

Jacks of All Trades

BY JERRY ASCIERTO

PHOTO BY SANDY HOOPER/AURORA

In the aftermath of the capital markets upheaval, many multifamily firms re-engineered their business models, while finding new avenues to distress acquisitions. Here are six strategies that today's CFOs are employing.

OVER THE PAST FEW YEARS, many multifamily CFOs added a new, albeit unfortunate, bullet point to their resumes: “loan workout specialist.” Some could probably also add: “crisis management expert.”

The recession has forced many developers to rethink their approach, as firms found out the hard way that a more diversified business model stands a better chance of survival. But a funny thing happened when these firms began adapting on the fly: The improvements just might insulate them from the next recession, proving that whatever doesn't kill you may ultimately make you stronger.

Consider Wood Partners. After cutting its overhead by about 50 percent, closing two offices, and laying off staff, the Atlanta-based merchant developer ramped up its acquisition team, hiring industry veterans Curtis Walker—formerly of Trammell Crow, Post Properties, and Fairfield Residential—and Don Foster—formerly of Harbor Group International.

Wood also started a property management division, hiring Mike Hefley, former COO of Gables Residential, to lead that program. In its 12-year history, the company always chose to farm out that service, but the newly created division will focus on managing Wood's own portfolio, which accounts for 13,377 units mostly located in Texas, Georgia, the Carolinas, and Florida.

“We were very development-focused and vulnerable to a capital shock like we experienced,” says Joseph Keough, CFO of Atlanta-based Wood Partners. “So we're diversifying our revenue sources.”

BIG BOOSTERS

Top 10 cost-cutting strategies that companies plan to take in 2011.

	RANK (VS. '09)
Renegotiate vendor contracts	1 (1)
Fight tax judgments	2 (3)
Pass utility costs to residents	3 (T6)
Use software to automate processes	4 (T7)
Reduce head count	5 (2)
Cancel or rewrite insurance policies	6 (T6)
Slow down purchasing volume	7 (5)
Defer maintenance	8 (8)
Reduce development pipeline	9 (4)
Reduce benefits	10 (T7)

Wood is not alone. In fact, in a survey conducted exclusively for APARTMENT FINANCE TODAY, nearly 44 percent of multifamily firms reported plans to launch or take on additional property management business in 2011.

Indeed, as owners and developers continue to carefully monitor the landscape for new opportunities, their teams—driven largely by the opinions of their chief financial officers—are beefing up their defenses and getting ready to go on the offensive. Here's a look at six strategies that multifamily CFOs are employing today.

1 Sell Your Intellectual Capital

For the first time, many developers have found themselves hawking their development or underwriting expertise to third parties, selling their intellectual capital to raise real capital.

Alliance Residential began to market its construction services—which had always

been an in-house operation—to others during the downturn as its own pipeline slowed considerably. Aside from general contractor work, Alliance also offers underwriting and analysis, as well as entitlement services. Plus, Alliance shifted resources into property management, taking on 10,000 new units since the beginning of 2009, mainly by serving as a “white knight” for lenders with growing REO assets.

“We’re doing a lot of work for banks and other financial institutions who are trying to figure out how to get out of the real estate they find themselves in,” says Jay Hiemenz, CFO of the Phoenix-based firm. “Some of that requires capital work, so we were able to redeploy a lot of our development resources into property management.”

The move into property management has been one assumed by a number of firms. Take Crosland. Throughout its 73-year history, the Charlotte, N.C.-based firm has mainly been a development shop, with only about 20 percent of its units coming through acquisition. But in the past two years, Crosland’s deep experience developing and managing properties throughout the Southeast attracted the attention of many opportunity funds looking for regional partners on the ground.

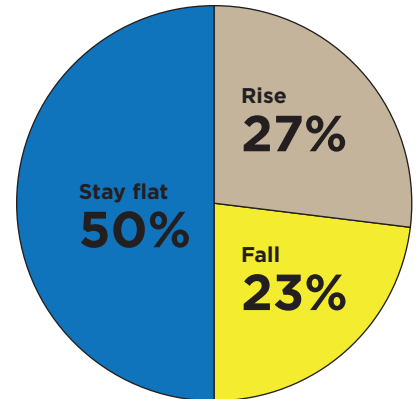
Private investors increasingly tap Crosland to do market analyses, complete entitlement processes, or find a deal and stay on as the property manager. In fact, Crosland’s property management arm has picked up about 1,000 units over the past year through these arrangements.

