



Real Estate Investment Newsletter – July 2004

The Case for Selling Real Estate in California

This month I am writing the newsletter for those investors who currently own rental properties¹ in California. In any type of investing, be it real estate, stocks, bonds, or commodities, selling at the right time (price) is at least as important as buying at the right time. Up until now I have focused my attention on the various aspects of buying real estate for investment, but, as I have alluded to in several past newsletters, (November 2002 and November 2003) sometimes you will need to sell a property to avoid a significant drop in your returns going forward. This happens when valuations in a particular geographical market get out of line with alternative markets. Thus, as an investment advisor, I must point out that the current environment calls for a redeployment of capital out of overpriced California markets in order to maximize future returns on equity.

First we'll put the decision in the context of investment management objectives. Next I'll explain the economic forces affecting Capitalization rates and why we should expect future trends in property value appreciation to differ from the recent past. Then we'll look at California property valuations and what they tell us about likely future returns. Finally, we'll compare expected returns on an example California property with two alternatives to illustrate how much money is at stake for California real estate owners.

Investment Management Objectives

Most investors will agree returns are good and risk is bad. Generally an investor's objective in managing investment capital is to maximize returns subject to a constraint on the risk of the portfolio. This objective calls for an adjustment of portfolio holdings whenever (after accounting for transaction costs):

1. A replacement asset is available that offers higher returns than an existing holding at the same level of risk, or
2. A replacement asset is available that offers the same return as an existing holding but with lower risk.

¹ This article is meant for owners of apartment buildings. I have not specifically analyzed houses.

An investor who actively manages their portfolio must continually assess not only the return potential of their existing portfolio but also the return potential of assets they could substitute for current holdings. At Berkeley Investment Advisors we use our expertise to help clients identify such opportunities for enhancing returns. We'll start by looking at Capitalization rates and the link to mortgage rates.

Capitalization Rates and Property Appreciation

The Capitalization Rate (the Cap) of a property is equal to its net operating income (NOI) divided by its value: (1) $\text{Cap} = \text{NOI}/\text{Value}$. Rearranging this equation² to (2) $\text{Value} = \text{NOI}/\text{Cap}$ we can think of the Cap rate as a market driven variable that translates a property's NOI into a market value. The NOI of a property is its cash flow before mortgage payments. When we divide by current value to get the Cap (equation 1) we are calculating the property's cash flow yield. This is one major component of returns. The other is appreciation: the gain in the property's value through time. Of course appreciation is a function of both NOI and Cap rate changes so understanding and predicting Capitalization rate rates is key to predicting returns.

Mortgage rates, investor requirements for return on equity³ (ROE), and investor expectations of future property appreciation jointly determine Cap rates:

$$(3) \text{Cap} = \text{LTV} * \text{Mortgage Rate} + (1-\text{LTV}) * \text{ROE} - \text{Expected Appreciation}^4$$

LTV is the loan to value ratio – meaning it is the percentage of value financed by the mortgage. Therefore 1-LTV is the down payment/equity. All of these variables shift around constantly depending on the monetary and fiscal policies in the U.S. and its trading partners as well as investor expectations about future NOI growth, Capitalization rates, and returns available on alternative investments. In the long run, appreciation is driven by NOI growth and should approximate inflation + productivity growth unless there is an unusual shift in demand in a particular geographic market. On average, over the long run, I expect NOI growth and appreciation of 3-4% per year.

In the last few years Capitalization rates have followed a declining trend as mortgage rates declined to 40 year lows. This trend caused appreciation rates to exceed the rate of NOI growth substantially. In fact, NOI has in most cases declined as renters took advantage of low rates to move into their own homes. In turn these higher appreciation rates contributed to further declines in Capitalization rates as investors extrapolated the higher appreciation rates into the future.

This trend towards lower Capitalization rates and higher appreciation rates is not sustainable in the long run and there are already indications that we have seen the low in Capitalization rates. This phenomenon was a direct result of the Federal Reserve Board's policy to bring inflation down to 2% or less. Thanks to the recession, they

² Multiply both sides by Value/Cap.

³ROE requirement should depend on perceived risk of the investment.

⁴ I am ignoring tax effects to keep this simple. This is derived from the fact that returns to the lender $\text{LTV} * \text{mortgage rate}$ and returns to the investor $(1-\text{LTV}) * \text{ROE}$ must equal cash returns (Cap) + Appreciation.

overshot their goal and loosened policy to bring inflation back up from near 0. Having flooded the market with liquidity and raised inflation, they are now in the process of tightening U.S. monetary policy. As a result, our foreign trading partners are under less pressure to intervene in the currency markets (i.e. buy U.S. bonds) to support the dollar. Both of these changes work to increase interest rates, as does increased government borrowing. Going forward I expect stable to higher mortgage rates and, since this feeds into Capitalization rates via mortgage rates, Capitalization rates should also move higher or, at best, hold steady.

