

Apartment buying in today's market ...What some big guys are doing ~ Short Hold

I have been assisting a large Orange County based real estate fund purchase small apartment buildings, in the 15 to 50 units range, in the Orange County area for the last 6 months. Their strategy along with others like them is to find value add opportunities for a short 3 to 5 year hold. Of course you need the right kind of financing (Leverage, Rate, Liquidity) to make this work.

What led to this interest in Class B Apartments in desirable areas where there is lower vacancy relative to other locations is due the following. First, the larger Class A apartments have led the real estate recovery starting 2 years ago and are what most funds were buying using their cash or their ability to secure attractive financing. The Class A property, especially apartments, have been what the large banks/lenders started to aggressively lend on and at interest rates much lower than the Class B property which accommodates lower Cap Rates. Therefore, with the available attractive lending, CAP Rates for Class A apartments have dropped into the 4% range making a short hold play unattractive. There is a low probability an investor could buy a Class A, do some minor rehab for curb appeal, increase rents, and sell at a profit in less than 5 years.

Next, you tend to get more return and are able to increase rents at a higher percent with older Class B property that may have not been managed by a professional property manager. Many of the Class B properties are owned/managed by individual investors for many years and tend to have lower than market rents for a number of reasons. It is amazing to see their rent rolls that show many of the tenants have been there for years without any rent increase even going back to years prior to 2008 and the recession. Small owners are hesitant and cautious of increasing rents and thus losing tenants. They would rather have tenants renew their lease rather than risk losing tenants. To make matters worse, many have offered unnecessary rent concessions which negatively affect the historical cash flow of the property and thus loan proceeds when a new buyer applies for a loan. Private owners simply do not have the time and resources to keep up with market data such as occupancy and rent per SF numbers and many are retired or semi-retired. The Class A property managers have the capital to subscribe to the expensive providers of data and they have the staff to efficiently advertise and find new tenants should some leave when there is a rent increase as well as respond to tenant's needs.

Thus going forward in 2011 and probably into 2012 there are many private real estate funds that are pursuing Class B apartment opportunities. They currently are able to justify a CAP Rate in mid 5% range with the idea of spending approximately \$10K to \$15K per unit in rehab and project rent increases by say 8 to 12% over the next few years for a minimum IRR in the 10%+ range. In addition to negotiating a realistic price that pencils and using reasonable rent

increase assumptions and rehab cost estimates, the right kind of loan is necessary.

Many banks in recent months have become much more aggressive in not only pricing small apartment loans with lower rates, but also have become more competitive with the underwriting mainly with higher leverage. In 2008 and 2009 many banks would not lend higher than 60% loan-to-value on a purchase transaction regardless of location. Today many are going to 70 to 75% LTV in desirable locations. Some even have lower DCR (Debt Coverage Ratio) requirements down to 1.15X.

An ideal loan for this "Short Hold" strategy would be high leverage to say min 70% LTV and Non-Recourse, with an option of interest only payments for a couple years, with fixed interest rates that are competitive with the large banks even FNMA. It would have a step down prepayment penalty structure to allow an early exit such as 3%, 2%, and 1% on a 3 year fixed loan. And it's absolutely necessary that the underwriting be user friendly to accommodate the buyers of these older Class B properties that often have "Tuck-Under" and/or subterranean parking, that may have been built prior to 1980 when new seismic building codes were implemented. For example, FNMA underwrites to a higher min. 1.25X DCR and usually will require a PML (Probable Material Loss) report for prior to 1980 apartments. If this PML study finds that there would be a greater than 20% probability of a complete loss when the "next big one" hits, then FNMA, and many banks for that matter, will require expensive earthquake retrofitting that usually results in killing the sale. For Class B property you need a lender that has greater flexibility in underwriting these concerns to avoid retrofitting. Lenders today will not underwrite Pro forma income, however, some will recognize the opportunity for the value-add play and likely hood of higher rents in the near future and allow items such as obvious capital expenditures in the seller's operating statements to be "backed-out" of expenses to allow higher cash flow and thus a larger loan.

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