KRUPP
REPORT

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Bay Area Apartments: Rent, NOI, and Value Trends

Given the cyclical and somewhat predictable nature of real estate, it makes sense to pay close attention to where the real estate investment market is in its cycle. Combining this information with clearly defined real estate investment goals allows you to choose the best strategy for meeting those goals. Right now, economic trends strongly favor both immediate and long-range plans, so it's a particularly good time to reevaluate your investment goals and, if necessary, tailor your strategy accordingly.

Bay Area street rents have been increasing over the past few years. East Bay street rents have increased 7.65 percent from Q1 2007 to Q1 2008. South Bay and San Francisco street rents have increased 11.13 percent and 13.78 percent, respectively, over the same period[1]. It's the portion of street rents that trickles down after vacancy and expenses and becomes the NOI that is the most important factor that affects value and cash flow.

Figure 1 is a study showing collected income, operating expenses, and NOI from 2000 through 2007 for eight Bay Area apartment buildings totaling 985 units. This study reflects an average for stabilized Bay Area apartments that haven't undergone repositioning or modernization of the units. Major capital expenses were excluded. Data were

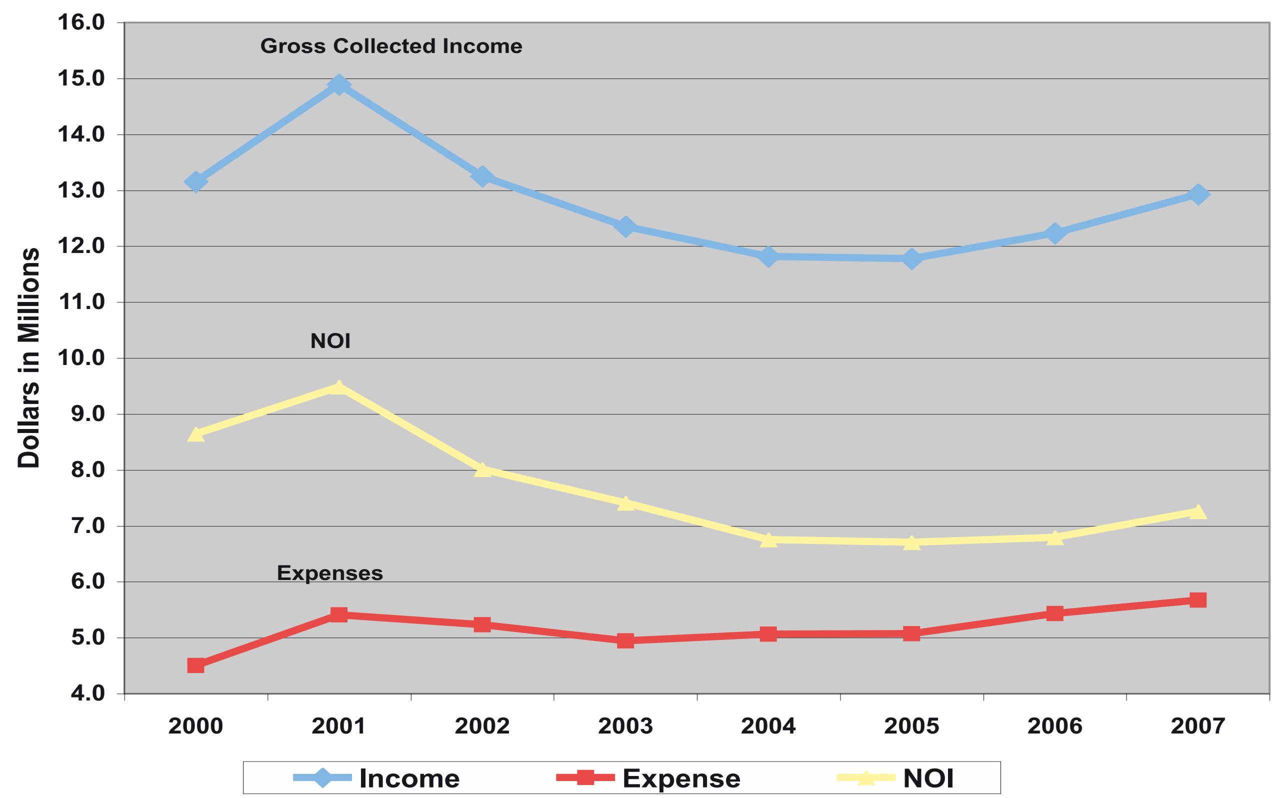

Figure 1. Collected income, operating expenses, and NOI from 2000 through 2007 for eight Bay Area apartment buildings totaling 985 units. All buildings have different property managers, some have different owners, and major capital expenses were excluded. Data obtained from actual income and expense reports.

