millichap, Grubb & Ellis/BRE Commercial, Transwestern Multi Housing Capital and Sperry Van Ness all said their sales were off significantly from the previous year.

CBRE Executive Vice President Laurie Lustig-Bower reported a 50 percent drop in transaction activity from the $1 billion in sales her seven-person team closed in 2007, and she expects next year will be worse. Curtis Palmer, managing director for Transwestern Multi Housing Capital Advisors, reported his sales declined by 80 percent from the $1.5 billion of transactions he completed last year.

The cause is a confluence of conditions. Banks are cautious about real estate lending, equity financing also is still tough to come by and the spreads between buyers and sellers remain wide. Moreover, the seller distress many apartment players, opportunity funds and especially vulture buyers are waiting for hasn't materialized.

Marcus & Millichap Managing Director of Research Services Hessam Nadji, who gave the keynote speech at Apartments 2008, believes the market is colored more by the expectation of distress than by actual distress.

"I see a lot of concern about loan refinancing, but most of the (apartment) product is getting refinanced unless it has project issues. The concern centers around rollover of CMBS debt that is coming due over the next couple of years," he said, noting that there are from $20 billion to $40 billion in CMBS rollovers in the pipeline, but that the bulk of those maturities are out at least several years.

"Many sellers still don't have a compelling reason to raise cap rates to what buyers want and lenders are worried that cap rates are going to go up, so they are underwriting more conservatively," said Camden Property Trust CEO Ric Campo during the BMO conference on September 11. He thinks the cure to the impasse in the transaction market is an improving economic story, and believes the tale will be told next year.

"Will there be stress in the markets? Will sellers blink before buyers? What will determine that is what happens in 2009. If rent growth and the situation in the markets pick up, then sellers will be right. Buyers will come back in and buy because the economy will be fine and people will want to invest in multifamily. Buyers will have to pay up to get those properties. But right now there's very few deals getting done," he said.

Ed Pettinella, president and CEO of Home Properties, which owns nearly 37,000 units primarily on the East Coast from Boston to the DC corridor and in one Florida market, hasn't closed a purchase transaction all year.

"This is the first time in our public existence that we have zero to speak of. We're happy about that because the deals don't work. They are all dilutive," he said, but added the 14-year-old public REIT has a couple of deals in the pipeline that would be accretive, if they actually close. "My chief investment officer told me the other day that 76 percent of the deals we bid on and lost in the past year ultimately did not get closed," he said.

What differentiates deals that have closed from those that haven't?

Debt is definitely an issue. Of all our deals that have closed this year, over half have closed with assumable financing, said Sperry Van Ness Senior VP Kitty Wallace. She noted that on a recent deal where the buyer wanted to assume the seller's loan, the lender required defeasance or, in its absence, that the borrower have as much liquid equity in his apartment to match the loan proceeds.

CB Richard Ellis Director of Multifamily Capital Kyle Draeger is seeing a trend in the type of buyers actually closing deals move away from the pension fund advisors and opportunity funds that have prevailed over the past few years, to large private buyers, many of which have been less active on the buy side for quite awhile. "Today, regional buyers are more apt to buy properties in their regions when they see good opportunities, whereas before they often had been beaten out by the national players," he said.

And, according to info provided by Camden during the REIT's Investor Day presentation, the type of deals that buyers are chasing is changing, as well. Where 18 months ago buyers were hot for core assets, they began to favor value-add six to eight months ago and are lining up for distressed deals today.

Campo noted that the few deals he has closed with private buyers have been positive spread investing. "We sold about $160 million of properties. The oldest was 25 years old, with high cap ex. We sold them at around 6.5 percent caps and they are getting financed by Fannie and Freddie at 5.5 to 5.75 percent. When you put a rehab, or some sort of operating cost program in, people are positive spread investing and getting seven- to eight -percent returns on their equity with that kind of leverage."

Camden sold seven assets totaling 2,392 units so far this year — three in Austin, two in Dallas and one each in Las Vegas and Denver — and has earmarked another 2,990 units for disposition, with an anticipated cap rate of seven percent.

Lustig-Bower said that, while she is not seeing many foreclosures for sale from banks, there are some banks looking to sell notes that are tied to land or partially and/or totally completed condo deals. "Condo deals are just stuck. The land can't achieve the prices the developers paid for it and developers who bought for condos can no longer get financing and so they can't build it," she said, noting that to sell land entitled for multifamily, the deal would have to be priced to support apartment development.

"And I do think we are going to start to see plain vanilla apartment buildings being foreclosed on, people who purchased at four caps with short term debt and they need to refinance that and will have trouble because of stricter underwriting and decreasing property values," she said.

In order to successfully sell their apartment assets in the future, owner/operators should be focused on property management, renter retention and lowering turnover costs, said Diane Miramontes, principal of Grubb & Ellis/BRE Commercial.

