KRUPP REPORT

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Bay Area Apartment Investments: Finding Solid Ground in a Shifting Economy

The time has come to either affirm a long-term commitment to owning a particular property or take a close look at your alternatives.

In the April 2008 Krupp Report, we discussed how rising unemployment often portends falling rents (a dynamic that played out soon after publication) and how that makes it challenging in the short term to either refinance or otherwise maintain profitability, depending on the debt structure of a property.

In this issue, we expand on those theories in light of current market information. Specifically, we dissect some of the factors we believe influence rent levels, assess the current lending market, and review information from third-party sources before drawing some conclusions about the direction of the Bay Area apartment market.

Establishing a Trend

A targeted study of gross collected income for Bay Area apartment buildings provides a useful framework for looking ahead. Figure 1 shows gross collected income from 2000 through 2007 for eight Bay Area apartment buildings totaling 985 units. Gross collected income truly reflects the state of the rental market as it is net of vacancy and rent concessions. The study focused on

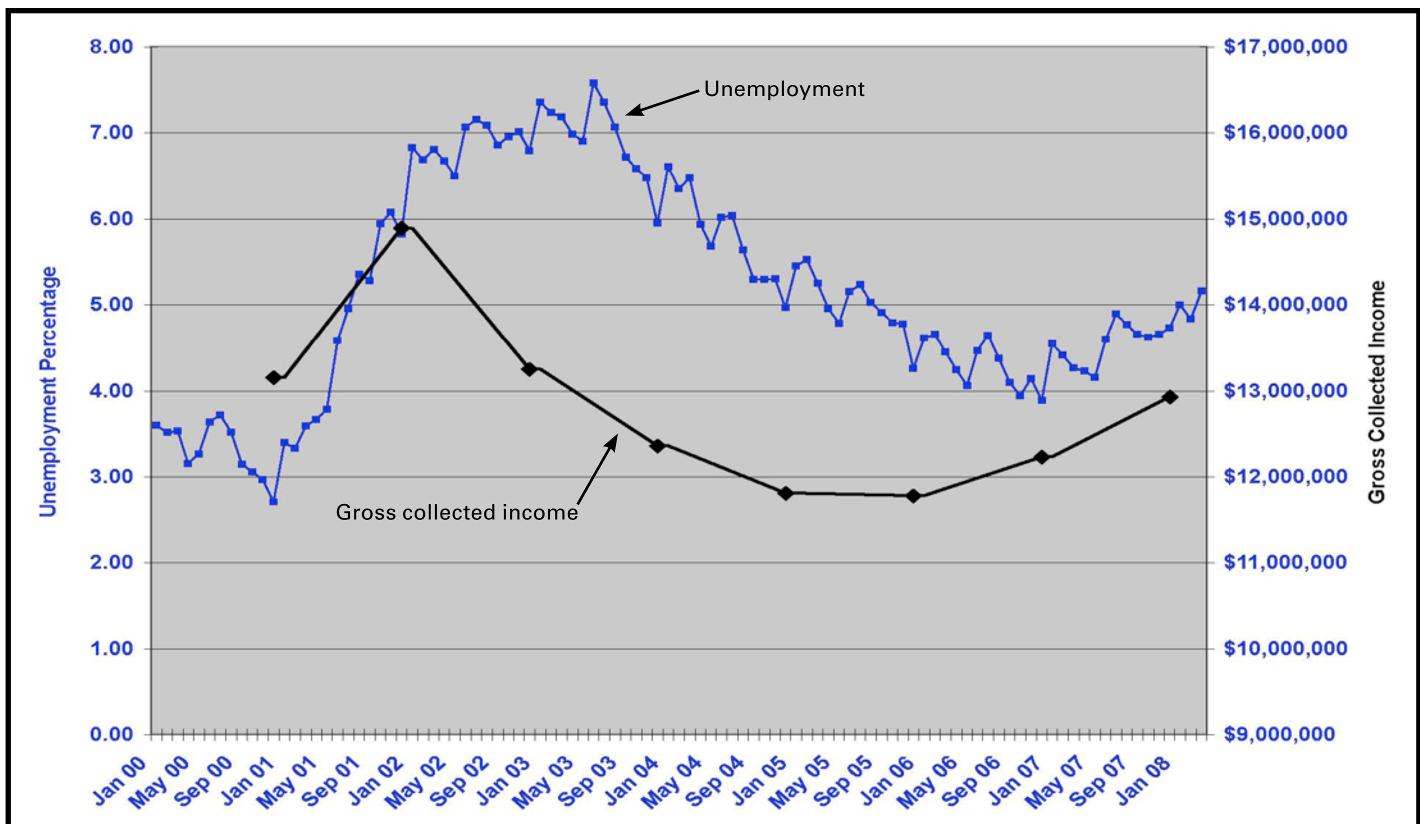

Figure 1. Collected income for eight Bay Area apartment buildings and unemployment percentages from 2000 through 2007. All buildings have different property managers, some have different owners, and major capital expenses were excluded.

