San Francisco Bay Area Apartment Valuations

March 2013 | Written by **Edward T. Hanley**, Principal at Shea Labagh Dobberstein; Kenneth Miller, President at Guardian Capital Advisors; Yates McKenzie, Managing Director at Stella Capital

So what's driving today's appetite for real estate risk in the apartment sector in particular? We think it is principally two factors; leverage, and the search for yield. The need for yield is obvious, but we'll leave it to others to prophesy on how that problem might resolve. Meanwhile, with the ten-year Treasury currently hovering a touch below 2%, a 3% premium over Treasury rates appears attractive. But, is it sufficiently rewarding of the risk of the inevitable rise in interest rates and, in turn, rising cap rates?

Today, apartments in particular are regularly trading at cap rates below 5%, and some are being developed to sub-5% pro-forma cap rates. Yes, apartment rents have been on a steady, albeit gradual rise since the depths of the recession, but with cap rates so low, many, many years of consistent growth must occur before unlevered cash flow returns meet or exceed long-term historical interest rates.

When you look to refinance or to sell a property in the future, what will the cap rate be? This "exit cap rate" is the elephant in the valuation room. For example, if, after 5 years, a cap rate goes up from 5% to 7%, then the property's cash flow would need to have grown by 4.5% every year in order to refinance the debt at the same loan-to-value. It bears pointing out that this compounded 4.5% annual cash flow increase is not simply a 4.5% annual increase in rental rate. The rental rate increase would need to be significantly higher to overcome inflating operating expenses.

Anyway, this sales example better illustrates the pain: An apartment property purchased today at a 4% cap rate, with aggressive annual NOI increases of 5% and sold at a 4% cap rate at the end of five years generates a 9% unlevered IRR. If sold at a 5% cap rate, the unlevered IRR drops to 4.8%, and if sold at a 6% cap rate the IRR is only 1.6%. 7%+ would be disastrous, so we'll stop there.

Future cap rates represent a very substantial risk to buyers of property in today's market. Our view is that with cap rates all but certain to rise as interest rates increase, the risk is not now being rewarded appropriately in the apartment market. On the other hand, a good bit of the small commercial real estate out there strikes us as priced attractively. That is, priced on reasonable assumptions about economic fundamentals, i.e., cap rates which reflect little growth but a meaningful risk premium.

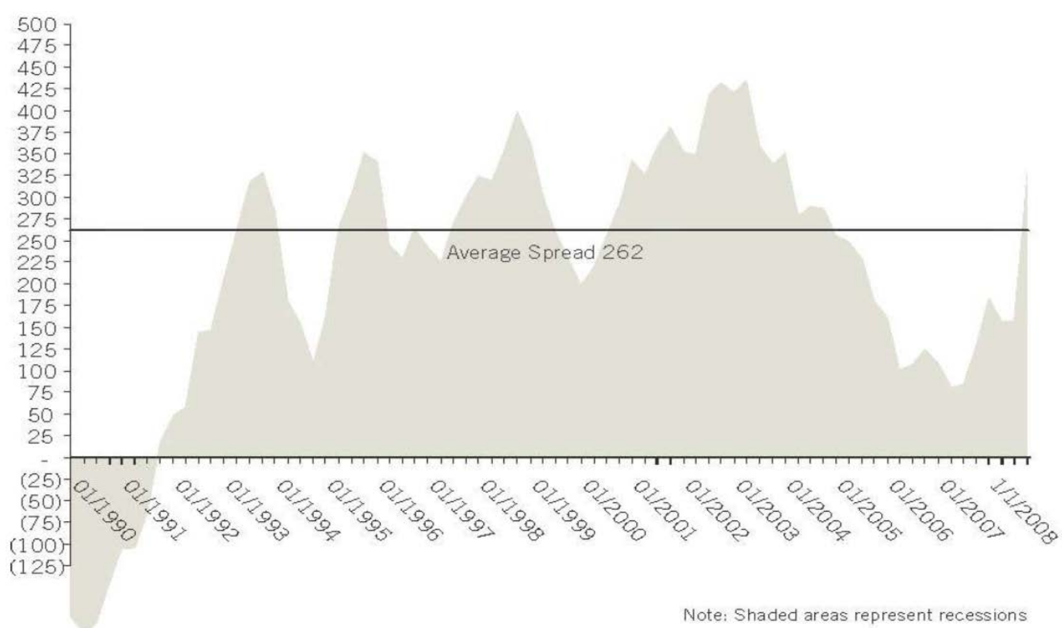
The charts below show first, that, across all commercial property, the long run average cap rate is 7.62%, and, second, that, historically, the spread of cap rates over Treasury's is 2.62%.

