Dec. 8, 2008

Betting on a Brighter Spot

INVESTORS LOOKING FOR SAFETY IN A TURBULENT ECONOMY MAY FIND SAFE PURCHASE IN THE MULTIFAMILY MARKET

CALIFORNIA
REAL ESTATE JOURNAL
SPECIAL SPONSORED SECTION

ROUNDTABLE ■ MULTIFAMILY

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The financial markets are in disarray. The economy has stalled and real estate investment and development have plummeted. It is the perfect time for opportunistic real estate players to place their bets on the eventual economic upswing and the best opportunities just might be found in California's multifamily market.

With the single-family housing market yet to hit bottom and unemployment rising, apartments still are performing with relatively stable rent growth and occupancy rates thanks to the state's chronic undersupply of housing.

Capital is more readily available for multifamily investment and development than other property types despite California being at the center of the subprime mortgage crisis and rising capitalization rates. And, with little competition for land, it is possible to consider starting to develop multifamily projects.

That doesn't mean uncovering opportunities will be easy. You just have to know where to look. The California Real Estate Journal gathered seven multifamily experts to help identify the risks and opportunities in the multifamily marketplace.

Moderated by Editor Michael Gottlieb, the Roundtable included:

SARAH L. BRIDGE, president, REALFACTS

STEPHEN D. CAULEY, director of research, The Richard S. Ziman Center for Real Estate at the University of California, Los Angeles

JOHN CONDAS, partner, Allen Matkins Leck Gamble Mallory & Natsis LLP

ALEX J. KATZ, managing director, Meridian Capital Group

LAURIE LUSTIG-BOWER, executive vice president, CB Richard Ellis

ALEX MOGHAREBI, vice president of investments, Marcus & Millichap Real Estate Investment Services

TIMOTHY L. WHITE, president, PNC ARCS

Turn the Political, Economic Page

CREJ: ow will the change in administrations at the White ouse affect commercial real estate in general, and specifically the multifamily industry?

STEPHEN D. CAULEY: Most economists think that an Obama administration would not be good for investments. Obama himself said he would raise capital gains taxes. That would be at least a moderate negative for real estate values.

The die has been cast in a lot of ways. The mortgage meltdown already happened. People's expectations will drive what happens next in the economy. McCain had some real problems, but he was right when he said that American economic fundamentals are still the best in the world.

Multifamily housing is probably well-positioned going forward. That doesn't mean this won't be a depressing time. The bottom line is, any president was going to have a hard time. The decisions Obama can make will be sorely constrained for the next couple of years.

TIMOTHY L. WHITE: If you like the idea of a strong government role in housing policy, the Obama administration is likely to deliver one. Nobody knows exactly what that will mean for Fannie Mae or Freddie Mac, though.

CREJ: ow are multifamily fundamentals relative to other asset classes in California?

SARAH BRIDGE: California multifamily rental and occupancy trends are good. The Northern California markets are surpassing the Southern California markets in rent growth. But that might be more of a response to the fact that Southern California has been outstripping Northern California, as it recovered from the last debacle, the dot-com bust.

Some markets are weakening. In the Inland Empire, the third quarter of '08 saw rents go down for the first time in five years. This is the only California market where we've seen actual negative rent growth.

In terms of occupancy, we track 24 MSAs in California, and about half are experiencing negative occupancy growth. That foretells that the rents will go down.

The biggest growth markets, such as San Jose and San Francisco right now, are both reporting negative occupancy growth.

CREJ: ow would you compare coastal to inland California?

BRIDGE: The Central Valley is always the first to show decline in bad times, and the

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last to experience gain when there is rent growth. Both Sacramento/the Central Valley and the Inland Empire are the laggers in the rent ranking and also in terms of growth.

Over the past four years, coastal California has had an average of about 24 percent rent growth, 5 percent per year, although there are signs of a slow down now. As of September, occupancy is uneven everywhere.

'There is an important difference between the Inland Empire and the Silicon Valley. They are different socio-economically. The bottom dropped out on the dot-com sector. Unless we have a rip-roaring recession, we won't see that kind of loss in Southern California. I don't think we are going to have growth, but what I would imagine is that we're not going to have the population/employment effect that we saw in Northern California.'

— STEP EN D. CAULEY, The Richard S. Ziman Center for Real Estate

One thing about California is that the bottom doesn't just fall out from under the market. RealFacts has been around almost 20 years and we've actually been through three major downturns now. The first one, when we got into this business, was the savings and loan debacle. Property values plummeted for multifamily, but the reason was that rents didn't grow as aggressively as projected.

The next downturn was the post-911 scare. In Northern California that coincided with the dot-com bust, so that area was harder hit then the rest of the state. Southern California continued to experience rent growth. It wasn't unprecedented, but it was still growing. It affected Northern California the most, between 15 and 20 percent of its rent value. On the other hand, it was a correction of the Bay Area's growth, which had been unprecedented in the history of the rental markets.

With the current crisis, the impact seems to be on rents, that they are flatlining. I don't foresee a dramatic change up or down.

ALEX MOGHAREBI: Commodity markets, like the Inland Empire where I work, have been impacted significantly by the shadow market — vacant housing competing directly with multifamily for the rental dollar. One of every 32 homes in the Inland Empire is in foreclosure.

Investors are purchasing these homes and renting them out. Tenants find they can rent a home with a garage, two bedrooms and a backyard for the same price as a Class A apartment. We've already seen the value of multifamily drop as a result, depending on area and class asset, as much as 30 to 40 percent, due to the shadow-market effect on the property's income and a lack of financing.

LAURIE LUSTIG-BOWER: Alex, are Class A buildings having to reduce their asking rents?

MOGHAREBI: Significantly. The biggest impact has been on the Class A building, because at that level of rent, they are competing with the housing market. There's less impact on B and C product so far, but I expect that the trickling-down effect will be even more so this time.

LUSTIG-BOWER: I would think that Class B properties are going to be affected, because the A's are reducing their prices.

