Redefining Value Add In The Apartment Space

Reflections on granite countertops, faux stainless appliances and achieving Nirvana in the Apartment Space.

Urban Land Institute  

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Pacific Urban Residential

Background | Introduction

- Founded in 1998
- West Coast focus multifamily investor
- 20,000 units acquired | 110 apartment communities. $3 Billion Acquired.
- 78 properties have come full cycle | exited.
- Current portfolio - $1.5 Billion
Value Add

apartment investment strategies seek superior investment returns by addressing managerial, physical plant or capital stack deficiencies which impede an asset’s ability to fully compete in the marketplace.
What Do **Investors** Want?

Investors seek to balance **Risk & Reward** within relevant yield tranch.
What Do Value Add Funds seek?

‘Tell Me A Story’

Why?
Funds are often raised on the premise of having ‘unique access to best of class operators’ and to off-market, below-the-radar opportunities.
Value Add ‘Stories’ That Sell!

Poor Existing Management; We Can Do Better!
• Lackadaisical or inferior onsite management
• Poor attention to resident needs/wants

Poor Physical Plant; We Can Fix It!
• Dilapidated.
• It is tired! Old! Ugly! It’s a Story! It’s a Value Add Deal!

Inefficient Capital Stack
• Poorly encumbered.
• Perish the thought... a 65% loan at a 4.5% interest rate!!!
Value Add ‘Story’ Is Viral. Seems Everyone Is ‘Doing It’!
Granite Ad Nauseam!

We have become the DIY’ers in the Apartment Space!
What Are the Key Drivers for Successful Value Add Investments?

Value Add Investments entail a successful polygamous marriage of multiple inputs!

1. Conducive Macro Environment
2. Improving ‘on-the ground’ fundamentals
3. Ability to access compelling investments
4. Interested Capital. They like the the ‘Story’. They ‘get it’!
5. Operator Expertise
6. Smart Asset Execution!
Achieving Nirvana.

The not so proprietary—but aptly named—“Nirvana” Value Creation Formula

- Value Driven by Fundamentals
- Value Driven by Improving Capital Markets
- TOTAL VALUE CREATION!!

Cap Rates

Capital Yield Expectations

“Normalized” Cap Rates

Fundamentals
Nirvana Key Drivers Value Add Investments

Macro Market Fundamentals

1) Treasury Rate Spreads
2) Retail Sales

Micro Market Fundamentals

Supply Demand Relationship

Institutional Capital Flow

Sub Market Fundamentals

Class A vs. Class B Rents
Future MF Supply
SFR Shadow Inventory
Affordability
Buyer Pool
Threats to Nirvana
Lessons From The GFC

Maxims:

1. Every recession since 1973 has been problematic for Apartment Net Operating Income.

2. Every recession since 1973 has been foretold by a combination of the following:
   - Declining Spreads in Long-Term vs Short Term Interest Rates
   - Declining Retail Sales
The Spread. It Matters. 
Long-Term vs. Short-Term Spreads

Spread between 10-year Note and 3-month Bill (in basis points) 
January 1973 to March 2013

Sources: Marcus & Millichap Research Services, Federal Reserve Board

ULI Spring Meeting
Retail Sales Growth.

Long-Term Total Retail Sales
January 1973 to March 2013

Sources: Marcus & Millichap Research Services, U.S. Census Bureau
...and For Sale Housing Foreclosures

2005-2010 SF Bay Area Foreclosures Per Housing Stock

Sources: MMCR, Dataquick
“Nirvana” Value Add Strategy

Value Add apartment success is driven by these conditions:

- Conducive Macro Market Conditions
  - Widening 10-year to T-Bill Spreads
  - Improving Retail Sales
  - Declining NOD’s

Nirvana occurs when the aforementioned is accompanied by

- Submarket history of **sustained** capital investment and participation
  - What if you drive NOI, but Investors don’t care?
  - Nirvana success requires both improving fundamentals and investors who want to participate. Preferably lots of investors.

The ‘Nirvana’ value add investment is the elusive ‘one’ (chant ‘OM’…..) that sits at the nexus of improving submarket fundamentals and increased capital participation within the market in which the asset is located.
INVESTORS IN MULTIFAMILY COMMUNITIES

Nirvana Deals.

Chateau Woods | 114 units | Kirkland/Woodinville, WA

- Acq. Date: June 2010
- Hold Period: 2.7 Years
- Purchase: $19.2M
- Sale Price: $30.0M
- IRR: 31.9%
- Strategy: Distressed Note

Montebello | 248 Units | Kirkland, WA

- Acq. Date: April 2010
- Hold Period: 2.3 Years
- Purchase: $39.4M
- Sale Price: $52.0M
- IRR: 31.8%
- Strategy: Rehab

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Does it Work?
Yes, Nirvana can be achieved.

Through “thick and thin”

- LTCC Implosion (1988)
- Great Financial Crisis (2008-2010)

- 78 transactions; $1.7 Billion full cycle
- 19% IRR; 1.49 equity multiple
- $260M made for investors
Granite or Laminate Countertops?

and...

You heard it here. First!
Granite is passé.
Caesarstone | Silestone is ‘in’...it IS the new ‘black’!
And Nirvana Is Forever.