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Balance Shifts Back to Multifamily

Investors look to apartments for opportunities, but tight credit, low affordability and the unpredictable effects of the single-family market demand smarter decision-making by real estate pros

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ROUNDTABLE ■ MULTIFAMILY

PARTICIPANTS

Stephen D. Cauley

Rory Ferlauto

Gary H. Goodman

Jason Greenman

James C. Hughes

Holli Leon

Alex Mogharebi

When the single-family residential market slows, the multifamily industry revs up to meet the needs of increased rental demand. The single-family market has slowed dramatically from several consecutive record-setting years with California home sales down more than 40 percent and the median price of existing homes down 9.9 percent in October compared with the same period last year, according to the California Association of Realtors.

But this cycle brings challenges that may impact the residential market's paradigm. The ongoing credit crunch will challenge multifamily investors and developers to finance new projects and deals that pencil out. The condominium market, which took rental supply off the market, is now giving that back in the form of shadow space, making the markets harder to track. With much of the new rental supply coming in at the higher end and rents already on the rise in general – statewide rents were up 16.9 percent the past four years while occupancy was down 0.1 percent since 2003, according to RealFacts – apartment owners may find it harder to raise rents.

The California Real Estate Journal gathered seven multifamily experts to explore these and other issues in this transitional market. Moderated by Editor Michael Gottlieb, the panel included

STEPHEN D. CAULEY, director of research, Richard S. Ziman Center for Real Estate at the University of California, Los Angeles
RORY FERLAUTO, senior vice president and director of the Private Capital Advisors group for Colliers International
GARY H. GOODMAN, senior vice president, Passco Cos. LLC
JASON GREENMAN, chief product officer and senior vice president of business and product development, LoopNet Inc.
JAMES C. HUGHES, real estate partner, Greenberg Glusker
HOLLI LEON, executive vice president of production, PNC ARCS
ALEX MOGHAREBI, vice president of investments, Marcus & Millichap Real Estate Investment Services

State of the Market

CREJ: What is the state of the multifamily market today, and how has it changed lately?

GARY H. GOODMAN: Two major changes have occurred in the last few months, one positive and one negative. Interest in owning a home, and the rush to finance those sales abated somewhat. In our portfolio, not as many residents of our multifamily properties are leaving to buy homes. They don't feel pressed to buy now — or be left behind. So we are seeing less turnover in apartments, and as a result, we are able to raise rents a little.

On the negative side, with the change in the capital markets, it's been trickier for us to acquire properties. There is a shift in pricing. Private capital investors are not sure what to pay because of the uncertainty of loans and the cost of financing. You're seeing a lot of deals go under contract that don't close. I've had a number of cases recently where brokers or even sellers have called and said, "We've gone down the road three times with three different buyers. Here's what we'd like to sell it for. Do you think you could buy it for that?"

I don't know how that's going to play out long term, but in the short term it's created a lot of uncertainty with respect to where yields should be for apartments.

HOLLI LEON: We're seeing that on the debt side. So many opportunities come up where somebody's going to buy property A, we work on it for a while, and it falls out of contract. Then the same property comes back with another buyer. We'll work on it for a while, and it'll fall out again. Then buyer A comes back, and now the price is several million less, and we'll work on it, and it will fall out again. The uncertainty of the financing has been a roller coaster.

We sell the preponderance of our loans to Fannie Mae and some to Freddie Mac. We do have conduit, but the conduit pricing is 50 to 60 basis points wide of where the agency debt is. The agencies are reliable, but they are not going to the stretched maximum position where we saw the conduits going just two or three months ago.

ALEX MOGHAREBI: The buyers that were acquiring these properties were not paying so much attention to the going-in capitalization rate, versus the cap rate coming out of those deals. If they believed they could do a deal at even a 4 percent cap rate, knowing that they could exit at a 6.5 or 7 percent cap, current income was not that important to them. It makes it really uncertain as to how much these rents could be pushed out.

What will it be two or three years down the road? The lack of an answer to that question is a primary cause of what's happening in the market. They don't know where the cap rate is going to end up.

That's the fundamental on every deal that went under contract. The cap rates were not making anybody excited, but people made a lot of money moving the cap rate around. It appears that the musical chairs have stopped. Everybody's pausing. There is uncertainty in the quality of the earnings today and down the road, and also in how much more can they push the rents before tenants are squeezed out of the submarket.

That's the big question on everybody's mind, with so many deals going in and out of escrow. I've had situations of people walking away from $1 million, $1.5 million, nonre-

CONTINUED ON PAGE 18

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CONTINUED FROM PAGE 16
fundable deals where it was supposed to close within two weeks, and I get a phone call, and they're not doing the deal. I'm actually happy to see it end. They pushed and pulled to see if they could get the money out of the seller, but there's really no reason to give it back, so they walked.

'The mantra for the past few years in Southern California has been: "Cap rate doesn't matter; it's all about how much I can move the rents." That's now shifted. Underwriting has to be based on where the rents are. Class A is probably a safer investment now, in terms of trying to figure out where it's going to go, rather than a 4 cap Class C property that needs a lot of work.'

— GARY H. GOODMAN, Passco Cos. LLC

The last time I saw anything like this was back in 1991-92. I never would have thought I would see this sort of environment again.

The other factor is that the majority of the properties have been repositioned. Almost every property out there has been repositioned two or three times. How much more money can you put into the property to justify the anticipated rent growth?

LEON: The exit that you mentioned shows up in the financing side as well. For a very long time, no one was looking at how a borrower would get out of a loan. We were doing 10-year, interest-only loans, very pushed deals. That's been turned off. Now we're looking at what might happen in five years. So it's the finance side that's affected.