MOGHAREBI: Yes, but not by as much. "A" trickles down to "B," but I don't think it's going to have much impact on the C properties.

KATZ: Even in the infill locations, although the foreclosure rate hasn't skyrocketed to the extent of the Inland Empire, we are seeing a lot of condo developers being squeezed and forced to rent their units out at rates that make it extremely difficult to get financing. I believe we are going to start to seeing downward pressure on the upper echelon of multifamily product because of this competition from what would have been for-sale product.

MOGHAREBI: They are always impacted. The question is; how much and what market?

BRIDGE: We did an analysis on the Inland Empire. Rents were down between the second quarter and the third quarter of 2008 for all unit-types. The hardest hit were the three-bedroom, two-bathrooms units. One possible explanation is the shadow market. One-bedroom one-bathroom units took a hit, too; that's the soft economy. People double up instead of getting their own units.

CREJ: ow about the fact that Class A multifamily is new in the Inland Empire because people mostly moved there for affordable single-family homes?

MOGHAREBI: The parts of the region closest to Los Angeles and Orange counties are the stronger markets, but most of the Class A buildings were developed in those areas. Affordability was a big factor and also jobs. We lost more than 40,000 jobs in the Inland Empire. Unemployment is getting close to 10 percent.

CAULEY: That's an incredibly important point. Look at the population growth forecast for Southern California. It's crazy as hell. This may be a perfect storm, in the sense that we have high housing costs, high labor costs, high taxes — why would firms want to be here? The Westside, for instance, is relatively immune to the problems we are facing. They won't see anything like this level of unemployment.

CREJ: Now that we've learned that we've been in a recession since Dec. 2007, and it certainly felt like it, what impacts will we see on multifamily fundamentals? Are there unique qualities that will make this cycle different?

WHITE: The biggest impact we're projecting is from the single-family foreclosure market, and the shadow inventories that it creates. In the nation as a whole, we've got great fundamentals — 95 percent occupancy, 2.3 percent rent growth projected for the balance of the year, across the country. But some areas will have significant problems, and where we have problems, I suspect they're going to stay with us for a long time.

Sarah said that the Bay Area took a long time to recover from the dot-com bubble burst. That is our observation as well, particularly the San Jose area. The outlying areas, which are not supply-constrained, will see the longest-term implications. It will stay with us for several years, is my guess.

CAULEY: I'm not disagreeing with you, but there is an important difference between the Inland Empire and the Silicon Valley. They are different socio-economically. The bottom dropped out on the dot-com sector. Unless we have a rip-roaring recession, we won't see that kind of loss in Southern California. I don't think we are going to have growth, but what I would imagine is that we're not going to have the population/employment effect that we saw in Northern California.

Golden State or Goose Egg?

CREJ: Are California multifamily investors and owners better insulated from softening apartment fundamentals than other markets in the U.S.?

BRIDGE: Absolutely. California is the goose that lays the golden egg, over and over. We just have to keep from strangling it. Stomping that goose. Kicking our goose. Throttling it, to extract every last dime. What happens in California is that we over-project and we over-supply because everybody wants a piece, and everybody believes in the market.

This market always seems to recover. We have a pattern of five years of good, strong, even unprecedented growth, and then five years of a lull or a flat line. It's never a big drop, except for the dot-com/Bay Area phenomenon.

If you look at a market like Phoenix, for instance, what you see is maybe three years of average growth — it would be a big triumph in Phoenix to have a 7 percent annual rent increase — and then you'll see three to five years of anemic growth. There's always some reason why there is softness in that market. They're vulnerable to every market condition — overbuilding, the economy, whatever — and you'll see an incredible rent loss. We just don't have that here.

I'm not convinced there is a shadow market, at least not in the strong markets of Cal-

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ifornia. There isn't a drop in demand. The same markets that are weak are weak no matter the circumstances.

WHITE: The shadow market is isolated. It won't affect Southern California as a whole.

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Two characteristics are very positive for apartment owners going forward. One is there's very little new apartment construction going on now, especially in Southern California. Two is the state's demographics. The trends are very positive for new household formation among young people and legal immigrants. These factors will contribute to strong demand in supply-constrained markets and there are an awful lot of jobs. This is an incredible economic engine that we have in Southern California. It's not broken. It has suffered, but it's not broken.

MOGHAREBI: The cost to reproduce existing properties continues to rise in infill locations because of the cost of energy, materials and labor. That puts a hold on creating more inventory in the marketplace, which creates a better base with which to move forward.

CREJ: Are builders no longer starting new projects, but rather seeking to finish the projects they've already started?

JOHN CONDAS: Some are close to getting finished, and they're trying to figure out how to preserve their entitlements and whether they want to switch from for-sale product to rental or vice versa. It is a pretty important decision.

owever, we are starting to see some activity at the very front end. Some of our clients are looking to buy land, and we are working on a couple of entitlement deals right now. These projects aren't going to hit the market for two or three years, when developers perceive the market will be picking up. California is so supply-constrained, especially in the multifamily market. Further, many jurisdictions that are less affluent don't want apartments, they would much prefer having for-sale units, even though new rental projects would improve the housing stock of the jurisdiction.

Investor Outlook

CREJ: A two- to three-year apartment entitlement is pretty optimistic, but that supports the point that California is relatively insulated from the worst of the economy's swings. Do investors see that?

LUSTIG-BOWER: Reports are saying today's problems in the financial markets are just the tip of the iceberg, so investors are on the sidelines. They say, "Why would I buy an apartment building today if I can buy it cheaper next year, or even from a bank as an REO?"

I hear that a lot of corporate debt is going to explode and will not be able to be paid off. We've got very high consumer credit card debt. These are going to be the next bubbles to burst, and it will have a direct effect on the whole population, including our tenants.

