

Why Apartment REITs Will Gain Ahead Of Commercial Real Estate

Share prices of publicly traded real estate companies often move in advance of property fundamentals, depending on investors' expectations for the future.

BY SCOTT ROBINSON

The capital markets ended the year in positive territory, but few real estate investors would say that 2009 was a good year. Property fundamentals, most notably rental rates and occupancy levels, continued to deteriorate, demand drivers showed few signs of recovery and banks gave little indication of a desire to restart lending to commercial real estate. Further, the bid-ask spread between buyers and sellers remains stubbornly high.

Nevertheless, Real Estate Investment Trusts (REITs) delivered an approximate 30 percent total return through December 2009 (as measured by the NAREIT index). It was a bumpy ride along

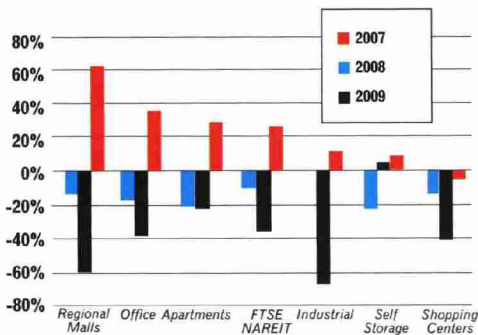
the way, with the index touching a multi-year low of 185 in March before ending the year at 325. This strong performance was initially driven by investors' realization that March valuations were absurdly cheap. Multifamily REITs were no different; delivering an approximate 20 percent total return through November 2009.

This seemingly inconsistent data—dramatically rising REIT pricing in light of deteriorating property fundamentals—is properly causing investors to question the outlook for 2010.

What Are Investors Looking For?

Investors generate returns in two ways: cash flow growth and appreciation. Investors also make decisions based on their expectation for the direction of these components.

Figure 1: Annual Performance Of Multifamily REITs

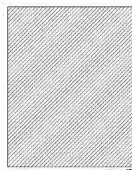


Source: NAREIT; Cadence Capital Group, LLC

Figure 2: Annual Performance Of Individual Multifamily REIT Stocks

Company	2007	2008	2009
Apartment Investment & Management (AIV)	-29%	-22%	25%
Associated Estate Realty Corp (AEC)	-29%	-38%	52%
AvalonBay Communities Inc. (AVB)	-36%	-34%	43%
BRE Properties Inc. (BRE)	-40%	-30%	19%
Colonial Properties Trust (CLP)	-38%	-31%	18%
Equity Residential (EQR)	-38%	-67%	38%
Essex Property Trust Inc. (ESS)	-25%	-9%	18%
Mid-America Apartment Communities Inc. (MAA)	-23%	-53%	19%
Post Properties (PPS)	-52%	-64%	41%
United Dominion Realty Trust (UDR)	-31%	-3%	23%

Source: SNL Financial, LLC; Bloomberg; Cadence Capital Group, LLC



As a result, the share prices of publicly traded real estate companies often move in advance of property fundamentals, depending on investor's expectations for the future of measures like rent rates and occupancies. Investors will buy stocks if they expect an improvement in those measures and will sell shares if they expect fundamentals to deteriorate. Investors have driven multifamily REIT stock prices higher during the past few months not only because they believe property measures will improve but also

because they believe REITs will be able to take advantage of historic buying opportunities.

Where Does This Growth Come From?

Multifamily housing REITs can generate growth from internal and external sources: Organic growth opportunities result from rising rental rates, improving occupancy rates or reducing operating costs, while inorganic growth arises from acquisitions. These REITs have historical-

ly been very good at getting the most out of their operations and outperforming their privately held competitors over the short term. However, revenue growth above market rates is not sustainable over the long term. Real estate market fundamentals will have to improve in order to support revenue growth.

The problem is that property fundamentals do not appear to be improving. Nationwide vacancy rates continue to deteriorate, rising to roughly 8 percent in Q4 2009, according to Reis, the highest level in 30 years. Additionally, multifamily housing residents do not appear to be willing or able to pay higher rents as nationwide rental rates also have contracted dramatically. Further weighing on this situation is the shadow supply of single-family residences stemming from defaults and foreclosures.

What About The CMBS Market?

Commercial mortgage-backed securities (CMBS) lenders were a terrific source of financing for multifamily investors during boom times (2005 to 2007). As the credit markets began to heat up and investors intensified their frantic search for yield, CMBS lenders were able to originate loans based on "forward-looking" cash-flow projections, resulting in distorted loan-to-value metrics and unsustainable financing levels. While this resulted in low-cost mortgage financing for prudent borrowers, it also laid the groundwork for a potentially huge wave of loan defaults.