“A lot of the money was raised without real estate expertise, so people came to us to help underwrite and find assets,” says Steve Mauldin, Crosland’s former CFO, now president. “Capital sources understand that the game’s won and lost, and value gets created at the property level—and that’s where we plug in.”

Since last year, the company also began marketing its management business, Crosland Investment Services, to banks, mezzanine lenders, and other merchant developers, picking up another 1,000 units through that effort and growing the division to 6,500 units. “We started providing a much more full-service organization,” Mauldin continues. “Over the last year, we have focused, really for the first time, on

CAPPING OUT

Half of multifamily finance professionals expect cap rates to stay flat in 2011.



Crosland Investment Services.”

The same goes for The Altman Cos. The Boca Raton, Fla.-based merchant developer has picked up some fee work from clients looking to acquire distressed condominium deals, helping the company grow its property management division by 1,000 units since early 2009.

2 Be Nimble, Not Quick—Especially With Distress

While fee management may pay the bills, a number of firms hoped that distressed acquisition opportunities would flow with as much ease as in the days of the Resolution Trust Corp. of the early 1990s. They were wrong.

The wave of distressed auctions that characterized the early 1990s hasn’t yet materialized this time around. Still, investors are increasingly optimistic that next year will be different. Nearly 62 percent of senior-level multifamily finance professionals expect more distressed acquisition opportunities in 2011, according to the 2010 AFT Strategies Survey.

Many feel that it’s a matter of time before all those short-term, interest-only CMBS loans made at the peak of the market finally come due, succumbing to pressure. After all, lenders can only extend and amend for so long. But it’s a different story for core assets. In 2010, Class A assets

inspired heated bidding wars where most players walked away dismayed by the size of the winning bid.

And those feeding frenzies will likely continue. Only 22 percent of survey respondents believe that more stabilized Class A assets will become available next year, compared to 39 percent that expect more Class B assets and 33 percent anticipating more Class C properties to hit the auction block in 2011.

In the meantime, multifamily firms are patiently working behind the scenes to find those elusive golden deals. Consider Essex Property Trust, which spent much of 2009 trying to find newly constructed luxury condo deals through its lender relationships. And to close its biggest purchase—a \$128 million deal for a luxury condo high-rise called Skyline in Santa Ana, Calif.—the REIT endured a roller coaster negotiation with the project's financier, iStar Financial, that lasted more than 12 months.

"It wasn't until the lender repossessed the asset that we were able to consummate a deal," says Michael Dance, CFO of Palo Alto, Calif.-based Essex. "That's not unusual. The lenders are between a rock and a hard place until they take the asset because they don't know if the borrower will file for bankruptcy."

Alliance Residential has also been forced to practice patience. In August, the firm purchased a site in Fairfax County, Va., on which it plans to build a 300-unit Class A development called Laurel Highlands. The land already has a parking garage on it from a project that was started, then stopped, by original builder JPI.

Alliance was able to buy it from construction lender U.S. Bank in an off-market transaction. But it was a drawn-out negotiation. "The bank wasn't sure what it wanted to do," CFO Hiemenz says. "First they were pursuing fee opportunities, then partnership opportunities, and then they ended up selling the land to us."

In short, many investors are constantly probing their lender relationships for off-market sales instead of waiting for the auction catalog to arrive. "You have to be very close to the bankers, talking to them on a daily basis to find out what their motives and goals really are," says Derek Kahn, CFO of Atlanta-based Brand Properties.

GET CREATIVE

Here are three cost-cutting techniques you may not yet have considered.

FINDING NEW COST-SAVING techniques during a downturn is as critical as it is difficult. Many owners have aggressively reduced staff and closed and consolidated offices since the Great Recession began. But that's the low-hanging fruit of cost-cutting measures.