Consumer spending runs the country. Everybody has pulled back, even if they don't have to. The stores aren't getting their sales, and more retailers are probably going to close after the first of the year. That's people out of work, building tenants clearing out, office space affected causing more people to be laid off. This is a black cloud over the whole country, and it's contagious to the rest of the world. Toy factories in China are closing down because they are not getting the U.S. orders they expected. This is a serious world problem, not like in the '90s when it was mostly focused on the United States.

If you own an apartment building, I believe you have a better chance of surviving this downturn than if you own other types of commercial property. But we are all in for a storm.

CAULEY: The rest of the world is in much worse shape than we are. Interest rates are very low everywhere, not only in the United States; and there's been an increase in availability of credit that has affected everyone. There is definitely a chance that we're going to have a very serious recession. The thing that would drive it is fear. If people are afraid of what's going to happen with their job, come Christmastime they're not going to go shopping. It's not that their incomes are lower. They are afraid their incomes will become lower. They spend less, so in effect their incomes are lower.

It's going to affect multifamily housing just like everything else. I'll be very honest with you, I'm in cash. I've been in cash for a couple years. My wife has been very unhappy with me until recently.

LUSTIG-BOWER: I bet that most of the people reading this and the people on this Roundtable have all had their net worth negatively affected.

MOGHAREBI: I don't believe the income hasn't come down. Employers are cutting back. They're not giving the bonuses. They're cutting back salaries.

Capitalization Rate Trends

CREJ: Typically, when the housing market slows, multifamily is the place for strength and opportunity for investors. Yet multifamily led the trend of cap rate compression at the start of the last cycle. What are the real expectations for property values?

WHITE: Risk premium has returned, so that is being built into the cap rate structure these days. Also, lending is more conservative than it was a couple years ago. The 1.15 loan that you might have been able to get is going to be in a 1.25 debt cover. That probably drives about a quarter of a point of cap rate increase, because the cost of equity is more expensive than the cost of debt. So it's necessary to raise more equity and it must be priced at an attractive return that allows for the risk premium to be earned.

We will continue to see an upward trend in the cap rates. Cap rates for multifamily will continue to be significantly lower than for other property types because there's a premium on the perceived safety of the multifamily product. But the days of the 5 percent cap rate are over, unless we are talking about the most prime location and the best-run apartment complex. We're seeing cap rates migrate in the 6 to 7 percent range in good markets. In the outlying areas, we see higher rates than that.

MOGHAREBI: The other thing is the debt-coverage ratio of 1.15 that's moving to 1.25. The lender used to look at projections, and on that basis use 1.15. Today they are looking at historical numbers. This shift alone in policy is a game changer.

KATZ: It's more than that. It's not just that the forward projections are no longer considered by lenders. That concept already has been out of play for quite a while. All underwriting criteria continues to become more stringent daily. Fannie and Freddie, the most active lenders in this realm, are taking a real fine-tooth comb over each number, even the in-place number, knowing that expenses, such as utility costs, trash, service contracts, all costs are all rising. In certain markets you have negative rental growth, or occupancy issues. That's where the cap rate decompression is going to continue, forced by the economics of the deals. Ultimately in this market, prices are driven by the available loan terms. You could borrow 90 percent before and afford to pay a higher price. Now you can't.

MOGHAREBI: That's my point. Not only are cap rates increasing, but also the NOI is going down. Lenders are looking at the quality of the buyer, their management expertise, revising historical operating information to the lender's standards, and then they use a 1.25 debt-cover ratio. This process impacts value significantly.

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Ultimately prices have to come down to fill this gap because not many buyers in the marketplace are looking to make a 50 or 60 percent downpayment.

WHITE: If you're a GSE lender, you've been

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— LAURIE LUSTIG-BOWER, CB Richard Ellis

making your major loans on trailing rents for stabilized properties. You might look at trailing rents different periods of time — 12, six or three months' worth — that you use to make your lending decisions, but that's the way the underwriting decisions are made.

GSEs lost a lot of business to people who did not make loans on trailing rents. I don't know the conduit practice that well, but I suspect that forward-rent-trending projections allowed conduits to lend higher dollars than the GSEs. That's been our history. Lending underwriting parameters are absolutely more restrictive now than a few years ago, and that's going to stay in place for the foreseeable future. It may even trend a little further toward conservatism.

KATZ: The GSEs did not entirely adopt the traditional conduits' approach, which is perhaps why they lost some multifamily business to Wall Street in recent year. Wall Street would lend aggressively on pro forma going out two years, or even further. They would assume wholeheartedly that you'd hit expectations, and they would lend significantly more at closing, even fully funding in certain instances.

When it comes to rehab deals or acquisition upgrades that rely predominantly on the future value and rents, the GSEs are looking a lot more strictly at those numbers now, wondering whether you're going to achieve them in the current environment.

MOGHAREBI: What is going to happen with all of the loans that are coming due in the next two years, when the lenders going to apply the new criteria?

KATZ: It will be very interesting to see. You have the 10-year maturities coming due, which were underwritten completely differently than the five-years. There are so many properties where it's not clear whether you can sell them for a price that works for both parties. They're underwater based on their outstanding debt. There's going to be a sizable wave of foreclosures, defaults or short sales. ow do you take out the overwhelming amount of debt? Lenders are coming up short, time and time again. It's going to be a coming-to-reality situation for everybody.

MOGHAREBI: There's been a disconnect between the real and perceived value for so long. We have to learn the real value first, and then hope that the perceived value is not significantly under it.

CAULEY: ow much higher cap rates does that translate into?

MOGHAREBI: 7 to 7.5 percent depending on the area. Perhaps it is better to say another 100 to 150 basis points.

KATZ: It's also probably going to be a function of where the cost of borrowing is. Today, borrowing costs remain reasonable for multifamily.

It's not even that it's simply cheaper to borrow for multifamily product. Reasonably priced and sized loans are not available altogether for many product types right now. To be able to borrow five-year money between 5.75 and 6.25 today for apartments, that's really what you may want to focus on. There's got to be some reason to invest in these properties. I would expect to see cap rates creeping up toward 7 percent in order for it to make sense, provided the interest rates remain the same.