JAMES C. HUGHES: "Pushed deals" is a very apt description of what was happening in the era of relatively cheap money. We've all been pushing to get the deal because it will be more expensive next month, or there will be somebody else to step up and pay that price. The era of tight credit — we've all been through these cycles — means we go back to fundamentals. We take a look at the underwriting again. It's better to walk away from a deal that's going to cost you money in the long run, or a net-even deal, than to just get caught up in the deal cycle.

Lifting our noses from the grindstone of doing deals just to get them done means we now have the opportunity to take a look at the diversity in the multifamily markets. There are greater choices than we've ever had before. A lot of it is centered at the luxury and near-luxury level, such as the apartments built around downtown Los Angeles to capitalize on the white- collar professionals who want to live closer to their downtown offices.

There is great potential for affordable-housing deals.

We're going to be looking at parcels in areas and in sites that have been over looked before, to try to find ways of fitting projects into different paradigms, different models.

Cheap scrubland out at the end of a freeway somewhere is no longer going to work on a practical basis or economically. People are going to have to take a look at the demographic and economic trends. They're going to have to go back to their spreadsheets and work very hard to satisfy the lenders.

There will need to be an entrance as well as an exit strategy. This will result in greater intelligence being brought to the field, so we can come up with products to serve the needs of not only the next week but five years from now.

MOGHAREBI: The business clearly has changed from market-driven to economics- and product-driven. It requires more of a technician to put together deals in a more lucid environment.

STEPHEN D. CAULEY: This implies a lot less development. Alex, you were talking about 1990 and 1991. It's different now in that we don't have a recession going on. But the way real estate markets respond to good things or bad things happening is very different from financial markets. If something good happens in a financial market, the stocks go up. If something bad happens, stocks go down. Liquidity doesn't change.

Real estate is fundamentally different. We don't know how much it should go down. No one knows what the right risk premium is. It's clearly repricing. The natural reaction of real estate markets under those circumstances is to do no transactions. Liquidity goes away. That's what we're seeing right now. It's been happening without a recession. If we have a recession, it will be a very different thing.

MOGHAREBI: Part of it is not being able to predict inflation. Bankers set the rates based on the cost of funds and the anticipation of inflation. They have to answer if you're going to put the money out at 5.5 or 6.5 percent. Right now there's a big disconnect around anticipated inflation. People can't predict what the cost of funds will be, just to be safe.

LEON: A risk premium should be placed on every transaction. The rating agencies got religion a few months ago. Every day is a new adventure since they stepped in. We are watching how the marketplace is going to price that risk premium.

MOGHAREBI: Isn't that tied to the anticipation about the inflation rate for the next three or four years?

LEON: I suppose. But it's also just evaluating how much risk there is with the transactions that are getting done.

CAULEY: It's the macro-economy. Look at Treasury Inflation Protected Securities and 10-year Treasuries. The difference between those rates gives you what the market thinks is going to happen with inflation. I don't think that we're going to have a big ratcheting up of inflation. The risk premium that we're talking about is that we just don't know.

Managing the Transition

CREJ: We're describing a market in transition. What does that look like?

JASON GREENMAN: The numbers are clear. For the third quarter, in all of California, with transactions of $5 million or above, there were 132 transactions, versus 168 in the third quarter of '06. It's about a $2.5 billion third quarter versus a $4 billion third quarter of '06. That's a significant drop. Half a billion of that came in the Inland Empire.

LEON: Are there more small deals happening, though?

GREENMAN: Yes. Your average price is lower. Average price per unit is lower too.

LEON: But also smaller deals — fewer than 100 units?

GREENMAN: Yes.

MOGHAREBI: Last year I did 52 transactions. Many were $5 million and above. This year we will be lucky if we do 30 or 32.

RORY FERLAUTO: We've seen a significant drop in the transaction volume as well. I looked at CoStar's $1 million-plus transactions list. We're off by 35 percent from '06 to '07 in Orange County, and the same number in the San Fernando Valley.

It has particularly hit the private capital market. We're at a pause. A lot of it is the uncertainty. We're not affected like Alex is in the Inland Empire, with the shadow market of single-family homes re-entering the market as rentals. I don't expect that to be a huge impact on the urban markets.

For the most part, the private equity players and the mom-and-pops have exited the market. You can see it in the dichotomy between sellers and buyers. Only the technicians, the sophisticated operators, expect to re-enter the market, probably in 2008. They were on the sidelines, outside of California. Now they are back, with their money lined up, ready to re-enter and find value.

CREJ: Wasn't there more condominium exposure in the urban markets in terms of the conversions?

CAULEY: Westside L.A. is really subject to that.

FERLAUTO: We haven't seen it happen yet. The transition is happening as we speak. We're on the lookout for the impact in particular submarkets where there were many conversions, but we're not expecting as much of an impact as in outlying markets where there's more land and supply is up.

MOGHAREBI: Private capital, which as you mentioned is out of the market now, is a big source of what drives value. They are more sensitive about the economics of deals. They would come into the market every five or seven years and acquire property. You would not hear from them unless there were some sort of refinancing bringing money into the marketplace, or if they were going through a 1031 Exchange. Almost every single one of these exchange buyers is gone. I used to get four or five calls a week

CONTINUED ON PAGE 20

CONTINUED FROM PAGE 18

from them. Today, it's maybe five a month, and half of those are more about paying their taxes.

LEON: We've had several situations where we were looking at deals and the acquisition fell out, where the buyers said they had 1031 money, and they would rather pay taxes than make a mistake.

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— ALEX MOGHAREBI, Marcus & Millichap Real Estate Investment Services

MOGHAREBI: I heard someone say that this is a great time to have the market pay your taxes. It's the psychology of the market. I believe the market is overreacting to all this stuff.

HUGHES: So much of the psychology of the real estate market is about looking for justification. It doesn't necessarily have to be related to the real estate industry or any sector of it. We extrapolate from one soft indicator, perhaps illogically or incorrectly, to a softness in the real estate market as a whole.

