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Connecticut apartments remain preferred RE investment for private and institutional investors

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Investment strategies among Connecticut investors will change course in 2010 as the buyer-anticipated wave of distressed properties comes out as a trickle. Prices have fallen, however, with the economy starting a slow recovery, buyers' and sellers' expectations will begin to align, sparking sales activity. While some troubled assets will enter the market in the coming quarters, lenders will continue to extend loans and renegotiate terms rather than reclaim properties, particularly in light of relaxed FDIC guidelines regarding markdowns of underperforming loans. Lenders ultimately will have to act on nonperforming loans, though this will likely occur in stages over the next few years as banks' balance sheets improve to the point where losses can be absorbed. Bottoming fundamentals and further evidence of a shortage of quality assets offered at distressed prices will move more buyers off the sidelines in 2010.

Sales velocity declined last year throughout, but activity began to improve modestly in the third and fourth quarters and will continue to gain momentum in 2010. Average prices have fallen approximately 20% to 30% from the peak, but the trend varies by quality. A recent frenzy of buyer demand has resulted in multiple offers and cap rate compression for quality assets in stronger markets. This trend will persist as investors look long term and position themselves ahead of the recovery. REITs have successfully raised capital and are re-entering the market, targeting large complexes in the state's largest metros, while institutions and syndicates are expected to step up activity as well. Among smaller private buyers, local investors will drive sales activity, as lenders continue to show a clear preference for investors with experience managing properties in their home markets. Following advances of 100 basis points or more last year, cap rates will tick higher this year primarily among lower-tier properties. Property values continue to be impacted by the 10 year treasury rate as many buyers purchase at a spread of 75 to 150 bps over debt.

Apartment development in the years leading up to the recession fell short of historical norms, especially in major markets in Connecticut, where limited new product has come on line. Additionally, tight credit markets have since cleared many planned projects from the pipeline. The lull in development will provide owners time to fill vacant units ahead of the next construction cycle, which is unlikely to reach meaningful levels until 2012-2013. Furthermore, apartment owners stand to benefit from echo boomers transitioning into their prime renting years, with the number of 20 to 34-year-olds projected to rise by approximately 5 million individuals in the next 10 years.

Apartments will maintain a financing advantage over other property types in 2010 due to the availability of debt from Fannie Mae and Freddie Mac. The GSEs account for almost 60% of new multifamily mortgage originations, followed by banks. Generally constrained lending, however, will keep sales and refinancing below "normal" levels despite some improvement over 2009. Agency lending should persist at a healthy pace in 2010, assuming government-mandated changes steer

clear of their multifamily lending arms. Furthermore, Freddie Mac's Capital Markets Execution program holds promise as a viable source of liquidity, following the securitization of \$2 billion of debt in 2009. They have also recently announced a program to replace short term mezz debt but details have not yet been disclosed. Nonetheless, traditional CMBS issuance remains limited despite government programs such as TALF and PPIP, and is unlikely to be a major source of financing in 2010. This presents the greatest challenge for deals over \$15 million, an issue exacerbated by a pullback in lending by life insurance companies. Though a handful of life insurers have showed renewed interest in lending, capacity limitations dampen expectations for a 2010 surge. Aside from the GSEs, local and regional banks will account for the greatest share of apartment financing this year, focusing on smaller, low-risk deals in primary markets with strong sponsors. Delinquency rates continue to rise, though increases vary by lender type. Fannie Mae and Freddie Mac, which account for 38% of apartment debt outstanding, boast sub-1% delinquency due to conservative underwriting through the boom.

Many risky CMBS loans will mature between 2010 and 2012, though recent tax-law changes granting special servicers greater loan modification flexibility may alleviate some default risk.

As Connecticut and the nation slowly emerge from the recession, long-term apartment fundamentals remain strong. Well positioned multifamily properties in Connecticut maintain a competitive edge as prices have not declined to the same level as other national markets and astute sellers are benefiting from a shortage of quality product on the market.

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