buildings that were already stabilized and not undergoing a repositioning or modernization of the units. Data were obtained from actual owners' income and expense reports.

The data show that gross collected income for the buildings in the study peaked in late 2001. When unemployment reached 6%, apartment rents began to decline; as unemployment reached 7.5%, collected income for the buildings studied had declined by 20%. It wasn't until unemployment dropped below 5% that gross collected income stabilized and eventually started to rebound.

The current real estate cycle departs from the previous cycle in several important ways. In the previous cycle, it took one and one-half years for Bay Area unemployment to climb from 6% to 7.5%. According to the Bureau of Labor and Statistics, unemployment for the San Francisco – Oakland metropolitan area jumped to 8.5% and the Santa Clara metropolitan area skyrocketed to 9.5% unemployment as of January 2009. Second, a 20% decline in gross collected income was associated with 7.5% unemployment in the previous cycle. In contrast, Bay Area unemployment has currently eroded beyond 7.5%, leaving much more uncertainty about the magnitude of the decline in gross collected income for Bay Area apartments.

Factors Affecting Value Today

Despite the sluggishness of collected income from 2001 to 2007, cap rates dropped and values rose. This long run of increasing values in the face of falling income was driven by an extremely liquid lending market, the availability of interest-only payments (producing artificial cash flows), and bullishness among buyers that rents would increase at a near-double-digit pace. Unfortunately, none of these conditions exist today, and it is unlikely they will return in the near future.

THE LENDING MARKET

Bay Area multi-family and commercial lending professionals agree the 2009 lending environment differs dramatically from that of recent years.

Jim Pappageorge, a mortgage broker with JP Mortgage Financial, says loan volume has dropped substantially, estimating the current volume to be a mere 5% of what it was in 2007[1]. Ted Levenson with the Chase Financial Group (formerly Washington Mutual) agrees, citing a drop of more than 50% in loans in just the last 12 months[1]. Both noted that there are fewer large deals and much stricter loan requirements.

The number of lenders overall is also down sharply, although contrary to occasional rumors, Fannie Mae and Freddie Mac are still lending. Conduits that formerly financed loans with 80 percent loan-to-value (LTV) ratios are gone, and remaining lenders are unwilling to extend credit beyond 65% LTV. Levenson's take-away: "money is available, it's just more difficult to get." Pappageorge concludes that not only are there fewer lenders, but those remaining want to do fairly targeted loans.

BANK CLOSURES

Recent bank closures are partly responsible for the reduced pool of lenders. However, takeovers and mergers can also have a substantial impact on apartment investors' businesses. New lending entities may not share the same priorities as the original, and may even dissolve their multi-family property loan divisions, reducing investors' access to credit.

Cyclical Perspective: Values and Rents

VALUES

Bay Area apartment values are expected to drop during the first half of this real estate cycle. At minimum, apartment house values will decline in line with any reduction in gross collected incomes. Cap rate compression, if it occurs, will further erode values. Levenson observes that "trophy" properties are likely to see smaller decreases in value, while other properties may experience the full brunt of the changing rental market. He also confirms that investors are now much more focused on cash flow, as they can't rely on significant increases in property values over the short term. As a result most buyers are no longer willing to buy a property at a price that produces a break-even cash flow, as they were from 2002 to 2008.

Transactional volume in all Bay Area counties has declined rapidly—further evidence that buyers are more risk averse than they have been in some time. Sales comps also indicate a decline in all pricing indicators.

RENTS AND UNEMPLOYMENT

Both here and in the April 2008 Krupp Report, we've discussed the relationship between elevated unemployment and a decline in rents. Specifically, we saw that after a sharp drop off earlier this decade, rents did not stabilize and begin to rebound until unemployment dropped below 5%.