MOGHAREBI: Exactly my point. We need to look at the cost of the funds when placing value on properties. The cost of the funds, as Alex says, changes with the cap rate.

CAULEY: I'm expecting cap rates to hit 8 percent, because I expect the risk premiums and interest rates in general are going to go up.

WHITE: In what markets for 8 caps?

CAULEY: Los Angeles apartments.

LUSTIG-BOWER: When, Steve?

CAULEY: In the next couple of years. Long-term rates will be going up at least 100 basis points.

CREJ: What are the latest investment transaction statistics for apartments?

BRIDGE: We track investment-grade multifamily. Right now, in terms of volume, we are at about 25 percent of what we were in 2007. We've tracked transactions of about 9,000 units compared to 40,000 last year. By the end of this year we are expecting to be at about one-third of last year's volume. Properties that are changing hands are older, smaller and more expensive. The cap rates this year are the lowest ever: 4.9 percent.

Sellers can't realistically settle for a lower price because of the way they bought their property and what it would take to make them whole. Rents are appreciating very slowly and buyers are looking for a higher cap rate. It's as if there has to be some foreclosure activity in order to drive the next round of transactions.

LUSTIG-BOWER: I suspect that the low cap rates you describe are because the deals that got done so far for 2008 might have been negotiated in 2007 or at the beginning of 2008. If you took an apples-to-apples comparison, you'd see the cap rates have gone up significantly — 100 to 250 basis points depending upon the asset and location. Those with low cap rates this year might have been trophy properties that were able to trade. People paid up for those because they were special locations or assets. A lot of the bread-and-butter stuff that traded all day long in the last couple of years is off the market now because of the pricing disconnect between the sellers and buyers.

BRIDGE: Exactly. The deals are all in infill. No transactions are happening in Fresno and the fringe markets. There's a stalemate going on for the work-a-day properties.

KATZ: You have a lot of people and cash sitting on the sidelines. They don't want to be the ones that bought now, when six to 12 months from now there's a wave of foreclosures and everyone else gets a steal.

We were seeing rates of 5 percent for five-year money during the first six or eight months of this year. As a result, there was a flood of interest from borrowers wanting to cash out and local a low fixed rate. Many of those people can no longer take *all* their money off the table, but they still can obtain reasonable cash out. For prospective sellers, instead of being dissatisfied with offers today, they can refinance into a low fixed rate that's assumable, and sell when the market comes back. We cashed many investors out this year for the purpose of buying deals that will come into play in the first and second quarter of next year.

WHITE: That factor's actually slowing down the discretionary refinance business right now. We have borrowers who have the ability to cash out, but they come back to us and say they're not sure what they want to do with the money. They don't have a good place to put it.

One comment on transaction volume. We've seen a decline in the transaction volume, but not as much as we hear about in the industry as a whole. We still see a reasonable volume of transactions under $30 million. Most of the buyers have been private buyers with private equity — not much on the institutional side. Maybe it's just a function of our portfolio, but it is a little different from what you're seeing.

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KATZ: The first six months of this year, people were just hand-over-fist getting into cash so they could buy. That has slowed down for two reasons. One is that interest rates are not 4.75, they are now 6 percent on average. People who were doing elective refinances now want to wait and see how Obama's presidency will change things, or if changes in monetary policy will take hold. The other reason is not knowing what to do with the money.

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— ALEX J. KATZ, Meridian Capital Group

Ending the Standoff

CREJ: What is it going to take to break this impasse between buyers and sellers?

WHITE: Part of the discretionary refinance market that's up for grabs right now is the cash-out refinance. There are plenty of loans that still need to be refinanced, and should be refinanced, at 6 percent. A lot of people believe that interest rates are going to go up 100 basis points — why not refinance now rather than wait for that to happen? That's a very likely scenario, and it will help. It will keep the engine running, even if the transaction volume slows.

KATZ: There are a lot of loans out there, especially in the $1 million to $30 million realm, that are moving into an adjustable phase. I had somebody just call me on a large portfolio of apartment deals, and I was able to obtain a 5.75 fixed rate for five years. e said, "Look at where LIBOR is. Why don't we just do a floating-rate deal?" For newly originated deals, borrowers are considering short-term, floating-rate debt now more than ever.

Even for existing business, it's hard to convince people who had a fixed rate of 7.5 percent that it's headed for 12, and they need to get off the sidelines and refinance now. They're saying, "If it's adjustable, why don't we just wait? If rates go down further, I get the benefit, and if they start to creep up, I'll do it then." That's what we are seeing.

CAULEY: What you can point out to them is that we don't know what's going to happen to the economy. That's what's going to determine the future.

CREJ: Will loan maturities force people to come to the table?

MOGHAREBI: It's the difference between a seller that would like to sell versus one that has to sell. As soon as we see sellers go from "like to" to "have to," you're going to see the adjustment, and the gap will close between the buyers and sellers.

KATZ: Your clients will be the banks and institutions. They underwrote it and put this all together.

MOGHAREBI: Last time we saw an increase in defaults, operations were dismal. We're not seeing that this time around, although that may change. In addition, the lenders were quickly foreclosing on troubled assets. Nowadays loans are being worked out before the property goes to foreclosure. The troubled assets are not being exposed to the open marketplace.

BRIDGE: Especially if you get to them all before the two-year window. Right?

MOGHAREBI: This may change if the market continues to deteriorate. I am seeing this in the Inland Empire where the rental market is soft and some owners are having a difficult time managing their properties.

CAULEY: There's going to be a lot more workouts.

BRIDGE: So what is going to turn this market into sellers that have to sell?

WHITE: Time.

MOGHAREBI: Time, erosion of equity or the inability to replace existing debt.

LUSTIG-BOWER: If we do have erosion of income due to the economy coupled with rising operating costs people who paid 3.5 percent to 4.5 percent cap rates in the past couple of years may find that their NOI disappears.

