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MULTIFAMILY ROUNDTABLE

Industry experts weigh in on the state of the Midwest multifamily market and what the future holds.

Compiled by Dan Marcec

The past couple of years have been a mixed bag for the Midwest multifamily market. On one hand, the rental apartment market has been booming, as more people turned to renting. On the other hand, condominium development ground to a halt and many of the gleaming, amenity-filled towers that were all the rage a few years ago are having trouble finding buyers, if they haven't already been faced foreclosure. Of course, every market is different, so what may be true for one major market may be the complete opposite for another.

That being said, this month Heartland Real Estate Business brought a who's who of the Midwest multifamily market to have them talk about what the market currently looks like, what's hot and what's not, and what the future holds.

HREB: In what markets and for what types of multifamily properties are deals getting done? What are some of the largest multifamily sales that have occurred in 2011?

Tom Lorenzini, managing director with Tremont Realty Capital: The traditional adage of real estate is holding true — deals are closing in the markets where supply does not meet the demand. In most markets, the lack of readily available new supply, coupled with the increasing difficulty in qualifying for home loans, has resulted in a captive rental audience for landlords. Class A properties are the most visible and desired properties in this product type and, as a result, have attracted institutional money to the Chicago and Minneapolis-St. Paul markets. Smaller markets such as Indianapolis, St. Louis and Milwaukee are also seeing activity; however, these transactions are smaller Class B/C projects in the \$5 to \$15 million range. A common theme among the larger properties trading is strong occupancy with year-over-year revenue growth. According to figures by Appraisal Research Counselors, dollar volume of Chicago apartment building sales year-to-date is already the highest it has been since 2007, which was an all-time high.



Lorenzini

Jeff Stingley, associate with the Kansas City, Mo., office of CB Richard Ellis: Low-leverage, trophy deals are getting done where buyers are securing low-leverage debt. At 50- to 60-percent loan-to-value, the life companies are beating the agencies with very attractive 7-year money. Fannie Mae and Freddie Mac are stronger on higher leverage transactions — typically well-maintained, well-located suburban properties with some value to be added.



Stingley

The three preferable product types are urban core; suburban, Class A, garden-style; and well-located, value-add opportunities. Distressed deals are also getting done across the Midwest, especially in Kansas City, where there were 10 distressed sales in 2010 — over half of the total transactions for the year.

Joel Kaplan, vice president of multifamily finance for Walker & Dunlop: The difference between this year and 2009 through 2010 is there are more value-add properties hitting the market. "Value-add" is one of those descriptors that can mean many things, from neglected common areas and amenities, all the way to the need for significant rehab in the units themselves. Transaction volumes are up thanks to more capital coming into the market under the "structured finance" model. Once again, another phrase that has many definitions but one commonality — a clear-cut plan in terms of timing, hurdles to meet and proper exit strategy that matches the shelf life of the capital and the yields its sponsors seek.



Kaplan

HREB: What is the status for multifamily development activity in the Midwest markets? What areas are hot, and for what type of product? For what reasons?

Lorenzini: The Chicago market currently has approximately 5,000 units on the drawing board. While experience says all these units will not be delivered, this estimate does speak volumes about the capital sources looking to invest in multifamily development projects.

Most development money nationally is targeting "core markets". Other smaller Midwest markets are seeing very limited development activity. In markets such as Detroit, Indianapolis and Columbus, Ohio, there are a larger percentage of overall distressed products that need to be cleared before new construction can begin.

Stingley: In the last year, Kansas City has had over 1,200 units delivered to the market — modest, historically, but an improvement over recent years. Primarily, these deliveries were in downtown Kansas City and Overland Park, Kansas — areas with strong fundamentals that can support lender and equity requirements.

Trends in new construction for apartments include condo-quality finishes and high-end amenities. For urban core construction in markets with an established public transportation system, parking ratios are dropping, as fewer residents have or want a car.

Mathew Dougherty, director of business development for McShane Construction Company: We are primarily seeing downtown product. With that comes high density and, almost naturally, mixed use. The other hot market is affordable housing because of the financing options it lends itself to.



Dougherty

Student housing is hot because there hasn't been a lot of new product in a long time, both for on-campus housing as well as the private development side, which is getting a foothold in the market as we speak. Senior housing is starting to ramp up, but it doesn't have as much velocity as the other types.