These days, some multifamily firms have also had to find more innovative ways to uncover latent cost-cutting opportunities. Here are three creative examples of slashing debits on the balance sheet.

1 Consolidate Contracts

Home Properties has seen big savings by adopting a new approach to national contract negotiations. In the past, the company would use a couple of different vendors for the same materials. Now, it has streamlined the process, and it's paying off handsomely.

For instance, Home buys about \$4.5 million in appliances each year and has always split those purchases between two vendors. "But we went to them both and asked, 'If we give you the whole contract, how much better could we do?'" says David Gardner, CFO of the Rochester, N.Y.-based REIT.

The winning vendor came back with a 20 percent reduction, meaning that Home will save \$900,000 on appliances this year just for choosing one primary vendor. Taking the same approach with carpet suppliers, the company saved about \$175,000. And by going with one vendor for maintenance and repair items—such as plumbing supplies and lighting fixtures—the company again had two vendors duke it out.

"We're going to get anywhere from \$500,000 to \$1 million in savings in a year because of the discounts they're willing to give,"

Gardner says. All told, those appliance, carpet, and maintenance materials savings could add up to more than \$2 million.

2 Require Renter's Insurance

Requiring renter's insurance has also been in vogue as both a cost-cutting—and revenue-generating—technique. Both Miami Lakes, Fla.-based owner/operator The Kislak Organization as well as Home Properties turned to the mandatory insurance approach this year.

Home Properties receives a rebate of about \$300,000 annually just for marketing its preferred insurance carrier to its residents, though renters are free to purchase policies from any carrier.

In the past, a large majority of Home's residents, especially at its Class B and C properties, did not voluntarily choose to have renter's insurance. And if, for instance, a resident started a kitchen fire that caused \$40,000 in damages, "we couldn't get anything out of the resident," Gardner says. "But now, if they have insurance with \$100,000 liability, we can collect on that."

The REIT also expects to save on its own premiums, given the increased coverage at the unit level.

3 Protest Valuations

Property taxes are one of the biggest expenses facing multifamily firms, but the downturn has provided some relief. For Camden Property Trust, which owns interest in 187 communities, property taxes comprise about 28 percent of the company's expenses.

So Camden redoubled its efforts on grieving taxes this year and has seen huge savings. "The amount of protests we've filed over the past year has gone up dramatically," says Dennis Steen, CFO of the Houston-based REIT.

The company went into 2010 budgeting for a 1 percent property tax increase but now expects to end the year dropping its property tax expenses by about 3.5 percent.

“It changes considerably as you get closer to quarter end—by then, they know how many more losses they can take.”

3 Make Inroads Through Distressed Notes

Kahn joined the privately held Brand Properties last fall after leaving his post as CFO of Atlanta-based owner/developer Lane Co. Brand launched in 2003, and Kahn was brought in to find distressed multifamily note purchase opportunities.

But Kahn soon found that every time he bid on a note for a Class A asset, it was

routinely outbid by institutional players. So he began to focus on loans in the \$2 million to \$10 million range, a level that falls off the radar of institutional investors. That means buying Class C properties at pretty steep discounts to face value, mostly in the \$10,000 per-unit range.

The company now owns 1,400 multifamily units, all of which have been acquired in the past three years. About 1,000 units alone came through distressed note purchases. The company sees its note purchase strategy as a preemptive move: Waiting for a lender to foreclose on

a property and begin a competitive bidding process means having to pay a much higher price for the asset. “We’d love to do straight-up asset purchases, but to make good outsized profits these days, you have to assume some of the risks that come with buying the notes,” Kahn says.

Essex has also been active in this space, purchasing a \$24 million permanent loan for \$20 million, a 20 percent discount, earlier this year. The note, which comes due in October, is for Santee Court, a 165-unit asset in downtown Los Angeles. The seller was an insurance company that grew nervous when the borrower threatened to stop making payments.

“We’re happy to own the asset if the borrower stops making payments,” Dance says. “But we’re also happy to get a \$4 million gain for a six-month investment.”