If we have an erosion with rents, those people are going to be under water very quickly. Then here is the problem: They've got to feed the building in order to not let it go back to the lender. If they try to sell it, they're going to lose. We're not in that environment of the 3.5 percent to 4.5 percent cap rates. They've got a lower NOI, and the cap rates, I'm seeing, are inching up to 7 percent. That's frightening. Their entire equity, even if they put down 40 percent, could be wiped out.

MOGHAREBI: In the Inland Empire, unfortunately, properties purchased in the past 2 ½ to 3 years, face very limited options.

WHITE: Those are likely to be the people that put short-term money on their properties. It's the loans with less than five-year terms that are more likely to have trouble. There may not be a clean answer for them. They got into the deal without a workable exit strategy, and now they have to pay for that.

CREJ: Are we talking about the value-add play, of putting some money into a property, raising rents, and getting out relatively quickly?

KATZ: It's partially that, but it's also the condo-conversion craze. A lot of these cap rates that you saw, crazy stuff between say 1.5 and 4, they're coming to us now and asking for our help. They filed the condo map, they've gone to marketing, and they can't sell units for anything reasonable. They don't want to sell just some units because if they do they could be in real trouble and risk not getting financing, period. At least if they convert to apartments, assuming that these people have the net worth to be able to pay down their debt, we can potentially get them some financing.

We're seeing a number of deals that are under water, where even if you rent out all of the units at market rents or even above-market rents, you're still at a sub-break-even debt-coverage ratio. These things are just not conventionally financeable.

Switching from For-Sale to Rental

CREJ: What are some of the issues you discuss with investors or developers who are considering switching their project from for-sale to rental? What are the entitlement challenges?

CONDAS: It really depends on the nature of the conversion. I always recommend to clients that when they're entitling a project, especially if they don't know what they are going to do with it when they finish, to put a condo map on it. Even if they decide to go with a rental, the city or county won't hit them up with a lot more exactions or conditions of approval, because the impacts are basically the same.

owever, many jurisdictions have higher construction standards and increased parking requirements for condo projects. Also, the entitlement decision depends on what they are going to do in terms of the density. A condo project generally has bigger units: three bedrooms, two baths, for example. That may not be the same product you would want for a rental project.

If you try to make the unit smaller, you could increase the density, and that can trigger more local government resistance to entitlement modifications, maybe even triggering the need for a new CEQA document. If there is an opportunity to reopen those approvals, a lot of jurisdictions do not favor for-rent units. They want for-sale units because they perceive that to be more stable.

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CREJ: Will we be seeing high-rise for-sale projects convert to rentals?

CONDAS: As unappealing as conversion to rental is for condo developers, the alternative of keeping them condos may even be worse. There is so much product available for sale and developers of for-sale product may not have the expertise or the capital commitments to hold as rental product.

We represent some apartment REITs. They generally build apartment units and hold them. owever, a lot of developers, who entitle or build condominium units are not geared to be holders of real estate, in other words an asset manager. They just want to build or get entitlement, and get out. Conversion to rental is a last resort.

'The deal is easier to underwrite, that's true. We don't worry about how to work through out-of-the-box things — we're just going to say "no" more often than in the past. There will be less structuring in the deals, but a lot more focus on what's going on with respect to the sponsor's REO: What does his REO schedule look like? Is he going to be able to carry this project if it gets into trouble? We need to worry about these things if were making non-recourse loans.'

— TIMOT Y L.W ITE, PNC ARCS

KATZ: We also represent a lot of REITs. They are coming now, saying they want to build multifamily. Eighteen months ago, they would say they didn't know if they wanted to go condo or multifamily, so they wanted to position themselves to leave it open for either.

Now it's become difficult to the point where REIT-quality borrowers can't get financing even for ground-up apartment construction. It's come to a screeching halt.

LUSTIG-BOWER: Even on a 30-unit apartment building, already entitled?

KATZ: If you told me today you want to build units in West L.A. and you were planning it totally as apartments, you could probably get a 60 percent loan-to-cost if you have a $5 million to $10 million liquidity position that's provable, and a $25 to $35 million net worth. That's likely your best-case scenario.

WHITE: The large apartment construction project is nearly impossible because you can't get bank syndication. Smaller deals can be done, but on a very limited basis for clients with long-term relationships with their banks. It is very difficult now to establish a new relationship with a first- or second-tier bank, and be able to get a construction loan, even on terms that made sense a year or two ago.

KATZ: One word that we haven't looked at yet is "recourse." It was a curse word for many years, especially to REITs. They are not allowed to take on a certain level of contingent liability. I'm working with a REIT right now, and there's a 300 basis point difference in the financing I can get for them if it's going to be recourse verses non-recourse, even a partial recourse, and they can't do it, or they won't. That's the difference. Some deals are not getting done because of that.

Mom-and-pop-type operators that want to build five to 30 units can find debt available, but it comes at a much higher cost. The last construction loan I saw was 60 to 65 percent loan-to-cost. We are now looking at 400 basis points over LIBOR, with a 6 or 7 percent floor, full recourse, and points in and out. It's prohibitive relative to what borrowers have become accustomed to.

Underwriting Is Simple Today

CREJ: Is underwriting more difficult today?

KATZ: Underwriting is simpler — that's for sure. Without future projections, there's less to talk about, right? You look at a piece of paper, at what's in place at the property. It makes certain deals more difficult to get done.

We are finding that Fannie and Freddie are looking at commercial borrowers much more closely — almost in the same way they would look at a residential borrower. They're really digging into credit scores and tax returns. Underwriting sponsorship has become a lot more stringent, and underwriting of properties has become simpler, but that's not necessarily better for our cause.

WHITE: We tell people that the relationship really matters now. No lender can be all things to all people, but we aim to take care of our good customers' needs, so they will do repeat business with us. That's different than in the early 2000s when there may have been more focus on the transaction than the relationship.