Sellers need to be disabused of the notion that they can hold out for unreasonable purchase prices or cap rates. The real estate market should be left to professional real estate people who will work with rates that make sense, and not tie everything to speculator-level investment profit expectations.

MOGHAREBI: Ultimately, professional real estate people are going to be running these properties. I like to demonstrate that with an apartment-owners directory. Do you guys remember the apartment directories that used to be published a long time ago? It was literally an inch thick. Today the same directory is a third as thick. The buildings haven't gone anywhere; there are actually more. It went from one name per property to one name for 20 properties. The market has become much smaller.

When you have more owners, there are more sales and refinancings, creating more opportunity for the rest of the market. Larger management firms have a different way of looking at the market. They do longer-term holds, unless they need to reposition an asset.

CREJ: Gary, is this what you're seeing with the tenant-in-common and 1031 markets?

GOODMAN: Yes. Our industry placed about $3.7 billion of equity for tenant-in-common investors last year, but this year we expect the volume to drop below $3 billion. Fewer people are selling the smaller properties, and some of them are paying their taxes instead of exchanging.

We are seeing a flight to quality outside California, for a couple different reasons. The fundamentals for Class A multifamily are better now than six months ago because people who could have afforded mortgage payments are now content to just rent, and they can afford the Class A properties with all the amenities. So there is a thought in the industry of, if I'm going to buy a multifamily property now, maybe I should stick with that end of the spectrum.

Financing is better — more aggressive on the Class A properties. Sizing and terms are better. You're more likely to get interest-only loans and other benefits that are more difficult to obtain in the value-added properties. The mantra for the past few years in Southern California has been: "Cap rate doesn't matter; it's all about how much I can move the rents." That's now shifted. Underwriting has to be based on where the rents are. Class A is probably a safer investment now, in terms of trying to figure out where it's going to go, rather than a 4 cap Class C property that needs a lot of work.

LEON: I disagree. We're seeing some very aggressive repositioning deals, where we are recognizing what the rents and the repositioned NOI will look like. There's a quality aspect. Loans are out there for long-term interest-only deals with significant rate-positioning opportunities. For experienced borrowers who know what they are doing, if the market supports the rents, lenders are supportive. They have a very strong belief that the demographics and the characteristics of our marketplace are such that those rents will hold and improve.

HUGHES: You're saying the same thing, Holli. You do your own underwriting, and determine if there's the potential to make that jump up to Class A or near to it, which is what everybody's really looking to. Those deals are definitely getting done. But those are not people who will wait in line, being the fourth or fifth offer on a property to somebody who's holding out for too much. They have too much to do to waste their time with that. They're going to go right for the jugular. They want to get the stuff that's off market. They're the people looking to get in now that a lot of the air is out of the market.

CAULEY: It suggests very different repricings for different areas of the market. Repricing at the top ought to be much less than it is at the bottom. Repricing ought to be fairly dramatically at the bottom of it. There has been a lot of cap rate compression, and that will reverse itself fairly dramatically.

Cap Rate Outlook

CREJ: What is the cap rate outlook across different markets?

GREENMAN: Los Angeles third-quarter closings for $5 million and up was 5.2 percent, versus 5.1 a year ago. It's been trending down over the year from 5.6 in the first quarter. Inland Empire, the same, 5.2 percent. Does that seem high?

MOGHAREBI: It's low. It's a difficult discussion, how you underwrite the deal, what kind of agency, and what kind of expenses. These cap rate reports are quite different from the real numbers, considering that I did 95 percent of the market share. It's more like a 5.5 cap, or 5.67, when all the dust settles.

CAULEY: Isn't that just for the better-quality properties?

MOGHAREBI: There's not that big a difference across the board, because the reproduction cost comes into play. The income is going to eventually catch up with it, and it will take care of the value. There's a lot of that discussion going on in a commodity market. Construction costs remain the same no matter where you go. What changes is the cost of the land, and challenges with the permits.

If they go to a Class C property, cap rates won't be that different; maybe a 6 cap. It's not like there's a 1.5 percent point difference. The Class A product was hit hardest in the Inland Empire; it moved from a 4 cap to a 5.25 cap rate. The economy is playing a bigger part. Those cap rates are more like a 5.5.

GREENMAN: That is closer to the statewide figure of 5.5 percent from the 132 transactions last quarter. It ranges all the way up to San Jose, which was over a 7 cap in the last quarter.

FERLAUTO: We are starting to see some of that decompression of cap rates, correcting for locations in some of the more dense areas in the San Fernando Valley. Two years ago, a Class A property and a Class C property were both trading at a 4.5 percent cap rate. There was no difference priced in the risk. If you looked at LoopNet a year ago, you'd see no deals over a 6 cap anywhere near the city. Today there are many deals on the market over a 6 cap. That's in some of the C and B-minus markets. So we are starting to see the market normalize itself.

On the high end, the cap rates are still very low and probably have about 50 basis points to go. But then I would say there's going to be an additional 25 to 50 basis points for location. It's just starting to occur. There haven't been too many closings at those numbers. You can certainly see it in the available inventory. Over the next six months we will see more market normalization. The low cap rate environment simply wasn't sustainable, and a large part of it was because of where the interest rates were and the pricing of debt.

MOGHAREBI: Part of that was the NOI. In some of these areas the NOI has gone backwards, so the cap rates remain the same while the value of the properties came down. Most people don't pay attention to that. They focus on the cap rate, but it works out of the NOI. If your NOI drops 5 or 10 percent, even if it's the same cap rate, it's going to produce a different value in terms of the cost per unit and per foot. That's what we're seeing in the Inland Empire. The prices are coming down more so than actual adjustment in the cap rate because the economics of the deal has changed quite a bit.

CONTINUED ON PAGE 22

CONTINUED FROM PAGE 20

Is Multfamily Back On Top?