More recently, Bay Area unemployment has been on the rise since early 2007. At the end of 2008 unemployment reached 6 percent and, within a month of that point, rents began to decline—just as they had in 2002. According to a rent survey by Pierce-Eislen—which surveys apartment buildings of 50 and more units in Santa Clara, Alameda, Contra Costa, San Francisco,

and the Peninsula—Bay Area rents have declined across the board since September 2008[2]. Depending on how bad the unemployment situation becomes, we can expect more declines in street rents in the Bay Area.

According to Pierce-Eislen, since September 2008 rents per unit have declined in key areas[2]:

San Francisco/Peninsula	-2.64%
South Bay	-3.17%
East Bay	-2.04%

Integra Realty Services also foresees falling rents and values in the apartment market. Figure 2 illustrates an Integra[3] study of the apartment market cycle with selected California cities noted. The data seem to suggest that the Bay Area market is peaking and is entering a period of stagnant or decreasing rents and contracting values.

Reviewing Your Strategy

In my experience, buying or selling is largely a *conscious decision*, while holding is largely an *unconscious decision*—but a decision nonetheless. In times of economic turbulence, it becomes even more critical to make decisions that are both informed and chosen consciously after careful consideration of your options and beliefs about the market and the economy.

Following are one general recommendation and three discussions tailored to your strategy.

Recommendation: Invest the time to conduct a "hold analysis" of one or all of your properties (sometimes called an "internal rate of return" (IRR) analysis). This analysis takes into consideration expected rent growth, cash-flow, pay down of your mortgage, tax shelter, and equity growth over time. For example: Say you believe that rents won't change significantly over the next four years. You also believe that vacancy will increase to 6%. At the same time, you know certain expenses will climb irrespective of rent rates and you believe that the market cap rate for your building is likely to move from a 6% to a 7% CAP. How will your property perform over the next five years? Can it withstand stagnant rents while expenses increase for that duration? Let's add one other layer of complexity and assume you have a variable rate loan. How could these variables impact a note you may have coming due in 2012? Would the cash flow still be sufficient to maintain everything you need? Armed with an IRR analysis, you can get much clearer answers to these questions. You can also run multiple IRR analyses side by side with any options you would like to consider.

IF YOU ARE INCLINED TO HOLD

It would be prudent to run two IRR analyses using what you believe to be the best- and worst-case possibilities of this real estate cycle. Doing so would help you design a strategy that minimizes the downside(s) of this real estate cycle.

Two additional recommendations: pay attention to the re-renting process and take a fresh look at your marketing.

Staying abreast of the re-renting process is paramount. If a unit sits vacant for more than a few weeks, and you're sure it's priced right, sometimes seeing the re-renting process through the eyes of a prospective tenant can highlight areas for improvement. (Re-rent evaluations involve us sending someone to act as a prospective tenant. We then provide you with a detailed, written report