Many investors found success in note acquisitions during the early days of the recession before bidding wars became the norm. The Kislak Organization acquired a distressed note through an FHA auction in 2008, paying about \$1,500 a unit, and is now in the process of flipping it for between \$9,000 and \$10,000 a unit.

Since 2008, however, the company has put in plenty of bids to online auction sites such as Carlton Exchange and DebtX, without success. “You’re getting 40 to 50 bidders now, and we’ve been about 20 percent off of the winning bid,” says Dung Lam, CFO of the Miami Lakes, Fla.-based Kislak. “But we see the bid/ask gap narrowing significantly of late.”

Indeed, the cap rate compression that characterized 2010 isn’t expected to last. Half of our survey respondents believe that cap rates will remain flat in 2011, while 27 percent expect cap rates to rise in 2011. Only 23 percent expect to see them continue to fall next year. Those results speak to that narrowing gap between buyers and sellers, as well as growing confidence that the market is reaching a level of equilibrium after the last few turbulent years.

4 De-lever the Balance Sheet

Of course, not everyone is in the position of being able to acquire distress assets—or the notes behind them. Many multifamily firms are still struggling to deal with their current backlog of loans.

Merchant developers are staying

MARKET WATCH

The troubled markets with the most upside may come as a surprise.

LAST YEAR, ATLANTA EMERGED as the top distressed market with the most upside, according to respondents of APARTMENT FINANCE TODAY’S Annual Strategies Survey. But this year’s results show more multifamily finance professionals growing pessimistic about Atlanta, as it enters a last-place tie with distressed poster child Las Vegas.

Where is confidence rising? Interestingly, around the prospects of South Florida and Southern California.

Alliance Residential, for one, remains bullish about the long-term upside in South Florida. In late August, the company acquired a fully entitled, permitted property in Tampa, Fla., on which it plans to build Broadstone at Citrus Park Village, a 296-unit Class A garden community. Construction is slated to begin in October, and it is expected to come online in mid-2012.

“Values are up, but land is still pretty depressed. We can build cheaper than we can buy in certain markets—some that you wouldn’t intuitively think are quite ready for new development, like South Florida,” says Jay Hiemenz, CFO of the Phoenix-based developer.

The Altman Cos. had one new development come online in July, a \$100 million mixed-use asset called Satori in Fort Lauderdale, Fla., with 279 rental units and 13,000 square feet of retail. And Altman is getting ready to start another new development in North Tampa. Grand Cypress, a \$27 million, 258-unit community, should break ground in October and come online in March 2012. “We think there’s going to be tremendous demand over the next seven years,” says Tim Peterson, CFO of The Altman Cos. “We’re coming through post-WWII lows in starts.”

Southern California has also seen its share of investment lately. In mid-August, Wood Partners made its first acquisition in the San Diego market when it purchased a site on which it plans to build a 379-unit luxury community. The deal is located within a master-planned community where developer Sunroad Enterprises sought to build an apartment complex—a plan stalled by the recession. Wood will use the original plans and permits to construct the \$90 million project, which is slated to begin in September.

“In markets such as Boston, D.C., and Northern and Southern California, we believe the best opportunities are to develop—and our capital partners agree,” says Joseph Keough, CFO of Atlanta-based Wood Partners.

on construction loans—which typically feature options for a couple of one-year extensions—much longer than they typically would. And with the 30-day LIBOR at 26 basis points (bps) and the three-month LIBOR at 29 bps (as of early September), many newly constructed properties are still cash flowing.

But all good extensions come to an end, underscoring the importance of managing maturities ahead of the due date. “There’s not a doubt in my mind: The reason we’re here today is we sat in front of our lenders, described the problem, and presented a potential solution,” says Tim Peterson, CFO of The Altman Cos. “You’re not going to get everything you want, but if you have a solution that’s a win/win, you’re a long way toward getting the flexibility you need.”