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As shown in Figure 1, NOI for the group peaked in 2001, with a drop in 2004-5, and has been climbing steadily since. However, as of the end of 2007, NOI still remains 20 percent lower than 2001. Despite the sluggishness of NOI numbers, cap rates have dropped and values have risen during this same 2001-2007 period. This was a long run of increasing values and was driven by:

- increased liquidity in the lending market
- availability of interest-only payments (producing better-than-typical cash flows)
- high sentiment amongst buyers that NOI would increase at near-double-digit pace

Where are we now?

LENDING MARKET

The lending market is in the midst of an abrupt restructuring, and the availability of money is tightening. Fortunately, apartment buildings are not as affected as retail or commercial property, but they are still affected nonetheless. Fannie Mae offers the most competitive money available for apartment buildings, and Kari Noomen of Washington Mutual (a Fannie Mae DUS lender) recently quoted loan programs for fixed money ranging from the low to upper-middle five-percent range, with no options for interest-only payments. Fully amortized loan payments erode cash flow if values remain the same.

Noomen predicts that treasury yields will climb in the next 12 to 18 months from the near-40-year lows that existed in January and February of this year.

Currently, investors in mortgage backed securities are demanding much larger spreads due to the fears drawn from the sub-prime meltdown. This caused lenders of all types to increase their margins to borrowers. The return of a more functional secondary market in late 2008 and into 2009 could result in lower spreads from lenders, which would temper the increase in yields.

The eventual result from this dynamic will be that fixed-rate loans will revert to being more expensive than variable rate debt as is historically typical. This is opposite the current fixed/variable relationship.

Supporting this prediction, in his book, *The Age of Turbulence*, Alan Greenspan discusses the necessity of interest rates rising. He points out that while low interest rates are necessary now, the weak dollar and inflation will push interest rates higher in the future[2].

NOI FACTORS: RENTS AND UNEMPLOYMENT

As mentioned earlier, street rents are currently growing. However, in a speech to the Senate Banking Committee on April 3, 2008, Federal Reserve chairman, Ben Bernanke, voiced an expectation that "the unemployment rate will rise, payrolls will shrink, and home construction will fall." He hedged on the issue of recession, warning that there are too many uncertainties to accurately predict the future, but did say that the economy could begin to gain strength by the end of the year and trend toward positive GDP in 2009.

Depending on how much unemployment rises, we could see rent increases temporarily stagnate or slow. For reference, in recent history (2000-present), unemployment exceeded 6 percent early 2002 and reached as high as 7.5 percent during 2003. Figure 2 uses the gross collected income from the properties studied in Figure 1 and the Bay Area unemployment rate[3] as reported by the Bureau of Labor Statistics from 2000 to 2007. Gross collected income for the group began its decline of almost 20 percent when the unemployment rate rose above 6 percent (see Figure 2). As unemployment rebounded and dropped below 6 percent mid 2004, gross collected income began to stabilize. It wasn't until unemployment dropped below 5 percent that gross collected income began to rise.

As of March 2008, the Bay Area unemployment rate rose to 5.1 percent[4]. The Bay Area job market has been on the decline and the unemployment rate has been increasing since early 2007. The question to ask is whether the 6 percent unemployment range truly is a threshold for rising or falling rents as it was from 2001 to 2003. One would expect the length of time the unemployment rate remains above 6 percent and how high it gets above 6 percent will also be a factor in answering this question. However, if unemployment does continues to rise to some trigger point, rent growth stagnates or contracts, and inflationary factors drive up operating costs, NOI could also stagnate or erode as it did in 2004 (see Figure 1). The potential for this phenomenon creates uncertainties for investors with an ownership time horizon of one to three years.

