New Rules of Real Estate

Hawthorne Companies Principal Ed Harrington discusses the financial situation in the apartment sector and how owners can improve their holdings.

Q: What led to the downturned economy this year?

A: A recurring point of view shared by most investors is that the United States' financial system has to change—nearly everyone has been critical of past excesses. Real estate was horribly overpriced, simply because of pouring on of excess leverage. Consistent warnings about the systematic risk posted by the abuse of leverage and derivatives were repeatedly ignored.

Q: What factors led to declining revenue and rising expenses at many Southeast communities?

A: Vacancy rates in the Southeast range from 5 percent to 13 percent and revenue declines involving the various property types range from 2 percent to 8 percent. As simple as it may seem, for apartment owners, a focus on basic, fundamental operations at the site level on a daily basis is mandatory. Some owners and operators are distracted because of other financial challenges within their respective companies and, consequently, they ignored some operational necessities. Allowing operations at the site level to deteriorate compounds existing job-loss challenges by adding to the lower revenues, increasing vacancy and decreasing net-operating income.

Q: How difficult is it for investors to determine bid and ask prices in this economic climate?

A: The confusion in real estate values is accentuated by disparity between the bid and ask prices of buyers and sellers. Today's most progressive buyers first are looking for acceptable cash on cash return. The range of acceptability may be from 8 percent to 12 percent.

Several of the most astute and successful investors in the United States (such as Warren Buffett and Charlie Munger) recently have reflected on the past excesses to make clear their complete disdain for the use of higher order mathematics in finance. Further, they commented that there is so much that is false and nutty in modern investing practice and modern investment banking that reducing the nonsense is a goal for which investors should reasonably hope. Regarding the complex calculations used to value purchases, they said that if an investor needs a computer or a calculator to make their calculations, they should not buy it. Some of the worst business decisions that Buffett and Munger said they have ever seen are those with future projections and discounts given back. In other words, we need to go back to basics.

Q: Where do cap rates stand?

A: When evaluating a purchase opportunity, buyers focus on the most recent 90 days of operations for actual revenue and then normalize the expenses based on market knowledge and experience. Revenue is projected to be flat or even decrease for the first two years of ownership with revenue increases of 2 percent to 4 percent in the subsequent years. Debt is being underwritten either with an assumable existing mortgage or with new Fannie Mae or Freddie Mac 10-year term and a maximum of 65 percent to 70 percent leverage, and some buyers are even paying a little principal in lieu of just interest only. As opposed to cash-on-cash-return buyers, there are still some cap-rate buyers in the market place. However, most are looking at cap rates from 8.5 percent to 10 percent.

Q: What about cap rates in the Southeast, specifically?

A: Cap rates throughout the Southeast range from 7 percent to 10 percent. This reflects an increase of 150 basis points over the past 12 months or so. Occasionally, a cap rate may go below 7 percent—this would be an A property in an A location that for some reason has a low occupancy, for example, in the mid 80s. Most recently, an A property in an A location has averaged a cap rate of 7 percent to 7.75 percent. Cap rates for non-A properties are difficult to determine and several well-known brokers have said that "outside the A category, cap rates basically fall off the cliff."

Q: What's it like to deal with lenders who now hold these distressed assets?

A: Based on my recent visits to many multifamily housing and retail sites throughout the Southeast and in talks with lenders, it is apparent that servicers are becoming more involved in assets because of delinquencies and foreclosures.

We found that distressed properties are really distressed, meaning they are risky investments, which makes it difficult to figure out what the fundamentals are going to be in the future. These distressed assets have above-average discounts, because the fundamentals are weak and difficult to underwrite. Reasonably, the lenders still are not discounting good assets because some hope remains that select assets may experience some recovery.

Lenders and seller servicers are preparing, on an organizational basis, to take back real-estate assets during the next 12 to 24 months. These financial intermediaries are working hard to get organized, react quickly to the market place and assign the appropriate people and advisors to particular assets.

Q: What advice would you give to owners today?

A: From a pure real-estate operating perspective, a return to the basics—one that focuses on people, price and product—is mandatory, as well as implementing appropriate quality controls on a consistent basis. Onsite audits must be performed every 90 to 120 days and communities should be shopped by professionals at least every quarter to make sure the leasing and management staff is professional and effective.

When the markets are ready, owners who adapt to the new rules quickly and who are supported by an efficient and effective operating platform will be real-estate leaders of the future.

This interview was conducted in early May.

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