CREJ: We're coming out of an extraordinary cycle in terms of the flow of capital into real estate. Multifamily has been in the lead, especially in markets like California, where you have

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— HOLLI LEON, PNC ARCS

great fundamentals of inadequate supply and high demand. Now that the single-family market has pulled back, the logic takes you back to demand for multifamily, tightened occupancy and increasing rents. Is that how it is playing out?

HUGHES: We don't know enough about the subprime mortgage market's impacts. Those loans are in certain locations, tied to the supply and demand of homes in the entry level or lower demographic areas. But the contagion hasn't spread outside those areas. There is a suggestion that mortgage foreclosures are increasing, but you don't have large-scale foreclosures throwing people out of their homes, just isolated areas. So we aren't seeing a rush to apartments.

We don't have enough indicators at this point to be able to assume that multifamily will be positively affected by these developments.

CREJ: How does it look in the Inland Empire, Alex? It's been one of the hardest-hit areas in terms of what's happening in the markets. You were just starting to deliver Class A multifamily product.

MOGHAREBI: A big percentage of the Inland Empire's new home owners, as much as 40 percent, were investors. They bought those homes to write off the housing market and get a benefit. These homes are sitting empty in the marketplace. They keep reducing the rent. So now the reasonable tenants with good credit are looking at moving into homes, versus staying in Class A multifamily. There's even a possibility of purchasing these homes later on. So that has been a big factor in the Inland Empire for Class A properties.

GOODMAN: I don't think it's as much to do with areas with foreclosures as the fact that the whole financing picture has changed for homebuyers. They can't get the 100 percent financing, whether they've got good credit or not. So now you've got to have a certain amount of cash to put down on a house, and that's a whole different proposition. You might be more inclined to rent longer and save, and do other things with that money, rather than put it down on a house, especially if you don't think values are going up.

LEON: Buyers are being sucked out of the buying market and put back into the rental market.

GOODMAN: Turnover is being reduced. For the last few years, and because we're heavily invested in Class A properties, our biggest problem was what we call the "backdoor" of tenants moving out to buy a house. That's not happening now. They're staying longer.

MOGHAREBI: So what's going to happen to those homes if the buyers remain in apartments?

GOODMAN: My guess is they're going to be put on the market by the lenders. From what I've heard anecdotally, they are not taking the discounts on those houses yet.

MOGHAREBI: But if it doesn't get sold?

GOODMAN: If we go back to what happened in the early '90s, it'll be a problem because they were offering 100 percent financing. Now they may require 20 percent down to buy a house.

HUGHES: Or those will be bought at a good price and held by somebody who's hoping for an adjustment in the market.

MOGHAREBI: Then we'll see a huge transition, as quality tenants purchase homes if they can get their hands on that 10 or 20 percent downpayment. It reduces the quality of the tenants significantly for Class A buildings.

GOODMAN: What is different at this point is that we don't have the deep recession that we had back in the early '90s. That had a serious effect on all kinds of housing. There is just less demand for multifamily, or single-family, when you lose jobs. So far, we haven't had that problem. Hopefully we won't.

Rental Pricing Power Limits

CREJ: Do we have the pricing power to raise rents, or are rents going to hold steady for the time being?

CAULEY: People are putting about as much of their income into renting as they can afford to. It's going to be a real issue with people renting today in California.

MOGHAREBI: Right now, 50 percent of the tenants' income in Orange County is going to a landlord. It makes you wonder how they can live off of what's left.

GREENMAN: Is that on Class A properties or across the spectrum?

MOGHAREBI: Across the spectrum.

CAULEY: It probably is worse.

MOGHAREBI: Moving tenants from one building to another is not going to be the answer. The ability to move rents is absolutely gone, and that's what drives the market. That's why the Inland Empire was so attractive — they could see $600 to $700 rents on a B-plus/A-minus-quality property. It was very easy to suggest that rents could increase by as much as 10 to 12 percent, even 15 percent in some cases. Now that they've got the $1,400 to $1,500 rents, with an average household income of like $45,000, you do the math. The cost of gasoline is a factor too, with a lot of people commuting.

LEON: That could drive people back into the more populated areas, where their jobs are.

CAULEY: Or drive firms out. These are families. They need schools, markets, neighborhoods. You just don't have those things back here in the city. So the people who are talking about coming back to the core city are really missing it. Firms are going to move out to where people can afford to live.

CREJ: That is one of the factors that has been driving the Inland Empire. But it seems like that market is being whipsawed.

MOGHAREBI: It's temporary. We're talking about today's market, not projections. For the smart money to revisit this market and position themselves for taking advantage for the next cycle, it can't be a better time. For patient money, with the right economics, and the right type of deal, Inland Empire is extremely promising.

Doing Deals

CREJ: What is it taking to do deals today, especially with the same deals coming back repeatedly?

LEON: We are looking for a clear deal, where either the loans make sense and there's no repositioning, or there is some significant repositioning story that you can buy into with an operator that has a proven track record, preferably in that marketplace. A lot of the borrowers we see are those expert repositioning players. They have a plan. They know roughly how much they've got to spend. But they don't want to button it down. They want a little bit of latitude, so that they can make changes, do the countertops a different way, do two colors of paint, whatever it takes to stay on the pulse with the market, and they want to be able to divert money to it.

We want to see deals that make sense. There is some really strong financing available today. We continue to have issues getting in excess of 65 percent of purchase price. We feel we've really hit the mark if we can do that in Southern California.

MOGHAREBI: What do you like to see in terms of the real cap rate going in?

LEON: We don't really look at cap rate. We're looking at debt cover.

MOGHAREBI: So you're looking at the deal as is.

LEON: As is, and then where it's going to be when the repositioning is finished.

CONTINUED ON PAGE 24

CONTINUED FROM PAGE 22

MOGHAREBI: So when the reposition is finished, what are you looking at?

LEON: In this market, we want to be at a 115.

MOGHAREBI: That's the biggest issue we have.