Not surprisingly, there is a rapidly growing level of loan delinquencies in CMBS. These delinquencies are concentrated in more recent securitizations and with those assets in markets with the weakest economic situation.

The CMBS structure is highly complex and offers poor transparency. As such, purchasing defaulted loans or REO assets from a CMBS pool is a time consuming and complicated endeavor. However, well-capitalized multifamily REITs will undoubtedly be looking to the CMBS market as a source of acquisition opportunities. The larger, well capitalized multifamily REITs with an

**Figure 3: December Delinquency
By Property Type**

	(%) of CMBS Universe	(%) of Property Type
Office	0.75%	2.68%
Retail	1.17%	4.19%
Multifamily	1.23%	6.04%
Industrial	0.13%	2.95%
Other	1.43%	-
Total	4.71%	

Source: Realpoint, LLC; Cadence Capital Group, LLC

Figure 4: IPOs during the 1990s

	# of IPO's	Capital Raised (in millions)
1992	8	\$919
1993	50	\$9,335
1994	45	\$7,176
1995	8	\$922
1996	6	\$1,108
1997	26	\$6,297
1998	17	\$2,129
1999	2	\$292

Source: Realpoint, LLC; Cadence Capital Group, LLC

experienced and deep management bench may be the best equipped to navigate the CMBS structure for good acquisition opportunities.

Expectations for 2010

Most investors seem to agree that property fundamentals will begin to stabilize in 2010 but will not show significant signs of improvement until 2011. The general consensus is that distressed selling and bank REOs will present "once in a lifetime" acquisition opportunities in 2010.

Therefore, the most likely source of growth in the REIT sector in the coming year will be from a wave of properties entering the public markets. There are a significant number of portfolios currently held in private equity funds that are over-leveraged and producing below-pro-forma operating results. Many of these portfolios will either be spun out as IPOs or sold in bulk to existing multifamily housing REITs. A telling historical example of this is from the recovery period of the early 1990s (see Figure 4).

What Could Go Wrong?

Many market commentators have begun debating the possibility of a stagnated U.S. economy. This would mean GDP growth remains flat (affecting household formation), job creation doesn't materialize (affecting household formation), and

**Figure 5: Analyst Consensus
NAV vs. Current Stock Price (on Jan. 4, 2010)**

Company	Consensus NAV	Stock Price
Apartment Investment & Management (AIV)	\$15.15	\$15.96
Associated Estate Realty Corp (AEC)	\$15.71	\$11.30
AvalonBay Communities Inc. (AVB)	\$60.15	\$81.20
BRE Properties Inc. (BRE)	\$28.59	\$32.69
Camden Property Trust (CPT)	\$34.33	\$41.49
Colonial Properties Trust (CLP)	\$13.97	\$12.06
Equity Residential (EQR)	\$26.07	\$33.40
Essex Property Trust Inc. (ESS)	\$70.68	\$82.62
Home Properties (HME)	\$40.04	\$47.22
Mid-America Apartment Communities Inc. (MAA)	\$40.63	\$48.19
Post Properties (PPS)	\$18.36	\$19.45
United Dominion Realty Trust (UDR)	\$13.11	\$16.21

Source: SML Financial, LLC; Bloomberg; Cadence Capital Group, LLC

inflation begins to kick in (resulting in higher borrowing costs and higher cap rates). The net result is a continued "slow bleed" in property fundamentals. Coupled with a dormant financing market, investors may become very uncomfortable with current REIT valuations and exit the space, driving the indices downward. It's worth noting that the initial reading for Q4 2009's GDP was 5.7 percent—the fastest such growth measured since 2003.

What History Shows

While multifamily housing REIT stocks appear to be "fairly" valued and there are clear headwinds facing additional price appreciation, history has shown us that publicly traded real estate performs very well during economic recoveries. Successful REIT managers will find outstanding acquisition opportunities, fundamentals will eventually improve, and there will undoubtedly be distressed private market owners who will sell into the public markets.

Multifamily REIT investors are advised to avoid momentum plays and invest their money with those managers who outperform their submarkets and will likely have the greatest access to deal flow in the next six to 18 months. ■

Scott Robinson is a professor of Real Estate Capital Markets at the NYU Schack Institute of Real Estate and Managing Partner of Cadence Capital Group, LLC. He is a 15-year real estate finance veteran with extensive experience in real estate investment banking, including secured debt securitization, unsecured debt syndication and equity valuation and has held senior positions at Citigroup and Standard & Poor's. He earned an M.S. in Real Estate (Finance) from NYU and has a degree in economics from the University of California-Riverside.