EFFECTS OF A RISE IN CAP RATES

If rising interest rates, the elimination of interest only payments, and a more conservative risk tolerance cause cap rates to rise, NOI will also need to increase to prevent a loss in value. A change from 4 cap to 5 cap requires a 25 percent increase in NOI. Over a five-year period, this increase can be achieved with a 4.57 percent annual growth compounded in NOI (not street rents). Movement from 4 cap to 6 cap requires a 50 percent increase in NOI. To preserve value, a property would need to achieve an 8.5 percent com-

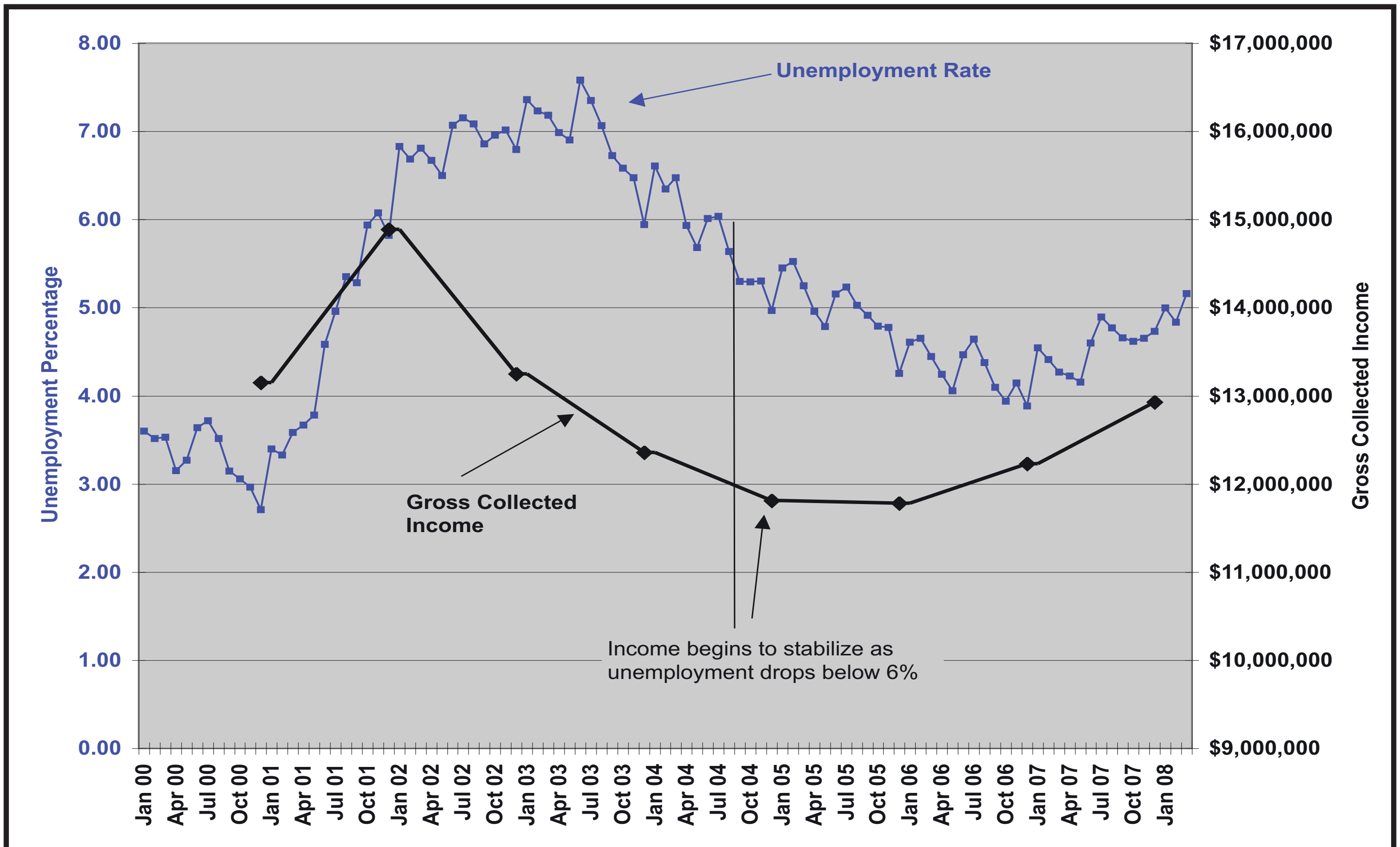

Figure 2. Collected income versus unemployment rate.

pounded annual increase of NOI for five years. This creates more potential uncertainty for the short-term investor, as the portfolio of properties surveyed in Figure 1 has only seen a 2.75 percent annual increase in NOI from late 2005 through 2007.