'We are going to have to pay closer attention to how each project justifies its existence in terms of location, integration into the transportation policy and energy efficiency. Those are going to be ways that developers, even in multifamily, are going to be able to get their projects to the front of the line, receive expedited density bonuses, and be able to justify them, plain and simple.'

— JAMES C. HUGHES, Greenberg Glusker

When you run the numbers on that basis, there's a clear disconnect with the majority of the deals.

LEON: A year ago, when a lot of deals were interest-only, there was so much extra cash flow that a lot of these deals were really engineered. They were financially engineered to support higher values. Now that's all been stripped away. That's why we're seeing the change in the purchase price.

MOGHAREBI: So it looks like liquidity drives the market, and that's changing that whole market.

FERLAUTO: A lot of our clients aren't quite there yet. There is a big disconnect from seller expectations. A lot of them are being driven to off-market deals. The bullishness and optimism for the Southern California market is still very strong. I've got clients underwriting on seven-year holds with rent projections at 5 percent for the whole seven years.

I'd be curious to see what lenders are underwriting to. In my opinion it would be more like 5 percent and then maybe down to 3 percent. It shows the optimism it takes to get the deal done. You're still seeing some fairly aggressive underwriting at more of the institutional level, the 100-plus-unit deals, where the appetite is so strong to enter the Southern California market and grow your portfolio.

CREJ: Gary, you've got some very particular targets that you need to achieve in order to be successful with TICs. Are you able to find deals like that in California?

GOODMAN: It's always been very challenging for us to acquire multifamily properties in California. Part of the reason is that we are advisors to private investors who are typically coming up with $100,000 to $1 million cash, pooled with other investors. Many of these investors are retiring and living on the income from their investments. It may be their whole nest egg. Obviously, it's very critical that we invest that very safely.

As a result, we aren't typically doing "deep value-added" rehab-type properties for them. We're looking for Class A properties that are stabilized, predictable, and we know exactly how much capital is going to be required during the holding period. We usually hold these for 10 years or so. Because our investors are income-driven, they need somewhere between 5 and 7 percent cash-on-cash on their money. So we're more likely to buy out of state where yields are higher.

CREJ: But you're entertaining the notion of buying here?

GOODMAN: We are. We're probably one of the few companies that can try this. We're actually contemplating coming out with an offering of a value-added-type property, for a TIC investor who is not necessarily concerned with current income, but is more interested in short-term upside potential and is willing to take more risk. We like Seattle right now, for example, for its strong apartment market fundamentals and rent growth. It may also be time for us to look here again, so I've been very interested to hear what people are saying about the fundamentals. Clearly this is a market where you aren't going to get much cash flow, certainly on a value-added deal, so maybe the transition that is occurring in the market will present an opportunity for us to buy.

MOGHAREBI: It would be, for a long-term hold, even in the Inland Empire. I see opportunity for someone with patient money.

CAULEY: How much repricing do you have to have before you'd see value go down before you see opportunities, 10 or 20 percent?

MOGHAREBI: We already had a 10 or 15 percent adjustment, depending on the market. The more outlying areas are at 15 percent. As you get closer to L.A., Orange and San Diego counties, those markets have adjusted 10 percent. There is another 5 to 10 percent to go for both, and once that happens, the market is positioned to make one more run of the next five years. The opportunity is there, once this adjustment takes place.

CAULEY: Places like Bakersfield will be the same.

MOGHAREBI: Bakersfield/Fresno actually is considered one of the best markets.

CAULEY: They don't have to have as much repricing as say Los Angeles?

MOGHAREBI: Yes. One of the key factors that we look at is the gap between a house payment and the rental market. That's how it translates to the income level within a five- to 10-mile radius. That transition can translate to income level. If they're making $200,000, $50 doesn't make a whole lot of difference. But if they're making $50,000, and if there's a $300, $400 gap between a house payment and the rental market, that's significant.

LEON: As soon as you start talking about no longer having those very short horizons of making a bundle and bailing, you make a more persuasive argument to invest in Southern California. We've seen a lot of California owners who go into other states, and we always get worried. They think they can buy a beautiful apartment property for a very small amount per door. The truth is, in 10 years it won't be worth that much more, while if you had invested in California, you would have a significantly better outcome.

HUGHES: I'll take a contrary position. There's no doubt that if you do invest outside California, if you're not committed to underwriting and fundamentals, and you don't spend a lot of time getting to know the area and talking to everybody you can about it, then of course you can get hurt.

They say all politics is local? Real estate is local as well. Investors who are bound to a particular location are going to get hurt from time to time. The only real way to look at it, even statewide in California, is that the light is going to be green in some areas at certain times — meaning it will be the right time to buy — and red at other times, for a complex web of reasons, from jobs and local industry to governmental attitudes and permits issued.

But real estate is an increasingly regional business — it's multi-state. Look at the West Coast as an integrated whole with a lot of cross-pollenization. It is possible even for a local or regional firm that does its homework, with strong lender relations to go in and tap these markets.

As we've described before, we are coming out of a cycle where pretty much everything has been repositioned and repriced to achieve the NOI numbers necessary to get the financing and the refinancing. So sure, a lot of the markets in California are fully priced. You've got to go elsewhere to find those deals and identify less mature markets that haven't gone through our several years robust cycle of appreciation and turnover or older product, product with problems like mold, fractious partnerships or manageable problems. People looking for inherent value are going there now and doing those deals, and they can do very well. But again, underwriting is the key.

CAULEY: I question the bullishness with regard to California. This is such an expensive place to live. I tell this story: I have a daughter who's an electrical engineer, she's 28, and she's doing about as well as anybody her age can be doing in terms of salary. She's in San Diego, and even with the repositioning in the condo market, she really can't afford a reasonable place to live. The idea of living outside of California is suddenly becoming much more appealing to her.

Wonderful climate is one thing, but it doesn't make up for the problems, including gridlock and rising fuel costs. She lives in downtown San Diego and works in Rancho Bernardo. When she was first doing that commute it wasn't such a big problem. Now it is.