The deal is easier to underwrite, that's true. We don't worry about how to work through out-of-the-box things — we're just going to say "no" more often than in the past. There will be less structuring in the deals, but a lot more focus on what's going on with respect to the sponsor's REO: What does his REO schedule look like? Is he going to be able to carry this project if it gets into trouble? We need to worry about these things if were making non-recourse loans.

KATZ: It's to the extreme. Fannie and Freddie are going all the way down to actual bodies for 100 percent of the ownership structure, and saying they want to know everything about everyone involved — not just the actual operators or the key principals to the transactions, but even passive investors. They turned a blind eye to it before, but if you've got skeletons in your closet now, it could have a drastic impact and they certainly want to know about it.

Outlook for Freddie and Fannie

CREJ: What outlook do you project for Fannie and Freddie, in terms of their continuing role in the multifamily market?

WHITE: Giant question — nobody knows for sure. To look at it short-term, what we know today is that both Fannie and Freddie are much stronger than they were prior to Sept. 7 when the Federal ousing Finance Agency was established as a conservator for Fannie and Freddie, because each now has access to $100 billion dollars from the federal government. They can get business done now that they would not have been able to, were it not for government support.

We also know that their regulator, the Federal ousing Finance Agency, has supported the multifamily business. It is encouraging to see both agencies engage in business as usual, and supporting their liquidity mission. These things are very positive. Both Fannie and Freddie have been saying it's business as usual, and both agencies are walking the talk very well. You wouldn't notice a change if you looked at their business volumes, except for some of the underwriting things that we've been talking about. They're great lenders and they're doing a good job right now.

Where it's all going is anybody's guess. Congress is going to have to get involved. That will be one of the first orders of business under the Obama administration. The conservatorship is supposed to end at the end of 2009. It's not clear whether that's enough time to resolve what to do with the GSEs.

A lot of people think the conservatorship will have to be extended. If that happens, it's a question of how long Fannie and Freddie will continue to operate in their current mode, and if that current mode will be endorsed or changed. That's where it's anybody's guess.

KATZ: The multifamily component of the agency business is relatively small — I had heard around 15 percent of their overall business — yet generally profitable for the entities.

The question is about liquidity in the marketplace overall. They are going to continue to need capital to put out there. I don't know what this will lead to, but at least one if not both of the agencies was looking at putting together construction-to-permanent loans for multifamily, and maybe branching out into some other arenas.

I don't know necessarily if those plans will be on hold, but it was encouraging to see the

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agencies considering creative structures like that, or forward-rate locks on supplemental loans. It will remain to be seen if they can fill some market niches, because other gaps are otherwise going to continue to widen.

Greening Multifamily

CREJ: ow will California Senate Bill 375, which emphasizes green construction through infill development and higher density, affect new development and current values?

'A lot of multifamily developers feel LEED certification is not that applicable to multifamily development. Some developers perceive that the U.S. Green Building Council is trying to jam a square peg in a round hole.
There have been attempts to come up with some different certification models for green building. The problem is that a lot of local jurisdictions are defaulting to LEED, especially in Northern California. That may be OK for office buildings, but it's a lot more difficult for apartment developers.'

— JO N CONDAS, Allen Matkins Leck Gamble Mallory & Natsis LLP

CONDAS: The state is in a real bind. Assembly Bill 32, which requires the state to substantially reduce greenhouse gas emissions, has many state agencies attempting to devise programs to decrease greenhouse gases. These include land-use regulation because vehicle miles traveled are one of the main producers of greenhouse gases.

When SB375 was first proposed it was revolutionary, usurping some of the powers of local government and almost mandating in-fill development at the expense of greenfield development. It was watered down before it became law. It sets a foundation for future regulation. It is not so much of a cause for concern for local governments.

owever, a huge tension is going to continue between the state government mandates and local government pushback against those mandates. We've seen it for a long time in terms of housing elements, where jurisdictions have to address their regional housing obligations. Some jurisdictions have been told by the California Department of ousing Community Development, which has to certify housing elements every five years, that CD is going to be withholding money and certification unless more affordable housing, and more housing in general, is produced.

Affordable-housing groups have litigated against cities, claiming that they haven't met their affordable housing obligations. This can generate good opportunities for apartment developers to process projects in such jurisdictions. SB375, and future legislation, may have a similar effect on local governments, pressuring them to meet affordable, and now, infill-housing mandates.

For developers willing to go into those markets, there are going to be opportunities. The question is how SB375 will affect non-urban communities. Governments in the Inland Empire are more concerned about SB375 because they have less, or no, infill locations.

CREJ: Don't these laws add costs at a time when executing a development is challenging at best?

CONDAS: Yes. The developers are squeezed to begin with. From their perspective, there are not many exceptional multifamily sites. Then, there's so much opposition to multifamily. SB375 possible creates another obstacle, whether something is an infill site.

A lot of multifamily developers feel LEED certification is not that applicable to multifamily development. Some developers perceive that the U.S. Green Building Council is trying to jam a square peg in a round hole.

There have been attempts to come up with some different certification models for green building. The problem is that a lot of local jurisdictions are defaulting to LEED, especially in Northern California. That may be OK for office buildings, but it's a lot more difficult for apartment developers. We represented a large multifamily developer on two projects in San Jose, and they were mandated to be LEED-certified. They are grappling with how to achieve LEED certification.

CREJ: The complexion of a value-add deal has changed because you may need to go beyond improving the aesthetic to create value, and that may trigger a green requirement, and an even more substantial investment into the property.

CONDAS: That's true, even in jurisdictions that don't have mandatory green building requirements yet. The California Building Code was amended in July, and although the revisions were modest, if you look at future revisions that will be phased in over the next few years, these upcoming revisions look almost like a LEED checklist form. The requirements are going to tighten and tighten.

Then on top of that you have jurisdictions trying to have developers solve the ills of the lack of affordable housing in California by mandating affordable-housing production. It just adds more cost to an area of development that already is hurting. It will be interesting to see how those will impact future development.

