September 20, 2012

FROM: Virtú Investments, LLC
TO: Investors
RE: Q3 2012 Apartment Market Outlook: **The Closing Window**

Where are we today?

Apartments continue to be the standout asset class within domestic real estate and one of the best performing investments across a broad spectrum of opportunities. For perhaps the first time in recent history, the apartment sector has helped to lead the way out of a recession, experiencing strong performance despite an otherwise anemic economic recovery.

As discussed in our recent papers, favorable conditions were setting up for the multifamily sector over the last several years. A relatively limited supply of new apartments was delivered during the top of the recent market cycle and almost no new construction occurred during the credit market correction. In addition, low levels of apartment development, a steep demographic trend of household formations, sustained home foreclosures, and an increasing sentiment among consumers to rent vs. own have further reinforced a robust operational picture. ***Combine this massive demand for apartments with incredibly low financing rates and a general belief in inflation, and it's hard not to be bullish on this asset class.***

Despite such strength and optimism, transaction volumes in the apartment market have remained below historical highs due to the relatively strict lending standards of Fannie Mae and Freddie Mac and an absence of competitive alternatives. Recently, underwriting standards have begun to loosen a bit as more lenders are lured by low default rates and the belief that strong fundamentals will persist. As a result, transaction volumes are now beginning to accelerate while apartment values are on track to surpass their 2007 highs.

Sellers of unencumbered Class-A and Class-B apartments continue to reap strong profits. Notable exceptions are those properties that were purchased at the top of the cycle or are poorly operated. Even as current buyers of Class-A and Class-B assets are paying low capitalization rates by historical standards, these buyers are typically walking into strong yields made possible by solid supply/demand momentum and extremely cheap long-term fixed-rate debt.

As usual, the late arrivals to this party are Class-C properties. Blue collar job creation and the corresponding wage growth in the lower income bracket are trailing an already tepid economic recovery. Lenders have thus been reluctant to lend significantly on lower quality assets. However, in recent months the Class-C market appears to have gained momentum, and we are now seeing transaction volumes picking up steadily.

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Is everyone a winner?

Looking across the apartment sector, it seems like almost everyone might be a winner - but one can only wonder how long the good times can last? Today's prevailing sell-side broker messages sound something like, "You can't afford not to sell where prices are today." These statements are running in parallel with the typical buy-side advice that generally advocates, "At today's interest rates, and with improving fundamentals, it's a great time to be buying apartments." But in the typically zero-sum game of professional real estate investing, is it possible that both of these views are right?

We believe the answer is a well-qualified "yes" – or at least for brief periods of time, where mature but not-yet-peaked segments of the cycle can offer favorable scenarios on both sides of the trade. It is this short period where we would argue the market is hovering today; a brief window where almost no capitalization rate is too low for a quality asset if paired with a long-term, fixed-rate debt, or if it is acquired with a business plan that is designed for a quick turn and exit into an environment of low interest rates and improving fundamentals. ***In other words, ridiculously low interest rates make virtually every acquisition cap rate accretive to the cost of financing.*** This arbitrage allows for cash yields to stabilize in the mid-single digits while the apartment owners' largest cost, debt service, can be fixed at low levels.

Despite this substantial opportunity, there are also signals that we are progressing past the initial growth period of the apartment cycle. Some of indicators include:

- Historically low cap rates and significant competition on "free and clear" transactions.
- An increasing variety of attractive debt options available to apartment buyers.
- A willingness by lenders to increase leverage levels to as much as 80%.
- The re-emergence of mezzanine debt that is willing to go even higher up the capital stack for larger returns, allowing investors to enter with very little equity.
- Slowing rent growth in some markets over the last several quarters as renters reconsider their options, including an increasingly attractive single-family housing market or sharing tenancy to absorb the cost of rising rents.
- Rapidly expanding pipeline of new apartment stock, fueled by equity in search of yields that can no longer be achieved through traditional acquisition strategies.

Respecting the cycle

Over the next three to five years, we anticipate seeing the multifamily real estate cycle reaching maturity. ***Virtú has participated in similar cycles and expects that this one will play out in much the same way.*** We believe the inflection point will come into greater focus as more apartment buyers with limited experience gain access to cheap debt at higher and higher leverage levels. Unfortunately for the buyers of this real estate, improved access to debt and leverage usually occurs at the same time as the second and third waves of new apartment supply are being delivered. Unless buyers are adequately prepared to hold through the end of the cycle, it is at that stage that business plans start to unravel for many market participants.

In the past, we have found that the latter portion of the cycle can be accelerated if there is an external shock pushing the market into an illiquid state. Conversely, the top of the cycle can also be prolonged if new competitors and builders are limited by lending standards that remain stubbornly tight, or if strong job and wage growth give the cycle extra legs through surging demand. In either case, the reckoning eventually arrives, allowing experienced investors to set up for the next cyclical expansion.

Well-considered strategies are the key to success

If you had the conviction and wherewithal to buy apartments in the last three years, you probably look like a winner today. But with most of the easy money off the table, the delta between successful investors and average-to-losing investors in the apartment sector will almost certainly widen and returns will increasingly be defined by investors' specific strategies and executions.

As an example, while using long-term leverage is likely a prudent strategy at this point in the cycle, it is not without its risks as the cycle reaches maturity. Poorly underwritten assets will feel pressure when over-leveraged or acquired in stagnating markets. Likewise, improperly financed assets in challenged locations will have difficulty finding buyers even in the best of times. This is doubly so during times of prolonged illiquidity. As such, the extended hold period required at the end of the cycle will expose ineffective operators or ill-conceived business plans.

A high tide market like we are seeing today offers little opportunity to differentiate between apartment buyers. ***Thankfully, the decisions made as we all move towards the end of the cycle will set the experienced buyers apart and demonstrate the importance of pairing the right business plans with their appropriate debt strategy.*** When executed properly we have seen that multifamily investments can generate strong risk adjusted returns through each phase of the real estate cycle.

Virtú's approach to the market

At Virtú Investments, our investment thesis remains ever-vigilant of the market cycle. Our first fund, The Virtú Multi-Family Opportunity Fund, was deployed over the last 18 months and enjoyed an investment period that is expected to allow asset dispositions to occur comfortably in advance of the top of the market.

We have recently begun to deploy The Virtú Multi-Family Opportunity Fund-II. Fund-II is targeting assets resembling those of Fund-I, and most of Fund-II's business plans will be similarly engineered for short turnarounds but will incorporate an increasing bias towards debt strategies that also allow for longer-term holds. This prudent approach has served us well in past cycles and we expect it will do so again.

Looking into 2014 and beyond, our focus will transition towards longer horizons. Virtú believes it has identified an exciting and unique strategy that addresses an overlooked niche of the multifamily asset class. Although still in a conceptual phase, we believe this new direction has the potential to be cycle-agnostic yet allow for both stable cash yields and visible long term appreciation. This idea will also bring Virtú's best practices in sustainability and community development to the forefront of our investment approach. We look forward to sharing this and other opportunities with you in the future.

– The Virtú Investments Team