MOGHAREBI: In my view, availability drives the market. It's gotten to the point that it's just not there. That's going to create whole new kinds of problems.

The Illusion of Affordability

CREJ: How does affordability play into the market today?

CONTINUED ON PAGE 26

SPECIAL SPONSORED SECTION

CONTINUED FROM PAGE 24

GOODMAN: The affordability thing is an illusion to some extent. I've been in California for more than 30 years, and I remember talking about the same problem 25 years ago. You can only raise the rent so high. People can't afford it. Their incomes are only so high. But if you look at other world-class cities, New York, London,

'We all knew that the market over the last few years was unsustainable. It's finally happened. It's come to a lull, which means there's a standoff between buyer and seller, and a lot of other complex issues with the financial markets. This is a very good thing. The market is normalizing. We're starting to see the decompression of cap rates. The smart pros will do well in the coming years.'

— RORY FERLAUTO, Colliers International

Paris, Hong Kong, rents are much higher than what we've got here.

Businesses have to adjust. They have to start paying their employees more. It's going to cost them more — they've got to pass it on to their consumers. But you have to make an adjustment, because people want to live here primarily because of the lifestyle and climate. So you'll always have a demand to live here, and business will adjust.

HUGHES: I was reading in an investment newsletter about the appealing vision a lot of us who live in cities have of moving to some very rural place, someplace with wide-open spaces and very cheap real estate. The investor would say that rates of return and appreciation for such property have been relatively flat in comparison with California and will remain that way. Why? Because nobody really wants to go there.

The business of business is to make profit based upon what works in the short-term, with solid underwriting projecting future profit and appreciation. The real estate business now is solid because people want the product. Over the past 30 years, real estate has continued to be one of the best investments you could possibly make.

But this business model, while good for relatively short-term profits has left us with problems we're experiencing with traffic, urban growth and inadequate housing especially for the lower-income worker. The business of a real estate developer is to replicate what was done before, perhaps with a little twist, because there's a certain profit in that. That's what you have to pitch the lender.

The forward- looking, foresightful, largely uncompensated higher function of how we develop our cities and where we place our housing and our jobs, post Prop. 13, has been driven by the development fees. And we've really done nothing to solve the problem of how our cities are structured, how our transportation policies facilitate or burden our lives.

Policies to Watch

CREJ: Are there policies we should be keeping our eyes on that will have a direct impact in California's multifamily market?

HUGHES: Absolutely. Where we used to think of these things as generational — 20 years away, so there will be plenty of time — the timespan now is a lot shorter.

We'll soon be building with a requirement of greater environmental and energy efficiency, both from a specific technical onsite standpoint and also in terms of integration of a property's carbon footprint and justifications under the CEQA process, to be able to support governmental approvals. Leadership in Energy and Environmental Design is a standard promulgated by the United States Green Building Council. The city of Los Angeles has announced that it's incorporating aspects of LEED into city building ordinances. We will transition from voluntary participation with density bonuses, to mandatory compliance for all. So from the standpoint of those of us who are building and constructing, we are becoming conversant with those ideas, if we haven't been before, because eventually we're going to have to incorporate something like LEED into our projects.

The question of CEQA and carbon footprints and current headlines concerning the failure of government and industry to incorporate the larger environmental impact of developments into general plans, means that we are going to have to pay closer attention to how each project justifies its existence in terms of location, integration into the transportation policy and energy efficiency. Those are going to be ways that developers, even in multifamily, are going to be able to get their projects to the front of the line, receive expedited density bonuses, and be able to justify them, plain and simple.

CREJ: Might green construction also be a way to improve NOI, by attaching a premium to your rent? And is that undercut by the added expense?

HUGHES: NOI is definitely dependent upon your operating costs. In conversations with the U.S. Green Building Council, they have indicated that they can justify the reduced operating costs of those buildings.

Is it more expensive to build green? According to green experts, as technology evolves and environmental and energy-efficient standards become better known within the architectural and development communities, I believe we will be able to build for not much of a premium above standard construction.

You're going to start looking at the physical plan itself and how it functions. The old model of multifamily development will change. Densities need to increase. We're going to have to be able to come up with living spaces that make less of a footprint overall, in order to accommodate the kind of price point we need, to make it affordable.

Some of those developments are being integrated into transit village properties right now. If you're a developer and you have access to a site that is on a transportation line, you have a valuable site, the usual problem, however, is an environmental challenge or unjustifiable costs — they can be very expensive. So there's a feasibility gap that hopefully a redevelopment agency will close for you.

CREJ: Transportation-oriented, mixed-use and higher-density developments have been the leading-edge products for the last several years. Are we seeing those kinds of properties trading hands yet?

FERLAUTO: You're a little early. Looking at downtown Los Angeles, several thousand units have come out of the ground, but they haven't started to trade yet. A lot of them exceeded what they had expected in terms of hitting particular rents, which is amazing to me.

MOGHAREBI: Particularly in Orange County, on Jamboree at the 405 in Irvine, a number of high-rises are going up, and it's a disaster. More than 70 percent of these buildings are empty units. I myself own four of those units. Right now, I couldn't sell them for $200,000 below what I paid for them. I can't rent them out below apartment prices. I tried. I changed agents. I did everything I could think of, and they sat there.

Orange County is just not ready for that kind of living. I don't know if that's five years from now or 30.

CREJ: Orange County seemed to have jumped straight from low-rise to high-rise.

MOGHAREBI: One of the biggest factors driving people to come out of California is that feeling of open space. We're not in Chicago with all the bad weather and congestion, where it's nice to just close the door and forget about what's outside. San Diego, obviously we know what happened, all of the high-rises and condominiums got sold, and in some cases sold below apartment units.

