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Not all apartment buildings lend themselves to adding value, therefore, be selective

bp Bruce Percelay



The Mount Vernon Co., LLC

Multi-family valuations have reached unprecedented heights which are often associated with unprecedented risks.

While the apartment rental market has strengthened, largely on the back of a weakened condominium market, prices are still significantly above historic mean levels. The questions facing today's apartment building buyer is what are the primary risks and how can they be

minimized?

The following is a summary of some of the most significant factors that could push down the values of multi-family investments and ways to protect you from those risks.

Overdosing on OPM

It is more than ironic that OPM (other people's money) sounds so much like "opium". OPM has become a powerful and somewhat addictive stimulant to the purchase market and one that seems to cloud investor's judgment.

Today, there is so much Wall St. and private money chasing developers to park cash into multi-family real estate, traditional purchase criteria are often going out the window. Rather than using the same risk adverse criteria applied to the investment of one's own money,

developers using OPM seem content to make purchases based on management fees, development fees and mark-ups on improvements versus any realistic hope of capital appreciation. With so little skin in the game, developer's "What, me worry?" attitude is pushing up values of often marginal assets.

If Wall St.'s appetite shifts to another asset class or they demand higher returns, the "greater fool" exit strategy will disappear and asset values could suffer.

Supply Growth vs. Demographics

Nationally, the average percentage of new apartments to existing supply in major markets is 1.6% but in eastern Mass. it is 3.6%. Credit Chapter 40B with helping facilitate unnatural supply growth at a time

when our population growth is zero at best and perhaps negative.

Just because a developer has leveraged a town into allowing for more apartments does not mean, "If we build it, they will come." Markets like Burlington are already showing signs of oversupply as apartment vacancy rates are beginning to rise and rental rates are starting to soften.

For the apartment market, less is more and hopefully apartment developers will apply restraint so as not to flood an already saturated market.

Higher Interest Rates and Cap Rate Expansion

With today's sub-6% cap rates and equally low interest rates, investors are often predicating their acquisition decisions based on the assump-

tion that rates will be this low when they sell. While it may be hard to envision significant rate increases, there is a scenario where interest rates could indeed rise, which would in turn put downward pressure on apartment values.

If the same foreign capital that has kept our economy afloat begins to demand higher returns, rates will have to rise. If Europe raises rates to lure money to their shores, we will have no choice but to respond in kind. Also, if the slide in the dollar needs to be checked by our government, interest rates will also have to rise.

Most pundits have called interest rate movements wrong but a meaningful increase would definitely hurt real estate values.

How to Minimize Risks?

1. Just Say No to Marginal OPM Deals

It is hard for RE "junkies" to just say no but nothing will impress an investor more than when you put their interests on par with yours.

If the deal does not make sense if it were your money, it won't make sense with someone else's. At the end of the day, many investors may be sorely disappointed with their development partners who refused up front to realistically assess their chances of making money. Those investors will not come back for more. Think long term and buy selectively.

2. Invest in Supply Constrained Markets

Select markets where it is difficult or not feasible to add supply. Focus on markets or locations within those markets where the brain damage associated with new development is so excruciating that over-supply is not a risk.

3. Go Long on Rates

Take advantage of Wall St.'s largess and go long to avoid possible rate shocks or reduction in market liquidity. An added benefit is that good and assumable long term debt can become an actual asset if rates rise.

4. Focus on Adding Value

While an appreciating multi-family market has enriched many who already own existing assets, at today's prices it is not realistic to expect the market to continue to automatically increase the value of all apartment purchases. Therefore, buyers in today's market should make purchase decisions based on their ability to increase the value of assets through capital or operational improvement.

Not all apartment buildings lend themselves to adding value, therefore, be selective.

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