Capitalization Rate Impact on LTV and Return on Equity

Rearranging equation 3 to solve for return on equity we get⁵:

$$(4) \text{ ROE} = (\text{Cap} - \text{LTV} * \text{Mortgage Rate} + \text{Appreciation}) / (1 - \text{LTV})$$

Decreasing Capitalization rates reduce the cash flow portion of ROE and at the same time reduce the supportable loan: the LTV. To examine the link between Capitalization rates and ROE we must understand commercial mortgage terminology. We calculate the Debt Constant (DC) by dividing annual mortgage payments by the loan amount. For a loan with principal amortized over 30 years the DC is approximately equal to the mortgage rate + 1% (at current market levels). Thus a mortgage at 7% would have a DC = 8%. LTV is constrained by lenders' requirements that NOI (before subtracting capital expenditure reserves) be at least 1.2 times the mortgage payments. Mathematically this constraint means: $\text{LTV} = \text{Cap} / (\text{DC} * 1.2)$. We want LTV at 70% or better. If DC is 8% this is only possible if the Capitalization rate is 6.7% or higher (before subtracting capital reserves).

As Capitalization rates decline so does the maximum possible LTV and since leverage usually boosts ROE, this decline will tend to lower ROE. Appreciation can compensate but over the long run this should equate to growth in NOI. Once Capitalization rates go below 6.7% in the current environment the cash flow return will be minimal (<1.3%). Appreciation magnified by leverage makes up most of returns. If long run NOI growth and appreciation are 4%, this will translate into 13% ROE at LTV = 70% but only 8% ROE when LTV drops to 50%.

Returns and Risk in California: Looking in the Wrong Direction

In the Bay area, occupancy and rents came down in recent years. Going forward fundamentals look to strengthen. After all, there is little new supply and demand is now returning slowly. Southern California has had consistently good occupancy and rental growth all along. Upside from NOI growth is, however, limited both by rent control (S.F., Oakland, Berkeley, and Santa Monica) and by the fact that rapid rent increases tend to drive away businesses, jobs, and therefore demand. Developers in inland areas will respond to rent and occupancy increases by building more units. When evaluating their California real estate investments, investors can look forward to decent if unspectacular growth in NOI.

⁵ Note that this simplifies the issue a bit since it applies to only a single period at a time

Decent fundamentals, combined with strong appreciation driven by the decline in Capitalization rates have left most investors feeling brilliant and happy. But investors are looking in the wrong direction if they are expecting appreciation rates to continue as they have in the recent past. As they say in the mutual fund prospectuses: past results are no guarantee of future results. A look at the current level of valuations reveals the difficulty of repeating past gains.

California Apartments: An Analysis of Current Valuations

Capitalization rates on apartment buildings with more than 4 units in California fall mostly between 4.0% and 5.2%. This is based on NOI after taking into account management costs and capital expenditure reserves. For example, the Oakland multiple listing system shows the sale of a 6 unit property on Marlow Drive for \$850,000 on 5/7/2004. The gross rent multiplier was 12. I estimate the Capitalization rate (before property tax reassessment) at 4.4%. Adding back Capital Expenditure Reserves the Capitalization rate would be 4.9%. The details are as follows:

Gross Rent and Laundry	\$70,912
Vacancy @6%	(4,200)
Management	(3,600)
Operating Expenses	(21,844) actual adjusted for under-insurance
Capital Expenditure Reserves	<u>(4,000)</u>
NOI	\$37,268 = cash flow before loan payments

This sold at a very low Capitalization rate. If it had sold at a more reasonable Capitalization rate, (say 5.0%) its price would have been \$750,000. Based on the property's cash flows it can support a mortgage of \$440,000 (LTV = 59%) at 6.75% amortized over 30 years. Cash remaining for the investor would be \$3,022 per year, a yield of .7% on equity of \$410,000. Loan repayment at \$4,689 represents another 1.1% return on equity. Further appreciation in excess of NOI growth will lower LTV still further and depress future cash flow derived returns even further. This is only possible in a bubble scenario where returns are driven, not by market fundamentals, but by irrational exuberance (to quote Alan Greenspan).

As an owner of California real estate you need to look at the current valuation of your property. The price paid in the past is irrelevant for managing your investment going forward. Value has already risen and you now face the choice of selling at the current value or holding. For purposes of comparison we'll assume you would be giving up a 5% Cap property (rather than a 4.4% Cap). Thus, using the above property to illustrate the economics, your equity would be \$310,000 (= 750,000 – 440,000) if mortgaged to the maximum possible.

