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Connecticut apartment sector poised to emerge quickly from current downturn

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Multifamily investment activity in Connecticut is expected to gain some additional momentum this year after a reasonably strong 2008. Last year, investors' fears of the added risks associated with lower-tier assets limited transactions to mostly Class A and Class B+ properties in the state's urban areas. While reduced investor demand for properties in secondary and tertiary locations will continue, buyers are expected to target Class B/C apartments throughout the state's stable CBD markets. Buyers will likely target lower-tier properties in the New Haven and Hartford core, Hamden and the Fairfield/Bridgeport/Trumbull triangle, where students represent a consistent pool of renters. Fewer Class A transactions and the presence of low-leverage opportunistic buyer funds will likely result in a shift in pricing trends, causing cap rates to increase to the mid-7 to 9% range.

Apartment properties are trading and being financed in the region, thanks largely to agency lenders and still-active local and regional commercial banks. There is no longer a CMBS market, which has created a financing void locally and nationally. In 2006 and 2007, CMBS originations nationwide totaled more than $400 billion, while no CMBS originations are expected to. More than $80 billion in CMBS loans are expected to come due in 2009-2010 and recapitalizing those loans will be a key to restoring financial stability in the markets. In Connecticut, apartment owners are generally not facing added competition from shadow inventory, unsold condominiums and foreclosed or unsold single-family homes, and as a result will remain net beneficiaries of the housing downturn due to the expanding renter pool, even though vacancies are expected to escalate in 2009 due to job losses. In addition to greater apartment renter retention generated by more stringent mortgage requirements, owners will also benefit from the return of many homeowners to apartments as ARMs reset at substantially higher rates.

Average per-unit sales value through Q4 2008 in Connecticut was $137,163 which compared favorably to $142,782 per unit at the end of 2007. The current apartment transaction climate, defined by various degrees of price declines, should be distinguished from the sector's long-term intrinsic value. Properties that must be sold in today's environment clearly require discounting from previous years' values in order to clear the market. Nationwide, property values are expected to drop by an average of 21% but we anticipate that Connecticut assets will fare much better. While opportunistic buyers in the market will be looking for "high-octane returns," well-managed and well-maintained Connecticut properties will still command reasonable prices although pricing on IRR and cap rate will yield to purchasing on cash-on-cash returns based on true, 12-month trailing data.

The challenge in predicting an exit strategy and terminal cap rate suggest that active investors in the market are looking for cash returns on investment year one of 8% to 10%. For an owner contemplating a sale in the foreseeable future (within 2 years to 4 years), there is no better time to sell than the present as we only expect yield criterion to continue trending upward. More than ever, a fresh look at each property's hold, refinance or sell strategy is warranted, given the recent market volatility.

Comparing 2008 to 2007 statewide, we observe the following:
Total units traded (transaction velocity) for 2008 were 5,532 versus 6,247 for 2007 (11.5% decrease).
Total sales dollar volume in 2008 decreased by 15% from 2007: $758,785,000 versus $891,958,998 (still above $689,781,646 for 2006 and $501,577,571 for 2005.)
Average per-unit sales value in 2008 was $137,163 versus $142,782 in 2007 (versus $122,803 for 2006 and $88,368 for 2005.) Fairfield County skewed the data somewhat with only 531 units trading but with total volume exceeding $283 million or average-per-unit value of $533,631.
Average per s/f value decreased to $143.41 as compared to $152.28 in 2007 but still up from $132.24 in 2006 versus $95.66 in 2005.

With nominal construction starts, excellent base industries, historically high occupancy and healthy rental growth, Connecticut remains at the top of many investors' lists of preferred markets for multi-family investing. With changing demographics, more echo boomers entering the rental market and baby boomers rethinking housing alternatives, we expect to quickly return to historically strong occupancy levels and solid rental growth for those property owners intuitive enough to competitively maintain their regional apartment communities.

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