Chart I

Source: NCREIF

Chart II

SPREAD – CAPITALIZATION RATES VS 10 YEAR TREASURY YIELDS 1992-2008



Source: NCREIF, The Federal Reserve

The lower left corner of Chart II above points to a condition which generally existed back as far as the data goes (The NCREIF index began in 1978. The National Council of Life Insurers compiled cap rate data as far back as the 1950's). Cap rates seldom exceeded borrowing rates until about twenty years ago. Cap rates have usually exceeded borrowing rates ever since, and ever since, investors have been stepping on the leverage pedal.

Until about twenty years ago, real estate investment was viewed largely as an inflation hedge; as an appreciating asset. After the S&L crisis reached its end and rates dropped markedly in the 1991 recession, vast amounts of real estate were cobbled together from the carcasses of S&L's into more centralized ownership, where the income streams could be better passed through to investors. Almost out of nowhere, counter to many decades of valuation, current income became the critical component of commercial real estate values.

Cap rates increased to reflect a newfound sense of risk about commercial real estate and to reflect an emphasis on current income, not property appreciation (putting more emphasis on current income than on appreciation means higher cap rates). Borrowing rates declined at the same time, a wave of debt capital followed, and financing became a driver of real estate transactions, not just a factor.

Many CRE transactions became financing transactions with a real estate component, rather than real estate transactions with a financing component. Investors stopped seeking leverage just to amplify the returns generated by property inflation and started levering up the difference between borrowing costs and a property's income. No better example exists of this than the current apartment sector. Until four or five years ago, 90% loan-to-value was common. Still today, apartment property leverage, largely sourced from government entities HUD, Fannie Mae, and Freddie Mac, commonly runs to 75% loan-to-value or more and at interest rates closely following US Treasuries. As we've seen time and time again, highly levered returns look great until they don't. Then they look really bad.

To be clear, we're not saying that the availability of debt shouldn't play a role in the attractiveness of a real estate investment. We recognize that there is such a thing as an optimal mix of debt and equity. After all, debt is tax deductible, and when times are good it greatly amplifies equity returns. But it is as established a principal as any in finance that, absent a few caveats such as those above, an asset is not worth more because it can be levered highly and/or cheaply. All else equal, the composition of the right side of a balance sheet shouldn't affect the size of the left. Unfortunately, as we have seen time and again throughout the various real estate cycles over the years, as the availability, cost, and amount of leverage becomes more attractive, cap rates compress and real estate prices rise.

This is the situation we find in today's apartment market. Debt financing through US government agencies has been cheap and plentiful for some time now and consequently, cap rates have fallen to historic lows. At what point and when will the course reverse? We do not know, but it is inevitable and it will be painful for many of those investing at today's cap rates.

So our further proposition is that value should be calculated first without leverage. Once the fundamentals have been assessed, then one is free to layer in a financing transaction. First, one should home in on growth rates and on underlying risks. In our experience, many apartment investors in particular don't do this. They start with a desired return to equity then they layer in the best available debt terms in order to value the asset. Doing so clothes the transaction in financing risk more so than in real estate specific risk and therefore changes the risk profile of their investment. All else equal, by using financing to back into a value, they have lowered their risk-adjusted returns.

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Ed Hanley has extensive experience in providing business and tax advice to closely-held businesses and their owners and to high net worth individuals and families. Ed has vast experience in all aspects of the real estate industry with a focus on developers, owner-operators and partnerships. Having been through a few real estate cycles over the past 25+ years, Ed has a specialty in tax planning for short-sales, foreclosures, work-outs and debt modifications.

Ed started his accounting career with Ernst & Young, LLP's Boston office. In 1991, he transferred to Ernst & Young's National Tax Department in Washington, D.C., where he specialized in real estate, partnership and S corporation taxation. Ed also served as a tax counsel at GE Capital in Stamford, CT before returning to public accounting. SLD recruited Ed to the West Coast in 2002.

Ed received his A.B. in History & Economics from Harvard College in 1983 and his J.D. from Boston College Law School in 1986. He was admitted to the bar in Massachusetts in 1986.

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Yates joined Stella Capital in 2010 to lead the investing and management operations of a real estate opportunity fund. Prior to joining Stella Capital, Yates spent a number of years with a San Francisco Bay Area development firm and developed numerous commercial projects for the company. Prior to that, Yates spent the better part of a decade with a real estate investment management firm and investing into various projects on behalf of a number of pension funds.

Yates has been involved with numerous industry organizations over the years and holds a Bachelor of Science degree from the College of Charleston in Charleston, South Carolina.

About Shea Labagh Dobberstein (SLD)

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