Let's look at the likely returns going forward if you kept the property. The key missing variable is appreciation. Since the property is in Oakland, rent rises shouldn't exceed the inflation rate. Assuming inflation is 3% and you hold the expense rise to 2%, you can grow NOI by 4%. This means an increase of \$1,496 per year in NOI and

cash flow. If Capitalization rates remain stable at 5%, the property would appreciate by the same percentage amount as the NOI growth: 4%. This is the best case scenario. It's far more likely that Capitalization rates will rise .2% or more as the Federal Reserve boosts short term rates. If this happens, appreciation will be 0.⁶ The following table summarizes ROE under these two alternative scenarios, with and without the maximum mortgage on the property.

	No Mortgage	Max Mortgage
Appreciation = 0% (Most Likely)	5.0%	2.4%
Appreciation = 4% (Best Case)	9.0%	11.6%

The higher the property value (& lower the Capitalization rate), the lower these returns would be. On apartments I generally recommend that investors target pretax ROE of 12%.

Alternative 1: Analysis of Phoenix Apartments

Now we'll look at what would happen if the California property is sold and the capital is reinvested in Phoenix apartments. Capitalization rates on Phoenix apartments are mostly in the 5.5% to 6.5% range (taking into account management costs and capital expenditure reserves). For purposes of illustration, we'll look at a hypothetical property with a Capitalization rate at 6% after deducting capital reserves, a 6.7% Capitalization rate before reserves. This will support LTV = 72%.

While the Capitalization rate difference between California and Phoenix allows the Phoenix investor much higher leverage, 72% versus 59%, potential NOI growth provides a big advantage for Phoenix. Currently Phoenix properties lose 15% of gross rents to vacancy and free rent concessions. As rising mortgage rates, rising home prices, and migration to Phoenix bring this down to single digits, NOI and cash flow to the investor will increase dramatically

Assuming a 9% vacancy loss and a 2% expense increase, NOI and cash flow will grow by 11% in year 2. When vacancy losses decline, it reduces future NOI growth potential. This should cause Capitalization rates to rise because investors will demand more of their required return in the form of current cash flow. Therefore I expect the Capitalization rate to increase by .4% in Phoenix in year 2. . My return estimates for Phoenix, corresponding to the prior Oakland table are given below.

ROE when Mortgage:	No Mortgage	Max Mortgage
Appreciation = 4.2% (Most Likely)	10.2%	16.7%
Appreciation = 11% (Best Case)	17.0%	38.4%

Alternative 2: Analysis of Triple Net Lease (NNN) Property

Now we'll look at an example that shows how to get approximately the same returns but with less risk and less management attention. The property is leased long-term to Sherwin Williams Company. This is a successful retail store of an "A" rated

⁶ Any rise in Cap rates greater than .2% will result in a decline in the property's value in this example.

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company. The initial lease term is 8 years and the tenant has three 5-year extension options. At the asking price of \$762,000 the Capitalization rate is 6.8%. As with the Oakland property, I believe rises in mortgage rates will cause market wide Capitalization rates to rise .2%. Applying this to next year's market rent⁷, I calculate a slight drop in value (<1%) over the first year. ROE should be:

ROE when Mortgage:	No Mortgage	LTV =61%
Appreciation = -.7% (Most Likely)	6.1%	2.2%
Appreciation = 2.5% (Best Case)	8.9%	9.4%

These returns are very similar to the Oakland property. What makes this option appealing is that it offers a significant reduction in both risk and management time. You can safely ignore this investment for at least the next 8 years because you have a long term lease with a top rated company.

Conclusion

In the language of Finance: the Oakland property is dominated by alternative investments; it is not an “efficient” investment. There are alternatives that carry higher returns for the same risk, or lower risk for the same returns. Investors who agree that higher returns are better and lower risk is better should put California properties on the market now. By doing so they can reap the benefit of past returns and build on them by actively managing their portfolio to maximize returns and minimize risk going forward. Berkeley Investment Advisors can help you analyze your specific situation to determine the extent that you can expect to benefit from an exchange of property in the current market environment.

Featured Investment Opportunity

Spanish Hills is a 15 unit apartment building in Phoenix with rents substantially below market (>20%). Based on a price of \$570,000 this would have a Capitalization of 5.8% at current rents, 6.6% at market rents. The required investment is \$158,000. I expect this to produce very good returns as rents are raised to market.

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⁷ For a triple net leased property with fixed rents over a term, we look to the underlying market rent increases to estimate appreciation of the property.