

By David L. Church, Reilly Mortgage Group Beyond capitalization rates in multifamily properties

Capitalization rates have been in a veritable free-fall in major metropolitan markets over the past 24 months. While some of the decline is due to the sale of apartment projects to condo converters, a large part of the drop is simply the result of the perceived long-term stability of multifamily properties as an asset class in commercial real estate.

Investors snap-up apartment projects as soon as they hit the market – or before. Historically low interest rates for long-term debt provided by permanent lenders - Fannie Mae, Freddie Mac, insurance companies and conduits – and 1031 money feed the frenzy for acquisitions at high prices per unit and correspondingly low cap rates. However, going-in cap rates tell only part of the story for long-term investors.

Many real estate professionals eschew the use of a 10-year discounted cash flow model to value multifamily properties because income and expense growth is typically forecasted at a steady pace, and because reserves for replacements are generally flat. While I agree that many financial analysts believe that income, expense and reserves are easy to forecast as compared to other types of real estate, I disagree that this perceived predictability lessens the need to analyze the performance of multifamily projects over a 10-year holding



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period.

Two stabilized multifamily projects may have identical net cash flow (NCF) after reserves but it is the operating expense ratio and whether a property is master-metered that will make or break targeted returns.

For example, assume that two stabilized and 95% occupied multifamily properties each have NCF after reserves of \$1,000,000. Property A has an expense ratio of 30% (typical of a project where tenants pay utilities) and Property B has an expense ratio of 55% (representative of a project that is master-metered). Armed with this information, the following basic operating statements can be constructed from the bottom up:

If NCF is capped at 6.5%, both properties are perceived to be worth \$15,384,600. The NCF supports debt of \$11,900,000 at 5.75% on a 30-year amortization schedule at 1.20x, which equates to a 77% loan to cost. The acquisition requires a cash equity contribution of

\$3,484,600.

Assuming that rents increase at 3% per year,

support an interest rate of only 9.30% - 104 basis points less. And, assum-

Property A.

Uncertainty is risk and a transaction with

	Property A		Property B	
GPI	\$1,503,800		\$2,339,200	
VAC(5%)	\$ 75,200		\$ 117,000	
EGI	\$1,428,600	100%	\$2,222,200	100%
OP EX	\$ 428,600	30%	\$1,222,200	55%
NCF	\$1,000,000	70%	\$1,000,000	45%

expenses increase at 4% per year and vacancy remains constant at 5%, the debt service coverage for Property A and Property B in Year 11 (the prospective year for sale) will be 1.54x and 1.41x, respectively. Projecting a terminal cap rate of 7.5%, Property A would sell for \$17,140,000 while Property B would sell for \$15,698,000 – before a deduction of 6% for costs of sale.

Based on the projected NCF figures for 10 years, a discount rate of 9% and a terminal cap rate of 7.5%, the value of Property A is \$14,321,400. However, based on the same assumptions, the value of Property B is \$13,482,900 – a difference of almost \$850,000 (note that both of these values happen to be less than the value derived via the direct cap at 6.5%).

Refinance risk for Property A is measurably less than it is for Property B. Year 11 NCF for Property A would permit a refinance of the outstanding principal balance of \$9,891,300 at 1.20x DSC with an interest rate as high as 10.34%, while Property B would

ing the interest rate at the end of the loan term were 5.75%, Property A would support debt as high as \$15,297,300 on a DSC basis, which is almost \$1,300,000 more than the \$14,010,300 that Property B would support.

The pre-tax internal rates of return differ dramatically depending on whether Property A or Property B is purchased for \$15,384,600. Based on my assumptions and calculations, the pre-tax IRR for Property A is 12.0% while the pre-tax IRR for Property B is 9.3% - Property A yields an IRR that is 29% greater than that for Property B.

The preceding analysis is purely “by the numbers” and, by definition, does not include non-quantitative factors. Most important among the non-quantitative factors is the uncertainty of future operating costs, utility costs in particular, which could have a dramatic impact on the performance of Property B. This makes accurate projections regarding on-going NCF, the terminal value and the IRR dramatically more difficult to assess for Property B than for

an enhanced level of risk should be modeled to generate a higher return. However, as the analysis above shows, when the same price is paid for Property A and Property B, Property B yields a lower rate of return – not the higher rate of return that investors should expect due to the enhanced level of risk.

As this simple example illustrates, investors need to be wary of purchasing multifamily properties based solely on going-in cap rate analysis. The performance of various acquisition targets needs to be analyzed with a focus on expense ratios, the allocation of utility costs, and realistic projections for annual income and expense escalations. Multifamily properties should be analyzed over a 10-year holding period to test assumptions and to make informed determinations about the value of future benefits being purchased.

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