Strategies

IF YOUR CURRENT OWNERSHIP TIME HORIZON IS 1-3 YEARS

There are definite benefits to avoiding current market uncertainties and selling now. The data suggest that, given the economic factors discussed, the value of your real estate may well be the same in three to five years as it is today, with the chance of a drop in value somewhere in the middle. While nobody has a crystal ball, choosing the route with the least amount of uncertainty is arguably a sound choice. Owners of investment real estate with a shorter term ownership time horizon have greater risk of getting caught in the middle of the real estate cycle.

Although there are fewer total buyers, there are still active and aggressive buyers in the apartment market today. These buyers have longer term holding strategies and are still offering very competitive prices. Finding these buyers requires a non-traditional and aggressive marketing campaign. This campaign should encompass a phone and direct mail campaign for all nine Bay Area counties and an internet component with national coverage.

Most importantly, the agent you hire should be able to manage this process directly. That is, your agent should conduct a direct mail and phone campaign of 1500+ investors exclusively for your property and with no other listings the broker may have. This process should be managed directly by your listing agent. Lastly, from the very beginning of the marketing plan, broker cooperation is key. If your agent is not willing to commit to a specific number in a direct mail and phone campaign in the listing agreement for a competitive fee, (1.5 to 3.9 percent depending on the value of the property) consider switching to a different agent or brokerage company.

IF YOUR CURRENT OWNERSHIP TIME HORIZON IS 5+ YEARS

If you're committed to long-term ownership and your objective is to grow, there is something to be said for adding to your real estate portfolio while fixed debt is still cheaper than variable rate debt.

Diversify. Real estate investors often overlook diversification. Given real estate market cycles and, more importantly, Bay Area proximity to active earthquake faults, it makes sense to at least evaluate the potential costs and benefits of diversifying. There are numerous ways to diversify. Consider investing in other market locations, product types (apartment, retail, etc.), or even simply multiple properties in the same market.

If you're looking to diversify, look at leased commercial and triple net retail investments this year. These properties are more of a cash flow investment, producing as much as 30 percent greater cash flow than apartment buildings. According to JP Morgan as stated in *Business Times* on March 6, 2008, retail and commercial triple net values are down and expected to decline in value throughout the remainder of 2008 because of interest rates. This may provide excellent buying opportunities.

KNOW YOUR OPTIONS

Regardless of your ownership time horizon, having a broker perform a "buy-sell-exchange-hold" analysis can give you valuable perspective on your real estate investments in this market. This analysis demonstrates the results of "what-if" scenarios for increasing or decreasing income, vacancy, expenses, interest rates, and cap rates that you choose. The potential impact of your assumptions for these categories is calculated and the resulting cash flow and equity growth are shown year by year for any of your existing properties.

This information provides insight for decisions about increasing or reducing your ownership time horizons. Also, for those looking to exchange, a buy-sell-exchange-hold analysis can be performed for your property and a potential exchange property for a side-by-side comparison that compares both properties' cash flow and equity growth over a 10-year hold. This provides for an informed conclusion to either continue holding your current property or exchange it for another.

Combine buy-sell-exchange-hold analysis information with reports from other real estate analysts to make better, well-informed conclusions for balancing risk with management, cash flow, growth, and tax shelter objectives. Reaffirm or adjust your strategy to meet your real estate investment goals. No question about it—there is money to be made in this real estate cycle. The more data you have, the better your choices will be.

For questions, comments, or a discussion over complimentary lunch, I welcome your input.

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3. Bureau of Labor Statistics – Combined Oakland, San Francisco, Santa Clara metropolitan statistics
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