On a different note, every job we're looking at has a sustainability element to it. Developers want to use that for apartments as a point of differentiation, but it's tough to call it that because everyone wants to do it. You do not see the paybacks on it now — maybe indirectly for competition purposes — but not higher rents, so for construction it's really about finding lower-cost but effective LEED elements.



Powell

John Powell, senior managing director of RED Capital: There is an increasing interest in development activity, especially in markets where cap rate compression has significantly bid up prices. Some investors are finding they can't get to their target yields at some of the current asking prices so they are turning to development.

Banks are rather quickly putting their toes back into the construction lending waters, which is helping to accommodate the renewed interest in development. Clearly, focus will be on developers with very strong track records and good balance sheets.

Kaplan: Within five miles from the center of downtown Chicago, there are more than 3,400 rental apartment units either in construction, near groundbreaking or searching for financing. These units will become available starting in the first quarter of 2012. Development in the suburbs is not nearly as active. The main drivers for this are a lack of demand at existing properties coupled with condominiums "converting" to rental units. There are submarkets with exceptions to this comment, but they are pretty scarce.

HREB: What are the challenges you're seeing with financing for multifamily properties — both for transactions and development?

Lorenzini: The rule of the haves and have-nots continues to hold true, whether we are talking about financing existing properties for refinance/acquisition or development deals. The larger, deeper markets such as Chicago or Minneapolis are able to attract higher-leverage, well priced financing either through the agencies or the conduits. They do not have a legacy of underwater deals like their smaller market counterparts do.

The leverage levels allowed by Fannie Mae and Freddie Mac in some of the secondary markets makes it more difficult to recapitalize existing deals, thereby continuing to keep a lid on rising values. New conduit lending, referred to in the trade as "CMBS 2.0," while coming back strong in the last 12 months, is also less likely to provide higher leverage in these markets.

Stingley: The challenge is with older, Class C assets, where there is little, if any, appetite among the agencies or life companies to finance. Smaller deal sizes are also challenging, as the agencies are focusing most of their capital on larger deals.

For value-add deals, it is difficult to secure financing for both acquisitions and renovations. As a result, the renovation capital is typically additional equity into the deal.

For development, low leverage and recourse are huge challenges for developers. Pre-recession, a borrower could fund 80 to 85 percent of the transaction, today they are limited to 60 to 65 percent. Also, recourse on the construction debt is tough for developers, particularly those who have more than one project in the works and don't have the balance sheet to support multiple deals.

Powell: Clearly, there has been a re-emergence of players into the debt capital space. Banks have begun to lend again, conduits have clearly come back, as have a number of life companies. With some uncertainty as to the future structures of the GSEs, having new debt capital back in the market is a plus. That's my optimism.

My concern is that the market doesn't become overheated with all that capital, and we start making the same underwriting mistakes we made in the middle of the last decade. We have seen some very aggressive deals done recently, which gives me a little pause. Everybody says we have learned our lesson from the middle of the last decade, but how long do we remember the lesson?

HREB: What types of properties and what markets are still struggling? For what reasons? How has the economy affected the current multifamily real estate market across the Midwest?

Lorenzini: Single-family home prices remain under pressure, and many people that would normally be looking to buy a home are opting to rent instead. This has helped create a larger renter pool than in previous years that may be predisposed to rent long term. Those families and individuals that may have lost their homes or simply can no longer afford home ownership add to the swelling number of

renters. This has created the enviable position of having more customers and demand than there is supply.

Stingley: Older, vintage assets with obsolete units and poor layouts are struggling. In Kansas City, assets built in the 1960s and 1970s are averaging occupancies in the 88-percent range, whereas assets built in the 1980s or later are averaging occupancies around 93 percent.

Dougherty: Suburban product isn't moving; it's more downtown, high-density areas. In the suburbs, anything that is getting built is near a train station or other transportation hub.

However, the focus for 90 percent of our clients is well-located city product. You wouldn't think it is available, but people are finding things, and if they can't, they are taking Class B product and giving it a facelift. Eight years ago, you'd renovate that into condos, but now you'll see people put some money into it just to get the location. None of it's surprising, but you wonder where those fundamentals were a couple years back.

HREB: How are occupancy rates faring in different markets? What are the challenges the multifamily sector is facing when it comes to filling units?

Lorenzini: Again, multifamily occupancies are up across the Midwest and the country as a whole. Secondary markets in Indiana, Ohio and Michigan predictably have higher vacancy rates than the larger markets such as Chicago (5 percent) or Minneapolis-St Paul (less than 4 percent), which are considered some of the tightest markets in the country along with New York, Boston and San Francisco.