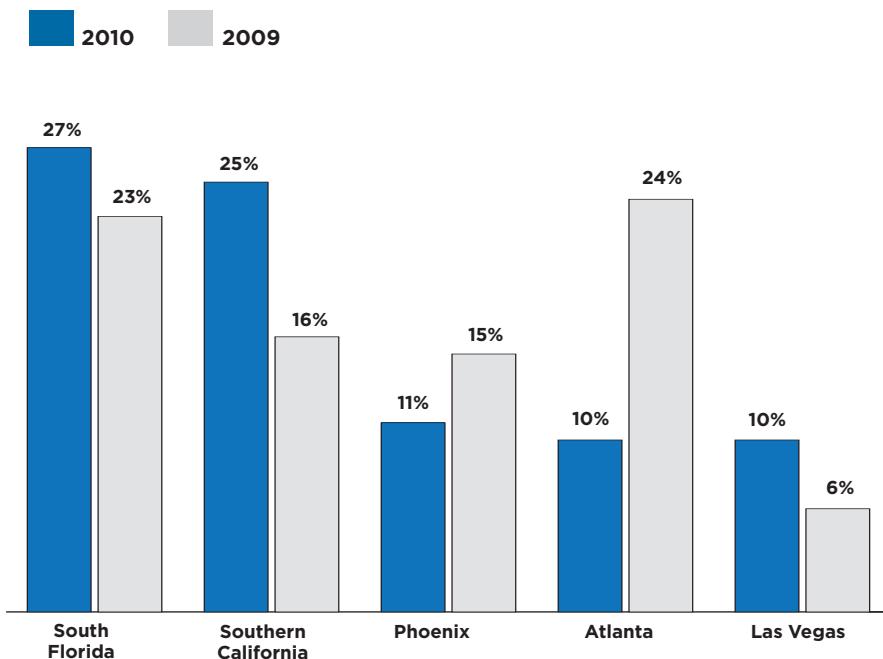
Developers looking to restructure debt are best advised to start the discussions at least a year away from any troubling maturities. But it’s a Catch-22: Banks are so inundated with restructuring requests that they often brush off anything that’s still 12 months off. “You can’t start the discussions early enough,” Keough of Wood Partners says. “You have to be very proactive, and you can’t take ‘no’ for an answer.”

Alliance Residential has always taken a conservative financing philosophy, often putting as much equity as it can into its deals to reduce the specter of looming maturities. The loan-to-cost ratio of the projects financed on its balance sheet is just 62 percent, though the developer certainly had the option of leveraging much higher than that during the peak of the last boom period. “Even though the market will give you more leverage, that doesn’t necessarily mean you should take it,” Hiemenz says. “If you finance with a lot of equity, you can position your company better going into the downturn.”

Essex, meanwhile, which grows mostly through acquisitions, takes a long-term view of debt financing, locking in 10-year rates to help manage its balance sheet. “We always had a philosophy of getting 10-year debt, so that only 10 percent of our debt came due in any one year,” Essex’s Dance says. “If we had big maturities looking at us, we couldn’t be as opportunistic as we’ve been. The companies that didn’t survive financed long-term assets with short-term debt.”

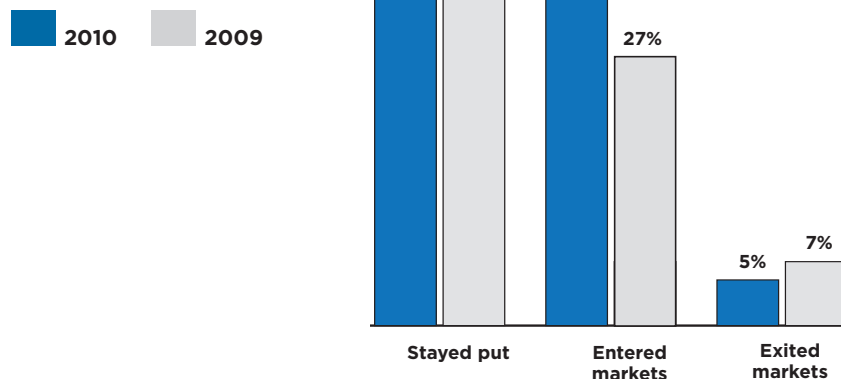
FROM DOWN TO UP

When it comes to distressed markets with the most upside, respondents bet on South Florida, which outranked last year’s frontrunner Atlanta.



