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Buyers Increase Risk Tolerance in Search of Higher Returns

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Many multifamily investors are turning away from stabilized assets in core markets and fixing their sites on secondary markets and riskier plays.

Throughout 2010, a mountain of pent-up capital came off the sidelines with a vengeance, as REITs, pension funds and other large investors entered bidding wars on trophy assets in major markets. As a result, cap rates on Class A deals in many major metros plummeted, forcing investors to look elsewhere for higher yields.

“We’re still looking in primary markets, but the reality is that we’re not likely to be the highest bidder for a deal,” says Tom Bartelmo, president and CEO of Miami Lakes, Fla.-based the Kislak Organization. “So that leaves our focus a little bit more on these secondary markets, like Tucson and Pensacola.”

Kislak owns nearly 3,200 units spread between Dallas, Las Vegas, Tucson and several Florida markets. Like many multifamily firms, the company has been taken aback by the cap rates at which some high-profile deals have traded over the last two years.

“It sometimes feels more like 2005 than I ever thought it would,” says Bartelmo. “What we see happening out there, with some assets with 5 caps on them, that’s not for us. Frankly, I think the risk of those purchases outweigh the reward.”

Toward the end of 2010, the company purchased 481 units across three distressed assets in Pensacola, Fla. from Ocean Bank, which had foreclosed on the properties. The all-cash transaction totaled \$11.5 million, and the company plans to spend another \$4.5 million on capital improvements for the Class B assets.

Kislak is targeting 8 percent to 9 percent initial cash-on-cash returns, though a lot of heavy lifting is yet to come. One property, the Villas at Jasmine Fields, is only about 50 percent occupied. Another asset, the Villas at Jasmine Park, was a broken condominium deal where Kislak purchased 130 of its 170 units.

Kislak certainly isn’t alone. The shift to a greater risk tolerance was the biggest change evident in the recently released fourth quarter Real Estate Investor Survey from PricewaterhouseCoopers (PwC). The report noted that interest in secondary locations, Class B properties and value-added Class A plays is heating up as the market for trophy assets becomes increasingly saturated with eager capital.

“People need yield, and if you just buy a core deal, the yields have been driven down to, for the best markets, sub-5 percent cap rates,” says Mike Kavanau, senior managing director for the Chicago office of Holliday Fenoglio Fowler. “To move back toward a 10 percent cash on cash, that generally needs something with some moving pieces. We’ve absolutely seen people start to move into soft rehab.”

According to the PwC survey, average cap rates decreased nationally by 61 basis points (bps) from the third quarter to the fourth of 2010, and more than 150 bps since the fourth quarter of 2009. But given the rising 10-year Treasury, most investors believe cap rates will hold steady for the next six months, the survey found.

And the cap rate compression that characterized 2010 hasn't been felt much away from the bright lights of the most desired markets. "When you move out of the core assets, you really haven't seen a lot of cap rate compression," says Bill Hughes, managing director of Encino, Calif.-based Marcus & Millichap Capital Corp. "The cap rates there are still higher than they were in the fluff years of 2005 to 2007."