



Investing in Apartments Today

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By Keat Foong, Executive Editor

Investing in apartments is a multi-part effort that involves determining return expectations, seeking apartments, conducting due diligence and exiting the investment. The economy and financing conditions have changed, and that impacts the apartment investment process.

One of the first questions is, how much return should investors seek? [Mitchell Bradford](#), president and partner of Sycamore Urban Properties, Irvine, Calif., says that investors seem to be continuing to seek IRRs north of 20 percent per year, and cash on cash returns of anywhere from 6-10 percent. But he notes that private investors seem to be able to buy at about 50 to 100 basis points lower than institutional investors. Cap rates in the Los Angeles area seem to continue to hover around the 6.5-7.5 percent range, while properties in Phoenix, Vegas and other over-supplied markets are trading at cap rates of 9 percent and greater.

After they determine their return expectations, investors can utilize a number of methods to seek apartments today. Jeffrey Friedman, president and CEO of Associated Estates Realty Corp., explains that his company has three major acquisition vehicles at its disposal when seeking apartments: brokers, potential sellers themselves and owners of portfolios.

Associated Estates' acquisitions team keeps in constant touch with owners, managers and lenders in target markets and submarkets. In this way, the company proactively keeps ahead of the competition in being informed about properties that may potentially be available for sale in the future. Associated Estates also keeps in contact with large portfolio owners regarding their divestiture plans. This makes sense as institutional investors, such as pension funds, are often culling their holdings.

There is also a lot of interest on the part of investors and developers in acquiring distressed properties and or mortgages today. The methods to acquiring such assets can

be similar to those for acquiring more conventional multifamily—with an emphasis, perhaps on reaching out to lenders in particular.

Bradford notes that very often, distressed multifamily assets may not even be in the market. One recent deal the company has been involved in was a note sale, whereby the bank did not want to take title to the property, says Bradford. “Investors can see only what are on file with the banks,” he says.

When companies find a deal that they want to bid on, some companies may conduct advance due diligence, an approach that can be taken in order to increase the certainty of closing and avoid retrading. This contrasts with the practice of throwing up a bid just to get one’s foot in the door. The importance of an investor having a reputation for certainty of closing is not to be underestimated, says Friedman. “Often, we are able to buy properties for which we are not the highest bidder because the seller understands our reputation,” he says.

For Sycamore Urban Properties, conducting due diligence on distressed properties may be a more delicate matter. Unless the seller is cooperating in a short sale by the bank, the feasibility study has to be “subdued, conducted silently and secretly,” says Bradford.

First, the physical inspection of the property is crucial to try and determine the completeness, quality and structural integrity of the buildings, says Bradford. Company staff may drive through a construction site, walk through a community open for sale or even just look over a construction fence. “While visiting the site, it also allows us to assess the status of the neighborhood and the potential rent ranges we will likely achieve,” he says.

Other sources of income estimates come from competitive communities, input from brokers, property managers and other property owners. The expense side depends on the type of product and amenities. “We tend to use historical estimates based on product type, area, age of product, and so on,” says Bradford.

In due diligence conducted for conventional apartment acquisitions that is undertaken ahead of the bid, the company will examine the information provided by the sellers, conduct a visual inspection, and decide whether the property is in a location in which it wants to invest.

After it has conducted the due diligence to its satisfaction, Associated Estates will make an offer based on its analysis, and if the offer is accepted, it will enter into a sales contract. Once the sales contract has been signed, the company will then conduct the third-party due diligence. “Until there is a contract, we will not invest in third-party reports,” says Friedman. The third-party reports are meant to ensure there are no unknowns that were not taken into consideration in the offer. “Part of the point of the due diligence is to uncover anything that is not noticeable in the visual inspection,” says Friedman.

Additionally, this is the point at which the lease file audit is conducted. Under a lease file audit, every lease is checked to make sure it adds to the pro forma rent that is contained in the sales packet and that concessions are taken into account. The expenses are also audited at this time. “On the expense side, we have a pretty good handle on what things cost,” says Friedman.

