B, C Spell Opportunity

If yield is your goal, class A multifamily is bouncing back too quickly for you. But millenials and new conduit financing will help underwater B- and C-class properties get back in the game.

BY RYAN CLARK

Investors have been waiting out the recession and chasing yield where they can find it, but tepid job growth is still a major concern for the economy at large. Office, retail and industrial landlords will have a tough time filling space without a large dent in the 8.9% jobless rate; however, multifamily's fundamentals show increased demand, ROI, stable cap rates and a paltry construction pipeline. Overbuilt regions are still lagging, but the sector as a whole has rebounded faster than the others and a returning confidence among millenials will drive demand. The real question for investors is how much demand can pull the class B and C products back into the black.

Private purchasers, though, kept pace in 2010 by taking advantage of Housing and Urban Development monies as well as the ever-present Fannie Mae and Freddie Mac.

In January of 2011 alone, JP Morgan Asset Management grabbed the Liberty Towers in Jersey City for $280 million and AvalonBay Communities Inc. dropped $78 million for San Diego's Waterstone Carlsbad, not too far from the price it commanded before the recession. However, these were straight-up acquisitions, not the type of loan-to-own or REO strategies taking place in office and industrial over the past few years. So where are the multifamily distress sales?

Michael Kelly, president and co-founder of Greenwood, CO-based Caldera Asset Management, notes that a lot of multifamily has yet to hit the market but will in 2011. Furthermore, Trepp's 90-day-plus Delinquent Loan Analysis for the sector is 4.79% for February 2011 and has been growing steadily since January 2009.

"The difference is that multifamily loans were longer-term loans, so in 2010 and 2011, you didn't have the large amount of loans coming due," explains Kelly. "You don't have as much distress as in the other asset classes."

Mission Capital Advisors principal David Tobin points out that loan origination for the sector was thin. Because multifamily is so straightforward an investment, compared to other asset classes, the loan terms were made a bit tighter.

"Multifamily always has the lowest debt-service coverage-ratio requirement among lenders because it's the easiest of the property types to underwrite," Tobin explains. "You don't have any revenue concentration risk in an anchor tenant, for instance." Compared to other asset classes, multifamily comps are easier to come up with and are more subject to annual re-ups. However, this leaves multifamily exposed to the fickleness of the market; losses are instantly assessed on the books.

This worked advantageously for distressed class A product, though. With tightening fundamentals, some formerly distressed product is righting itself, and purchases from REO and servicers are

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Apartment property sales of $10 million or more clicked over $2 billion in January of 2011, according to Real Capital Analytics. Cap rates are holding steady at 6.7%, with only 14% of those sales coming from the distressed markets. Like everywhere else, REITs and institutional investors played a large role in buying, unleashing their pent-up capital to scoop up class A properties.

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being made at almost full price. "There's still class A and B-plus default," Tobin says. "But we've sold a number of class A multifamily assets this year and some of them go at 95, 96 and 97 cents on the dollar, even if they're not performing. Investors think they can get control of the property pretty quickly, there's plenty of agency and CMBS financing available and, again, the value is ascertainable. It's clearly the most liquid property type, and it's the focus of all the renewed interest in doing conduit loans."

Ronald S. Ladell, vice president of development at Alexandria, VA-based AvalonBay, points out, "People won't forget that one of the biggest problems when the recession hit was a lack of liquidity." Access to capital was a major factor in multifamily's quicker recovery, he explains. Fannie Mae and Freddie Mac funding buttressed the sector while other food groups were waiting on money from limping banks, leery private investors or the decimated CMBS marketplace. Purchasing power was not slowed as long as the government-backed agencies were involved. "Clearly one of the benefits of multifamily was that the GSEs provided liquidity, whereas in retail, office or industrial, there was no comparable governmental entity."

So what's available to buy if an investor is looking for yield? B-minus and C product are falling into special servicing and will continue to do so at a higher rate, explains Kelly. "There's very little demand for the B-minus and C stuff," he says. "A lot of them are just sitting with the servicer, and when they come out have to be all-cash buyers." Since there is not a lot of financing for that kind of product, they can sit in the "black hole" of servicing for at least a year.

But the housing crisis may save the day yet. "The myth that buying a home is always a good investment has been shattered," says National Multi Housing Council senior economist Mark Obrinsky, based in Washington, DC. "Even if they're going to buy someday, renters feel no urgency because prices for houses aren't going up any time soon.

"One of the things that contributed to the defaults was the fact that, over the past six or seven years, there has been a huge movement of the highest-quality renters into homeownership," Tobin explains. "And on a macro level, that has reduced the overall tenant quality—however slightly—across all multifamily stock. That reduces the credit as well as occupancy and collections." The return of those "high-quality" tenants to the rental pool bumps everyone down, helping fill in some of the B and C product. And let's not forget the millenials.

The graduates of the mid-2000s earned the dubious moniker "boomerang kids" as they fled rental units to go back home to mom and dad or doubled up with roommates as the recession killed their jobs. But the slow addition of jobs—100,000 to 150,000 per month in 2010, on average—along with a decline in layoffs has instilled a sense of confidence in the market.

Construction is also facilitating this bumping effect. A still-limited pipeline, left over from the recession, helps increase demand, with the exception of previously overbuilt markets such as Florida, Arizona and Nevada. (Phoenix's apartment vacancy is hanging around 15%). But nationwide vacancy is actually closer to 6% for 2011. Kelly notes this is more a class issue than a regional one.

Tobin sees the rising occupancy and the B and C products coming out of servicing as a good opportunity. Whereas now there is little cash waiting for this, it won't be empty of financing for every long. "A-quality multifamily is really being driven by financing from Fannie and Freddie," he explains. "B and C quality is being driven by the availability of conduit financing, which is exploding. You've got every conduit out there restarting and new ones launching. Their strong preference is for multifamily yields over every other property type." ■

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