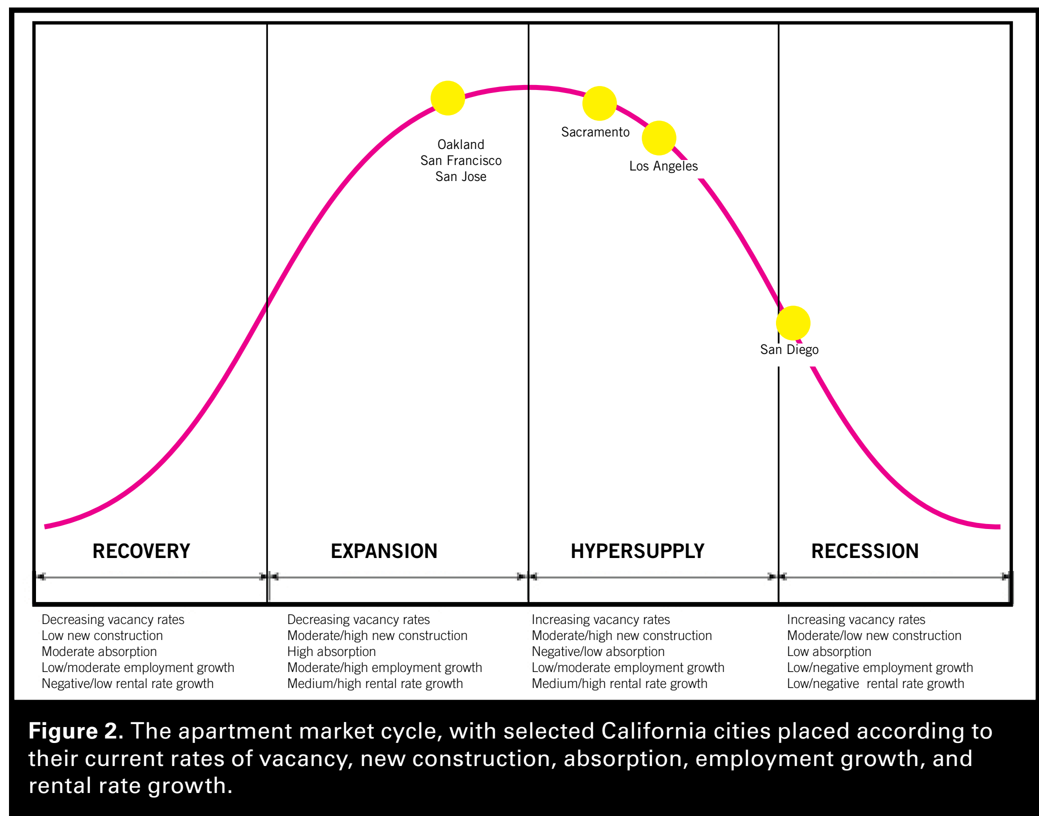

Figure 2. The apartment market cycle, with selected California cities placed according to their current rates of vacancy, new construction, absorption, employment growth, and rental rate growth.

that covers all the major steps—from the meet and greet process, through the showing, and to the manager's closing for an application and deposit.) Many owners have been able to cut vacancies by making a few simple adjustments to the re-renting process that cost them absolutely nothing.

Use of Internet advertising such as Craigslist has become more widespread. How will you make your ad stand out from the scores of others? Offering prospective tenants an online brochure—with pictures, a list of amenities, floor plans, local shopping, and proximity to public—is one of the most effective marketing tools. Even better, make it easy to download and print from your Internet ad. The resident manager should also have printed brochures to distribute to prospective tenants that visit the property. This is standard practice with national investment companies and real estate investment trusts. (If the cost of a brochure has prevented you from obtaining one in the past, we can design and print a brochure for you at no cost. Call us for details.)

IF YOU'RE INCLINED TO SELL IN 2 TO 4 YEARS

Start with an IRR analysis that looks at the ramifications of sticking to your guns versus either (1) holding through the entire cycle, or (2) shortening your time horizon and selling in the near term. Evaluate management and how the property would perform throughout the worst part of the cycle. In an IRR analysis, all of your beliefs can paint a picture of your property's likely performance through this cycle. If you are inclined to sell now, know that you don't need to pay a big brokerage commission to obtain a complete, fully cooperative, well-thought-out marketing effort that will still produce multiple offers even in this market.

IF YOU'RE INCLINED TO BUY OR EXCHANGE

Sometimes, the "right" deal comes up only once in 20 years. If you are a long-term holder of real estate, and you've found the right deal, it really doesn't matter where you purchase in a real estate cycle.

I had the luxury of driving a long-term owner through his favorite market. He remembered every deal he ever looked at and pointed out numerous properties that he could have purchased. One by one he told me, "I could have had that building for $42,000 per unit. It wasn't worth a nickel over $41,000 so I didn't buy it." Today, those same properties are worth $130K per unit. The lesson? If you have the right deal in the right location and you're able to look past the current and at least one subsequent real estate cycle, try to make the deal work. If the underwriting or due diligence doesn't make sense, a good broker should step forward and discussed the logic of walking away from a transaction.

Summary

Conditions in the investment real estate market are just as turbulent as the rest of our economy. At minimum, the viewpoints contained here may help you adjust your management strategies to minimize vacancies should the rental market move in the direction suggested by key data. But by identifying higher- and lower-risk strategies and sharing how we arrived at our recommendations, my goal is to help investors appraise their personal ownership strategies.

The need for market information without an agenda is more important now than in most other periods of the real estate cycle. Regardless of your interests or our current relationship, it's my practice to provide you data that I have, or know where to obtain, so you can choose a course of action that's best for you. People include me in their information chain because I am diligent in communicating not just the benefits I see, but the burdens, as I find little merit in accepting an assignment from a client who is not fully aware of the potential downside.

References

[1]Per phone conversations conducted, February 2009.
[2]Pierce-Eislen, February 2009.
[3]Integra Realty Resources, Viewpoint 2009, pages 5, 17. 2009.

For questions, comments, an IRR analysis, or a discussion over lunch, I welcome your input and feedback.

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