Because of their size and availability of resources, companies such as Associated Estates are able to perform their due diligence over a relatively short period of time. For Associated Estates, this is 15 to 30 days. The company’s in-house underwriting team is quite comprehensive, consisting of four to seven officers, including staff from the company’s acquisitions, operations and legal departments.

The apartment investment process for affordable housing departs in many ways from that of market-rate housing. In the case of Low Income Housing Tax Credit (LIHTC) projects, the developer remains in the deal to manage the property, and the investor holds the deal for at least about 10 years.

IRRs for LIHTC equity investments have doubled to more than 9 percent compared to two years ago, notes Tony Lyons, vice president and regional manager for the Northeast region of National Equity Fund (NEF).

Nevertheless, in affordable housing investing, calculating returns from a property is not as major a task, as prices investors pay for tax credits—currently about 65 to 70 cents per dollar of tax credit—are consistent across the board.

Another difference with market-rate multifamily investors is that LIHTC investors currently have more deals coming to them than there is capital available, so they do not necessarily need to seek out transactions in the market. NEF receives calls every day for investments, and the company is in the process of weeding out projects that it prefers, says Lyons.

A transaction begins with a developer approaching the investor after it receives an allocation of LIHTC from the state housing finance agency. The developer provides the application package containing information on the project.

In considering an application package, NEF would first look at the location of the property from the point of view of whether it is in an area in which its investors have a need to invest, says Lyons. “In the last one to one-and-a-half years, project location has become most important,” he says. Many of NEF’s clients are banks who are satisfying their Community Reinvestment Act requirements to invest in the communities in which they operate.

Second, NEF will consider the strength, experience and track record of the development team, says Lyons, such as whether the development team has completed previous projects. “We want to know that they know how to manage tax credit properties, and we want to know that they have experience,” says Lyons.

Third, NEF will consider the strength of the market. There are two standards the company imposes with regards to the markets in which it invests. Rents should generally be at least 10 percent below market. “We want to make sure the rents proposed are below market rents. This is mostly not difficult to achieve,” says Lyons. The second criterion is that the project’s market capture rate has to be under 10 percent—the project needs to capture no more than 10 percent of the total target market in order to fill the apartment.

If NEF decides it is interested in investing in the project, the investor will provide a letter of intent and a proposal that lays out the prospective purchaser’s terms and conditions for investments. If the developer agrees to it, due diligence will be conducted.

Under the due diligence process, which takes about 60 to 90 days, NEF will order a market study, conduct a financial analysis of the strengths and weaknesses of the developer and undertake a third-party site and environmental review. The company will also ask for data on other projects that the developer owns and comparables for properties in the same area to make sure the pro forma rents are realistic.

The underwriting is led by the acquisitions manager, with help from management, construction and financing specialists in the company. When it is completed, a detailed report is issued to NEF’s investment committee, which makes the final decision on whether to invest. The report will provide information on the project’s risks.

Sometimes, if the developer does not meet the standards or the market is not strong enough, or if a tax issue is uncovered, the investment committee can decide to not move forward on the project, explains Lyons.

Exit strategy is also very important in an investment program. Investors purchasing for the long-term would depend on cash flow, while those wanting a quicker, but riskier, return can afford to invest for the shorter term of three to five years.

Investors that are purchasing distressed properties analyze not just the going-in cap rate, but also the going-out cap rate. Sycamore Urban Properties targets distressed properties and Bradford says that his company would like to see a spread of 1.5 to 2 percent between the initial and exit cap rates.

“If you buy and sell at the same cap rate, the only way you make a profit is through cash flow or rent increases,” explains Bradford. However, Bradford acknowledges it is hard to predict what buyers will want to pay three to five years from now.

Financing for apartment investments today is available from Fannie Mae and Freddie Mac. However, when it comes to the purchase of distressed properties that do not have stable cash flow—they may not be stabilized or they may be vacant or partially completed—it is very difficult to obtain financing today.

According to Bradford, it is almost impossible to fund the acquisition in such cases unless the seller provides financing or it is an all-cash transaction. "Seller financing will help move the transaction," he says.

And the difficulty with all-cash transactions is that equity is more expensive and requires a higher return. The difference may be as much as 15 to 20 percent in purchase price, which few sellers may be willing to accept.