HUGHES: In San Diego's downtown there was a building boom. There were more cranes there than any of the most construction-ridden cities. They were encouraging people to come back to the downtown core. A couple of my relatives fit exactly within that demographic. They sold their house in the suburbs and came downtown. They have a stadium and other recreational amenities to enjoy, and they got rid of their automobile.

But that demographic has to be in the right context. What you've described in Orange County was missing a couple of key factors. You have South Coast Plaza, and you have sunshine. You lack the public transportation infrastructure and the recreational amenities necessary to concentrate people in that kind of development.

Final Thoughts

CREJ: What is your short-term outlook for the multifamily market going into 2008, and what are your strategic recommendations for investors and developers during this transitional time?

GOODMAN: The No. 1 issue for us investing in multifamily properties is to protect our client's

CONTINUED ON PAGE 28

CONTINUED FROM PAGE 26

capital. We're going to be very conservative in looking for markets where we don't have a big shadow market of homes that might be for sale or for rent, or broken condos that might end up in a rental pool. We can stay in the markets where we've got very strong job growth, some reasonable barriers to entry, and we're going to continue to focus on newer properties that have predictable cash flow.

'The most in-demand, high-profile properties are seeing more exposure. More people are looking at them than they were at this time last year. There's artificial concentration on these higher-quality properties. If the smaller professional investor is willing to look below that level, within the B or C quality properties, there are some great opportunities. If they are on the sidelines now, there will definitely be great opportunities by the middle of next year.'

— JASON GREENMAN, LoopNet Inc.

CREJ: And your outlook for the coming year?

GOODMAN: We're very positive despite the fact that the TIC industry is shrinking a little bit. We're one of the largest TIC sponsors and one of the founders of the industry. We think that in the coming years, larger sponsors will get larger, and some of the smaller sponsors will end up going out of business.

HUGHES: The next quarter will be an opportunity for the real estate pros who understand strong underwriting and understand their markets to capture the assets that they have been looking at, that had been overpriced. With their good management and operational skills, they will be able to take those properties, rehab them where necessary, and bring them from good to better. That's generally a good message for the multifamily industry, that the rental stock is going to be stronger.

The jury is out on what is going to happen thereafter, however. We have larger, more interconnected problems than we've had before. It isn't simply a question of reductions in the federal funds rate. People are looking at the established paradigms to make sure they don't get caught without a chair when the music ends.

The people I deal with are already doing these things, paying attention to their fundamentals. They are looking at strong properties, Class A if they can get them. Even better is the chance to bring a property up to Class A.

They're looking for the long term, and becoming conversant with affordable housing and diversity of product. If you're in it for the long haul, to have 20 percent of your units be affordable can be very worthwhile and productive. They're management-intensive, but if you have the infrastructure, it can work out very well, especially if you can partner with a nonprofit who has the expertise.

Minimize the impact of your portfolio by considering diversity in locations with strong fundamentals. And don't drink the Kool-Aid. Don't always believe those numbers that are published in terms of NOI or cap rates. Do the math yourself.

Long-term, frankly, it's an exciting time. We have an opportunity to have a break, to rethink. Let's not just do that cookie-cutter deal we did before. Let's take a look at the underlying fundamentals. What's going to happen in five or 10 years? What do I want the portfolio to do? What kind of business do I want to be in? We have an opportunity to put thought and content into the way we shape the city and the nation.

FERLAUTO: I don't think we will see prices really coming down until the second quarter. There is still supply and demand imbalance. That's going to continue to drive the desire to be in the Southern California market. Whether it's an A, B, or C property, I'm a believer in the long-term, that there are significant barriers to entry here.

The population that will never be able to afford a home is rising rapidly, but Los Angeles hasn't figured out how to add all the thousands of units needed at the affordable level.

There is still a redevelopment opportunity along the major transit corridors, such as Ventura Boulevard in the San Fernando Valley. We just haven't started to see that yet. There are a couple of projects coming on-line that will be interesting to track. We need to see a lot more of that throughout Los Angeles County. Orange County, we're not so sure yet.

We all knew that the market over the last few years was unsustainable. It's finally happened. It's come to a lull, which means there's a standoff between buyer and seller, and a lot of other complex issues with the financial markets. This is a very good thing. The market is normalizing. We're starting to see the decompression of cap rates. The smart pros will do well in the coming years.

GREENMAN: There are tremendous redevelopment opportunities in L.A., and not only for the big guys. In the past three or four years a lot of the smaller professional investors were pushed out of the market by market conditions that moved in on their asset classes. They are coming back into multifamily now.

The most in-demand, high-profile properties are seeing more exposure. More people are looking at them than they were at this time last year. There's artificial concentration on these higher-quality properties. If the smaller professional investor is willing to look below that level, within the B or C quality properties, there are some great opportunities. If they are on the sidelines now, there will definitely be great opportunities by the middle of next year.

CAULEY: We need to be concerned about the possibility of a major recession. This has been a very long period to have gone without one. Think about what's happening with the price of oil. Take a look at the loan rates; they're over 100 basis points below long-term average. Just as sure as what goes up must go down, when interest rates are depressed, they are going to be going up. So if we're lucky, which is what most of the economists think right now, we won't have a recession.

But there is a chance we will. If that happens that's not very good for real estate. Not in California, not any place else.

If we're taking a look at where to make money, I anticipate larger repricing. I would expect in the Inland Empire, Bakersfield, Fresno and places like that, that real prices after inflation may be going down 15 to 20 percent. Once that happens, that's when there's going to be a once-in-a-lifetime opportunity. I'm really bullish on those places. We talk about transportation corridors, sure, but that's a small fraction of the population, and the action. I anticipate firms are going to go where there are people to work for them.

MOGHAREBI: It's a great time for people who can just watch the market and wait for the next six to nine months to see what's going to happen.

