CAPITAL MARKETS

Weathering the Next 18 Months

BY MIKE KELLY

The days of 300 properties trading hands per month at increasing values are gone. Multifamily housing debt now exceeds $895 billion, according to a recent Federal Reserve report. The apartment market will be lucky to clear 600 properties nationally in all of 2009.

The recent upside cycle from early 2005 to early 2008 was better and longer than most cycles. However, it looks like the current downside cycle may also be longer and deeper than most. The majority of owners are feeling pain, and that could be mitigated and recovery could start sooner if banks, agencies, credit companies and insurance firms would use their cash to refinance assets.

However, nearly all are suffering from feeble balance sheets and challenging stock prices. Without these critical players quickly filling the gap in capital, many owners will be crushed by the weight of the existing loans and declining rent rolls. Multifamily housing's CMBS delinquency is increasing at an alarming rate with the June 2009 multifamily delinquency rate at 5.4 percent.

The recovery is not right around the corner, so owners must become realistic about their properties' conditions and be proactive. Do not look back to the positive cycle. Instead, look ahead and act.

Plans that worked in previous cycles no longer work. Expectations of ever-growing rental rates, low cap rates and high loan-to-value are shifting to negative rental rates, higher vacancy and 60 percent loan-to-value agency debt on current rent rolls. The players involved today are enduring substantial losses and often are exercising a degree of defiance and denial that makes them blind to a possible collapse of their assets.

Here are constructive thoughts on weathering the next 18 months:

Owners: Have frequent and realistic conversations with equity partners. Do not assume they are going to fund a project just because they are big or because an owner has an excellent relationship with them. Many funds are strapped because of a lack of cash with a big exit queue. This limits their ability to fund. Treat equity investors as true partners because this market will improve. It might not happen in the next 18 months, but it will happen. Investors have a long memory. Sometimes poorly timed deals can be forgiven, but bad partners rarely are.

Equity Partners: Understand the property, its cash flow needs and the underlying loan terms. It's your deal now because most deal sponsors are just staying in for the fees. Be realistic with pricing, the hold period and, most importantly, the partner. Sponsors who excelled when buying or building deals may not necessarily be the best partners to choose today for taking a long, tough road that requires a different skill set.

Lenders: Dig deeper when seeking a borrower. Make sure its financial house is solid. Just because they had a great name or a large balance sheet in the past does not mean they have the money to rebalance the loans now. Be prepared for the possibility of having to take the assets back. Do not extend loans just for the sake of extending. Certain loans should be extended because of the asset's quality level and submarket, or even the sponsor. Other loans should not be extended for the same reasons.

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