LUSTIG-BOWER: Are any cities offering incentives to go green, where they allow an increase in density to help offset the cost? I think it would be a win/win. When they did bonus densities for affordable units, it didn't pencil, but I'm thinking with green development it might.

CONDAS: Many local governments mandate LEED, period. In jurisdictions with voluntary programs, the incentives they offered are supposedly streamlined approval of plans. That is good, but it isn't going to encourage that much housing.

The point you raise about density bonuses is important. In 2005, state law changed concerning affordable housing. Government Code Section 65915 is a very powerful statute. If you're willing to provide affordable housing, you're mandated to get incentives or concessions in parking or height requirements without the need to go through a variance process.

It is a very complicated statute, eight to 10 pages long, and it's a challenge to educate local governments and developers about how it works. But it, coupled with SB375, offer strong incentives for affordable-housing and transit-oriented development, higher densities and a streamlined CEQA review.

Perhaps it's a way that we can get more units built. Potentially, if the density is high enough, it will make the affordable units, even with green-building components, pencil out.

CREJ: Bringing density into a community doesn't necessarily streamline your entitlement process.

CONDAS: That's true, it sounds great in theory, but bringing high densities to an infill site often generates political backlash from the NIMBYs. Where higher density has worked — although it doesn't seem that dense if you are from San Francisco or Los Angeles — is Irvine. Irvine allowed higher densities because there weren't a lot of residents nearby. It was mostly office buildings. There were some lawsuits filed by nearby light industrial users who were afraid that the new homeowners would want to have the industrial uses shut down. Also, untington Beach has approved several innovative mixed-use project with extremely high densities.

Final Thoughts

CREJ: What do you foresee as the biggest risk in the multifamily marketplace for 2009? What are the biggest opportunities?

BRIDGE: The biggest risk is investing in fringe markets, but it sounds like the lenders aren't going to allow that to happen anyway. We're really getting back to basics.

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We have to be very careful about analyzing the underwriting and the fundamentals. Long gone are the days where we can ask our lender to become our partner in a joint venture for a projected increase to occur at some point down the line.

The best opportunity in 2009 will be the chance to innovate and create new models for multifamily property. When everything appears to be breaking down it's my favorite time in the market. It leaves it wide open for innovation and imagination.

'The opportunities come from waiting for owners to *have* to sell. Once we see that change in psychology, there will be a lot of deals. As long as you buy below production cost and in infill locations with the right fundamentals, you will do extremely well. owever, buyers need to calibrate themselves with the market. Buyers that are overly pessimistic and not in tune with the market will miss the boat.'

— ALEX MOG AREBI, Marcus & Millichap Real Estate Investment Services

KATZ: There are a couple of risks. The first is, as operating expenses increase across the board with respect to utilities, service contracts and wages and NOIs for multifamily decrease overall, owners and developers could feel a crunch when it comes to covering their mortgage payments and expenses every month, and hoping to have anything left at the end.

Another risk is the wave of defaults that could follow as the loans originated over the past 10 years come due and can't be refinanced at their unpaid balances or even close to it.

Those same risks, however, also are going to create great opportunities. There are a lot of well-capitalized individuals, from mom-and-pop operators to opportunistic funds, sitting on the sidelines waiting to swoop in and pick this stuff up. We don't know what the Obama administration will do fiscally, but it could create some opportunities toward the middle or the latter part of next year.

LUSTIG-BOWER: The biggest risk for multifamily in 2009 is going to be the overall economy. Multifamily is going to go up and down with the tide. Everybody's exposed to it. Additionally a lot of the multifamily outlook depends on what happens with Fannie Mae and Freddie Mac because the multifamily industry so heavily depends on these two lenders to provide financing now that a significant number of other lenders are out of the business or have become too expensive. Multifamily lending is really only a small percentage of Fannie Mae and Freddie Mac's business. If Fannie Mae and Freddie Mac more crises coming down the line, they may not be able to keep the lending going for multifamily. They may need to divert that money to the bleeding crises rather than make new loans. If we lose the ability to go to Fannie and Freddie for debt, chances are high that cap rates will increase significantly as the remaining lenders in the market are more expensive than the agencies. The disconnect between the buyers' and sellers' expectations will increase, most likely causing a stagnation in sales volume, similar to what other commercial properties are experiencing today.

Retail centers are already finding it hard to get financing. We may join the other asset classes, unable to get reasonable conventional debt. That is a big risk.

The opportunity on the horizon is that there's going to be some smart buys, either through the lender or distressed sellers. We may not hit the bottom of the market in 2009 necessarily, but if you're buying on the way down, or on the way up, you should come out ahead.

CAULEY: The biggest risk is obviously economic. That may be short-lived or long, but near the bottom there are always deals. If you recognize the bottom, you're going to do very well in the long-run. Apartment buildings in Southern California are going to be a lot more valuable 10 years from now than they are today.

WHITE: The biggest risk is the job market. The foreclosure situation is not going to stabilize in the near term if we have a serious unraveling of jobs. The unemployment picture is going to hit us in many different ways. Anybody who has invested in apartments is betting on the U.S. economy. It's a good bet as long as things are reasonably stable with prospects for growth. It's not a good bet if things really go south.

In terms of opportunities, those that have kept their powder dry are going to be in a position to help themselves, and stabilize our business, by coming in at the right time with the right purchase.

MOGHAREBI: It comes down to jobs, affordability, and lack of financing — the biggest risk could be a combination of those. Investors looking at deals should ask how well they can preserve their investment, rather than how good of a deal it is. If they want to buy something, their view should be long-term, based on how well the deal has been underwritten, and how well they can preserve their real estate. We know the reproduction cost is going to be higher in 10 or 15 years. The short-term deal is gone for the next four or five years, until the dust settles and we understand what direction jobs, affordability and financing are headed.