What makes this market is affordability. Areas that are more affordable will present a great opportunity as the prices adjust another 5 or 10 percent, offering opportunities to revisit markets and go after B properties that can be repositioned more like A properties. They could be purchased for reproduction cost, and get repositioned and would be affordable. They can take the rent growth, which ultimately is what drives the value, and NOI, which ultimately pushes the prices up. As long as you buy below reproduction cost, with a good fundamental in an affordable area — not getting the A product that's going to be competing with the finished product or the new homes — and be patient with the money and just hang in there as the prices adjust, that will provide a tremendous opportunity. You will see a return to fundamentals, a true NOI and a true tenant-base profile.

LEON: You have to be realistic about cash flows in determining your projections for the NOI going in, and if you're going to be doing any work, what that real NOI can grow to.

From a lender's perspective, borrowers have to be prepared to put in dollars in terms of equity, because you're not going to get a 70 or 75 or 80 percent loan to purchase price. You have to position the properties and manage them alertly by being really focused on what renters are looking for. We see a lot of properties that miss the mark and aren't as successful in attracting renters.

Borrowers focus too much on the spread. Rates are very low right now. You can do a five-year deal for between 5.45 and 5.65, and a 10-year deal is somewhere in the 5.45 to 5.75 range. These are really great rates. For borrowers to say, "Oh, but the spread is so wide, it's so much more than it was last year," is really missing the mark. If the Treasury is low enough, and the all-in rate works, don't get too hung up on the spread. There is going to be some fluctuation in what's being priced in for risk, but the end result is really very respectable.

CREJ: Clearly this is a timely discussion. It's going to be interesting to see how this transitional period plays out in multifamily and how people will capitalize on the opportunities presented, because one thing we know is that someone is always making money.

So I want to thank you all very much for helping suggest a way to identify those opportunities.

SPONSOR BIOGRAPHIES

STEPHEN D. CAULEY

Stephen D. Cauley is the director of research for the **RICHARD S. ZIMAN CENTER AT UCLA**. He 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, Cauley teaches real estate investment and development at the Anderson School.

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

RORY FERLAUTO

Rory Ferlauto is a senior vice president with **COLLIERS INTERNATIONAL PRIVATE CAPITAL ADVISORS**, serving the private client sector of the investment marketplace. Her expertise in the capital markets and her ability to access private capital, as well as underwriting and developing marketing strategies for apartment properties has served to create optimum value for her clients. Her platform for marketing properties and sourcing private capital generates the greatest activity and therefore drives the highest values for her clients' properties.

Ferlauto ensures that every transaction is completed with the utmost commitment and highest standards of service delivery. Throughout her career, she has been responsible for more than $690 million of multifamily properties consisting of over 3,700 units in 85 sales transactions.

GARY GOODMAN

Gary Goodman is senior vice president of acquisitions for **PASSCO COS**. LLC. Prior to joining Passco, Goodman was vice president of acquisitions with the Steadfast Companies, a real estate developer and management company. From 1998 through 2003, Goodman was vice president of acquisitions for PM Realty Advisors, where he acquired properties for the firm's public pension fund clients.

Goodman has more than 25 years of commercial real estate experience in acquisitions. He has been responsible for locating, negotiating to acquire, underwriting and completing due diligence for office buildings, industrial parks, shopping centers, hotels, assisted living facilities and multifamily properties with a combined value exceeding $2 billion. Prior affiliations include Consolidated Capital, August Financial, Berkshire Realty Advisors and Sares-Regis.

JASON GREENMAN

Jason Greenman is chief product officer of **LOOPNET INC.** LoopNet operates the largest and most heavily trafficked commercial real estate listing service online, with more than 2.5 million registered members, 915,000 visitors monthly, more than $425 billion in commercial property available for sale and more than 3.7 billion square feet available for lease.

As chief product officer, Greenman oversees design and development of LoopNet's information services for the commercial real estate industry and manages itss market research group.

JAMES C. HUGHES

James C. Hughes is a partner of **GREENBERG GLUSKER FIELDS CLAMAN & MACHTINGER LLP** in Century City, California. He specializes in transactional real estate, including land use, development, redevelopment, entitlements, leasing, operations, management, permitting, compliance, equity investment and brownfields.

Hughes serves as counsel to developers, owners, operators, managers, financial institutions, pension funds, insurance companies, investors, high-net worth individuals and others in a wide variety of real estate projects including office, commercial and industrial properties; regional, neighborhood, lifestyle, entertainment, enclosed and open-air shopping centers, malls and power centers; apartment communities; master-planned communities and merchant builder projects; hotels and resorts; custom estate lot developments; and condominium and cooperative developments throughout California and the United States, as well as in Mexico.

HOLLI LEON

Holli Leon is executive vice president, loan production administration for **PNC ARCS**, a PNC real estate finance company. PNC ARCS is the successor moniker of ARCS Commercial Mortgage, which became part of the PNC group in 2007.

Leon has been involved in mortgage banking for more than 25 years of national lending experience. She directs ARCS' loan production efforts, structuring transactions to maximize competitive loan quotes, identifying emerging trends to develop business opportunities and managing the loan production team.

Immediately prior to joining ARCS, Leon was director of multifamily affordable housing for Fannie Mae's southwest office in Dallas, Texas, where she was responsible for strategic leadership, loan structuring, and overall performance of that business unit. She was cited by Fannie Mae as a Top Performer in 1995, 1996 and 1998. Before Fannie Mae, she was chief underwriter at Washington Pacific Mortgage, and served in various capacities at Western Savings, GMAC Mortgage and Colonial National Mortgage Company.

ALEX MOGHAREBI

Alex Mogharebi joined **MARCUS & MILLICHAP** in 1989. He is vice president/investments and has been the no. 1 investment specialist on 12 occasions. Over the past 18 years, Mogharebi has become one of the top brokers in California and the country, specializing in the multifamily investment market. He exclusively represents some of the Inland Empire's largest property owners in their commercial real estate needs. Within the last 18 years, Mogharebi has sold more than 39,000 units totaling more than $3 billion in sales.

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