Stingley: Market fundamentals are sometimes painted with too wide a brush. In every market there are some submarkets that are performing extremely well and some that are performing not so well.

As a market, Kansas City's average occupancy is currently 92 percent with year-over-year rent growth of 2 percent. However, Overland Park is performing even better, with occupancy of 94 to 95 percent, and year-over-year rent growth is 4 to 5 percent.

The lack of new construction in recent years has helped to create positive occupancy trends, especially in markets that are experiencing real job growth (i.e. Chicago) and/or in markets that were less affected by the recession and have low unemployment (i.e. Minneapolis). Rising household formation and a drop in the home ownership rate are also contributing to improving occupancies. However, this is less of a factor in the Midwest, as it has experienced lower household formation than other parts of the country and already has the highest home ownership rate in the nation.

HREB: What are some of the differences in the trends you're seeing for condos, apartments, student and senior housing?

Lorenzini: Condos continue to be the poster child for bad loans. We are seeing many projects sell remaining units in bulk in an effort to satisfy lenders' desires to recoup what they can on troubled properties. Those units in partially sold-out buildings are either being resold at a lower basis or they become shadow rental inventory to the traditional multifamily market. There is very little capital available for any form of for-sale housing.

Student housing continues to be a darling among multifamily investors. Colleges and state universities have seen their funds on hand dwindle and are teaming up with developers to build today's new student housing by way of joint venture or outright sale of university land to private developers for use to build student housing.

Senior housing is a multifaceted topic. Assisted living and age-restricted projects largely follow typical multifamily trends. Skilled nursing, on the other hand, follows a different pattern, and lenders and investors here are seeking healthcare real estate. Capital for this asset class is highly dependent on sponsorship and history. Some agency programs such as Fannie Mae and HUD offer very attractive terms, but expect extended closing time requirements.

Powell: Market fundamentals for apartments and seniors housing, especially assisted living, are much stronger right now, so that is where the development interest seems to be focused.

Student housing has begun to stabilize after a period of overbuilding. While there is some new building, the number of new starts is clearly down, and I think there will be greater focus paid to closer locations and those on public or school transportation routes. I also think there is increased concern about the affordability of these highly amenitized properties, given the stress on many family budgets.

Recent Midwest Multifamily Sales

One Superior Place - \$320 million
1 West Superior Street, Chicago
Number of units: 809
Buyer: Hartz Mountain Industries

CityFront Place - \$106 million
Address: 480 North McClurg Court, Chicago
Number of units: 480
Seller: Crescent Heights

Country Lakes Apartments - \$60 million
Location: Naperville, Ill.
Number of units: 640
Buyer: AIMCO/Hayman Company

Mondial River West - \$30.8 million
Location: Chicago
Number of units: 124
Buyer: Wateron Residential

Marquis at Lakeside - \$23.5 million
Location: Olathe, Kan.
Number of units: 284

Stratford Wood Apartments - \$23.1 million
Location: Minnetonka, Minn.
Number of units: 297

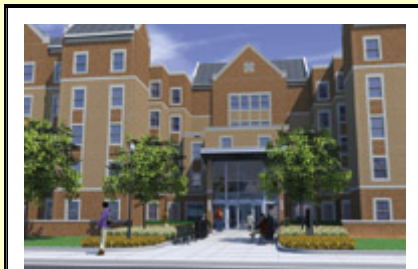
ACC Kicks Off Two Illinois Projects

DeKalb and Normal, Ill. — American Campus Communities (ACC) has started construction for on-campus student housing projects at two Illinois universities as part of public-private partnerships with the respective schools.

ACC will construct a 1,008-bed live-learn community at Northern Illinois University in DeKalb. The \$132 million community will consist of two five-story buildings and a central 32,839-square-foot community center with a 500-seat dining hall

The company is also building a \$59.6 million apartment-style community on the campus of Illinois State University in Normal. Cardinal Court Apartments will consist of 228 fully-furnished apartments in two, three- and four-bedroom configurations as well as a 16,400-square-foot community center

Both projects are being financed and will be owned by the non-profit Collegiate Housing Foundation, which will ground-lease the sites from the universities for 40-year terms. ACC is serving as developer and construction manager.



A rendering of the new residence hall at Northern Illinois University in DeKalb, Ill.