The opportunities come from waiting for owners to *have* to sell. Once we see that change in psychology, there will be a lot of deals. As long as you buy below production cost and in infill locations with the right fundamentals, you will do extremely well. owever, buyers need to calibrate themselves with the market. Buyers that are overly pessimistic and not in tune with the market will miss the boat. In addition, private investors will be able to re-enter the market, which they haven't had a chance to so in some time because the institutions were buying larger properties. You couldn't get at a Class A building with private capital. Today institutions are gone and private capital has the opportunity to take advantage of the market, provided they have patient money.

CONDAS: From a regulatory standpoint, the risks and opportunities are almost mirror images of each other. If the new development is green, sustainable, a transit priority project, dense residential — at least 20 units to the acre — or a mixed-use project under SB375, litigation and regulatory risks are minimized as governmental agencies tighten down the requirements. Such projects also will improve the likelihood that such a project will be approved.

There is much political will to decrease greenhouse gases. If the development community can conform to these expectations, they will be miles ahead. The California Government Code has some tremendous provisions to help get affordable-unit projects built. Developers should look for jurisdictions that are having problems meeting their regional housing needs. They're going to be much more open to approving development with affordable units.

CREJ: It's an interesting time for multifamily. There's an essential dichotomy in the marketplace. Quality operations, quality locations, quality markets, essentially, solid real estate fundamentals, will drive and sustain opportunity going forward in the multifamily marketplace, particularly in California. But on the flip side of that there are unprecedented challenges in terms of the restructuring of the financial markets in an economy that perhaps will have a shallow recession or perhaps is in for something long and painful. And we've seen the beginning of the unwinding of the financial engineering that really dominated the marketplace, compounded by the fact that we are seeing essential changes in the makeup of our communities in terms of greater density and going green.

Definitive answers may be hard to find but at the very least it creates an interesting marketplace going into 2009. So thank you very much in helping point us in the right direction to spot these challenges and opportunities.

SPONSOR BIOGRAPHIES

SARA L. BRIDGE

Sarah L. Bridge has been active in multifamily investment real estate for 25 years. She has been a commercial real estate broker, in-house broker for a merchant developer and presided over disposition and recapitalization for a large portfolio.

In 1989, Bridge co-founded **REALFACTS**, a research organization and database publisher. The online service covers more 3.1 million units of investment grade apartments in 60 MSAs.

Realfacts will celebrate 20 years in business in 2009.

STEP EN D. CAULEY

Stephen D. Cauley is the director of research for the **RICHARD S. ZIMAN CENTER AT UCLA**. e conducts research on the application of recent advances in economics, finance and statistics to the valuation of publicly and privately held real estate, and has developed innovative statistical and visualization techniques to analyze spatial variation in real estate markets. Cauley was responsible for the development of the CRSP/Ziman REIT databases. In addition to research, he teaches real estate investment and development at the Anderson School.

Cauley has held academic and research positions at the RAND Corporation and the Department of Economics at UCLA.

JO N CONDAS

John Condas, a partner at **ALLEN MATKINS LECK GAMBLE MALLORY & NATSIS, LLP**, has broad experience obtaining and defending all types of land-use and environmental permits. e has particular experience working with multiple-species habitat plans and advises clients on the developing climate change and green building requirements they face.

Condas has led legal due diligence and entitlement teams for real estate projects in more than 160 jurisdictions. e has represented national, publicly traded and private homebuilding clients acquiring more than 18,000 residential lots.

Condas has taught real estate law at the University of Southern California law school and in its MBA and Master of Real Estate Development programs. e serves on the NAIOP-Inland Empire Board of Directors as well as the USC Lusk Center Executive Committee. e has been recognized by his peers with a Martindale- ubbell A-V Rating and in Southern California Super Lawyers for Land Use/ Zoning in 2007 and 2008.

ALEX J. KATZ

Alex J. Katz manages the day-to-day operations of the West Coast division of **MERIDIAN CAPITAL GROUP**, including a staff of 12 and based in Century City. In addition to overseeing and implementing the firm's ongoing business development initiatives, Katz personally works with many existing and prospective clients on the structuring and placement of their debt needs. This regional office has been open since the middle of 2006 and has enjoyed tremendous growth and market traction in California and neighboring states.

Katz previously worked in the real estate department of Kramer Levin Naftalis & Frankel, a New York-based law firm. e had also managed various land-development projects at the Kushner Companies, a real estate development company in Florham Park, New Jersey.

LAURIE LUSTIG-BOWER

Laurie Lustig-Bower began her career in commercial real estate 20 years ago with **CB RICHARD ELLIS** and now holds the title of executive vice president with the firm. She is the founder and leader of Team Lustig-Bower, a group of seven professionals specializing in the sales of apartment buildings and land for development of apartment buildings and condominium communities in Los Angeles. In the past three years alone, Lustig-Bower has handled nearly $2.5 billion in real estate transactions and has been rated one of the top brokers in the United States for more than a decade.

ALEX MOG AREBI

Alex Mogharebi joined **MARCUS & MILLICHAP** in 1989. Over the past 19 years, Mogharebi has become one of the top brokers in California and the country, specializing in the multifamily investment market. e exclusively represents some of the Inland Empire's largest property owners in their commercial real estate needs. During his career, Mogharebi has sold over 40,000 units totaling over $3 billion in sales. e has been the top investment professional companywide for Marcus & Millichap a record 13 times and is one of only three executive vice president of investments in the firm.

TIMOT Y L.W ITE

Timothy L. White is president of **PNC ARCS**, a PNC real estate finance company and a leading supplier of commercial mortgage financing, with an acknowledged expertise in multifamily financing. ARCS is one of the leading financiers of apartment projects in the U.S. and as of July 2007 became a wholly owned subsidiary of PNC Bank.

White joined the original ARCS Mortgage as general counsel in 1993. When ARCS Commercial Mortgage was formed in 1995, he became chief operating officer and general counsel. e played a key role in completing the sale of the company to PNC and has spearheaded the transition team since the emergence of the new ARCS.

Prior to ARCS, White served in counsel roles with United California Bank, Weyerhauser Mortgage Company and Pillsbury, Madison, & Sutro, with a focus on real estate and finance.

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