Marcus & Millichap Executive VP Gregory Harris agrees. Maintain your occupancy and remain sensitive to the concessions you are giving, because the lenders, and, as a consequence, the buyers, are interested in the income the property is producing. And, having fixed-rate debt in place to offer to the next buyer is a great tool for sellers.

Especially since no one knows how long Fannie and Freddie will be supplying financing for multifamily, he said.

A market tendency that is becoming glaringly apparent would suggest buyers should adhere to the old tried-and-true real estate adage of location, location, location. "A trend that is most significant is the return of spread between quality of markets. Cap rates are rising much faster in secondary markets, and this flight to safety appears here to stay," said Nadji.

Meanwhile, REIT execs think public multifamily companies today have a distinct advantage in the capital markets over the private players and that advantage could lead to some private-to-public M&A activity when the privates need to refinance their portfolios over the next three years.

"Some of these three- to five-year loans that were done in the CMBS markets in '06 and '07 with very aggressive underwriting criteria and really high LTVs—if the market stays very conservatively underwritten the way it is today, they are not going to be able to refinance their properties. They'll be looking for a home somewhere and I think you'll see the public companies start to grow again by virtue of privates merging into public companies as opposed to public companies merging together," said Campo.

Essex Property Trust CEO Keith Guericke expects to find deals among a number of high-leveraged private equity types that have used mezzanine- type financing, when those loans come due. "A lot of them that didn't like the leverage of Fannie and Freddie, and wanted higher leverage, might be in the CDO or CMBS markets, and there might be buying opportunities for REITs like us that have low leverage ratios and plenty of dry powder," he said during the Bank of America 38th Annual Investor Conference on September 15.

Weston Andress, president and CFO of Colonial Property Trust, with 37,000 units in high-growth Mid-Atlantic markets and Texas, also expects to capture attractive accretive returns by investing in or buying thinly capitalized developers, as well as busted deals. "You haven't seen the excesses in multifamily that you have in other property types, but there still will be opportunities," he said on September 11.

But Pettinella thinks the distress is not widespread, because owners are not selling in his markets. Instead, they are pulling back or looking for free appraisals. He thinks those owners on the fence today will have to get serious about selling, or become distressed, before his REIT can get back into the acquisitions game and make the deal numbers work. "In my opinion, we have not reached that point for a player like us that likes a lot of B and C acquisitions," he said.

Mid-America CEO Eric Bolton thinks a window of buying opportunity is opening and his REIT is in a terrific position to capitalize on those deals "There are deals out there and it is likely that, with some moderation in leasing fundamentals fueled by the slowing economy and a more disciplined financing market, the acquisition opportunities are going to improve," he said.

Bolton believes the best acquisition opportunities are associated with new lease-up development, properties that are in markets with excessive vacant condo and single-family inventory, and properties that are facing near-term refinancing requirements.

Mid-America's approach to positive spread investing differs slightly from some it its REIT peers. "Being in a position where you are immediately accreting FFO is not what compels us to do a deal. We are an IRR buyer and look to achieve a return on capital that is well in excess of what the cost of our capital is," he said. Several years ago, Mid-America began shifting away from development and its inherent risk, choosing instead to predominantly buy new product.

The company closed on one newly built asset in the second quarter—the 313-unit Providence at Brier Creek in Raleigh-Durham and another, the 312-unit The Edge at Lyon's Gate in the Chandler/Gilbert submarket of Metro Phoenix, in the third. Also in Q3, Mid-America paid $38.5 million to Post Properties for the 14-year-old, 250-unit Post Oglethorpe in the Brookhaven neighborhood of Atlanta, changing the name of the asset to Sanctuary at Oglethorpe.

Those acquisitions were followed in late August by the acquisition of a four-year-old busted condo deal in Tampa out of receivership. The 234-unit Village Oaks at Tampa was completed in 2005 by a joint venture of Opus South Corp. and Florida East Development Inc. and sold for a record price of $153,846 per unit to condo converter Boca Raton- based EB Developers, which converted the asset and sold 19 units for an average price of $215,000, with some buyers paying as much as $259,900 per unit.

Mid-America bought the 215 unsold units for $21.2 million, or $98,837 per unit, nearly $14.8 million less than the condo converter paid for the property when the market was at its peak almost three years ago, and $11.2 million less than the converter owed its lenders on the asset. Executive Director Bryon Moger and Associate Luis Elorza of Cushman & Wakefield's Florida apartment brokerage services negotiated the sale on behalf of the receiver, Radco Management LLC.

"We acquired from Lehman the units that had not sold. Of the 19 units that had been sold, 17 of those units currently are in, or headed towards, foreclosure, and we expect to gain control over all the units over the next year or so. I don't know if it's a spread investment or not, but it's a great deal," said Bolton.

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