ON THE MOVE

More firms entered new markets in 2010 than 2009.



Essex would like to reduce the number of secured assets on its books but is seduced by the low rates currently offered by Fannie Mae and Freddie Mac. “We’d like to grow unsecured debt, but GSE debt is so desirable right now,” Dance says.

Fellow REIT Home Properties has made a conscious effort to reduce the number of its properties encumbered with debt. In 2007, around 10 percent of the assets in Home Properties’ portfolio were unencumbered, but today, that figure is about 22 percent. Having nearly a quarter of its portfolio free and clear of debt allows the firm to tap its credit line to fund development or acquisition opportunities. “It’s certainly one of the things that strengthened our balance sheet and adds a lot more flexibility for us,” says David Gardner, CFO of the Rochester, N.Y.-based REIT.

5 Cash In or Cash Out

In that respect, REITs and other institutional players today have a significant advantage: strong balance sheets with plenty of cash on hand, a critical asset when opportunity knocks. For smaller firms, such as Wood Partners, generating that cash means striking joint venture relationships, or disposing of non-core assets and using the equity to break into

new markets.

Starting in the first quarter of 2010, Wood Partners began receiving unsolicited bids for some of its assets, which prompted it to take a deep look at its portfolio. “The rebound in value was much quicker—and steeper—than we thought it would be over the past 12 months,” Keough says. “The implied rent growth and exit cap rates today are very aggressive; thus, in many cases, it makes sense to sell today.”

The company has sold six legacy assets since the first quarter, which helped Wood pay off old construction loans and de-lever its balance sheet. Bolstered by the cash in hand, Wood Partners has reignited its development pipeline, with five new deals under way and another four planned to break ground in the second half.

Consider its Domain at Alta development, a 264-unit Class A apartment and retail project in downtown Oakland, Calif. The project was only about half complete when condo developer Olson Co.—which had already pumped about \$83 million into the deal—abandoned it three years ago. Looking to pick up where Olson left off, Wood Partners initially lost out as the second-highest bidder. Then, when the winning bid fell through, Wood quickly resubmitted an offer for \$5 million which,

significantly, featured a one-week close. It was the first deal the company had done in Northern California.

While larger firms like Wood begin to build again, many developers are concentrating instead on more humble value-added plays next year. About 48 percent of respondents pegged rehab projects as their top investment strategy for 2011, compared to only 36 percent who are ready to pull the trigger on new development projects. This also correlates to the perceived prevalence of such opportunities in the marketplace: 34.5 percent of survey respondents believe that value-add assets will be more available in 2011 than they have been in the past.

6 Know What You Want—and When to Strike

It’s this kind of ingenuity and patient agility that has kept the stronger multifamily players in the front lines, as they take their time and weigh their decisions.

Take Home Properties, which sat on the sidelines most of 2009. “We almost didn’t want to make a transaction—the capital markets were in such disarray, and everyone was nervous about what would happen next,” Gardner says. “We took a breather and set our underwriting standards higher to make it more difficult to pull the trigger.”

In 2009, the company was averaging about 15 percent below the winning bids. But today, Home sees the bid/ask spread narrowing down to 3 percent to 5 percent, “and you don’t necessarily have to get to 100 percent,” Gardner adds. “Ultimately, they may take a little bit less.”

That growing confidence in the transaction market is reflected among survey respondents, as well: 38 percent of firms entered new markets in 2010, compared to just 27 percent in last year’s survey.

What’s more, Home’s value-added strategy—taking older properties in good locations and rehabbing them—plays well in today’s marketplace since Class B and C assets aren’t seeing the same level of competition from institutional investors.

“We now see opportunities to buy properties that are accretive out of the box,” Gardner says. “And we’re not sure how long those opportunities are going to be there.” ■

Editor’s Note: All charts and data derived from APARTMENT FINANCE TODAY’s Annual Strategies Survey, conducted August 2010.

UP FOR SALE

Distressed properties are the asset type that finance pros believe will be most available in 2011.

