March 1, 2011

Re: Shopping Small for Outsized Returns

Dear Investor,

It has been close to 18 months since our last real estate market outlook. Looking back, our call of the bottom of the real estate cycle in August of '09 almost seems obvious as hindsight's view has a way of making the bold look banal. Today, the optimism in real estate, particularly the multi-family sector, is palpable. At the annual National Multi-Family Housing Conference in Palm Springs in January, the entire spectrum of real estate professionals supporting the industry were bullish on the operational recovery of apartments and the expansion of both debt and equity to support an increase in transactional volume. In this letter, we will recap the recovery with an eye on highlighting today's potential pitfalls and opportunities in the investment cycle for the apartment asset class.

2010 The Recovery

Although 2009 saw the stock market recover substantially, it wasn't until 2010 that Commercial Real Estate (CRE) started to find its footing. Historically, Commercial Real Estate does lag the stock market, so this delayed recovery wasn't altogether unexpected, and played out much as we anticipated. Probably the most notable aspect of the real estate recovery has been the extent to which capital flows have decisively returned to the multifamily sector. Debt today is readily available to buyers, though at lower leverage levels and only to the most qualified borrowers. Freddie Mac and Fannie Mae maintained the ability to fund multi-family transactions even through the worst of the capital crisis, and are still active today. The debt market is further buoyed by the return of other historical participants such as life insurance companies, regional banks, and, to the chagrin of many industry insiders, commercial mortgage backed securities (CMBS), albeit all at much lower volumes and with more conservative underwriting than we saw at the top of the cycle. Equity is also chasing the asset class, as institutions, REIT's and well-funded industry survivors looked to capitalize on the expectations of favorable operating fundamentals that began in early 2010, and look to continue for several years. The limited supply of new apartment units built over the last few years, in conjunction with a modest uptick in the economy that brought much needed stability and confidence to renters, began to lift occupancies and firm rents in most markets around the country. Our existing portfolio endured the downturn quite well, and across the board, property stabilization in late 2009 served as a strong indicator that a broader market recovery was on its way. This strength was a signal to us that it was time to begin easing in with new acquisitions after a long absence. We bought four properties in 2010, and in most cases are exceeding our performance expectations. Our biggest regret of 2010 is that we didn't buy more as we are already seeing investors return en masse and our asset prices recovering swiftly.

Today's Cycle and Outlook

Today we are at the strongest operational risk-return phase of the multifamily real estate investment cycle. Major declines in occupancy and rental rates are behind us, occupancy has rebounded strongly, and rent growth is beginning in many markets. The probability of more robust job growth is ahead, and with limited new supply of apartment units in the foreseeable future, the promise of improved operating fundamentals seems almost certain. Although the period between 2009 and early 2010 was likely the bottom of the multi-family cycle in terms of pricing and the best time to buy, the improvement in operating fundamentals was not yet transparent. However, we are now able to look back at 2010 as a period of apartment absorption not seen in over a decade. What makes this particularly noteworthy is that it was done with some of the lowest positive job growth in a decade, the classic litmus test for apartment health. The key for apartment absorption in 2010 was that nearly 65% of jobs created in 2010 were for younger workers with a higher propensity to rent. We anticipate this trend to continue as the economy improves and we see additional younger renters "leaving the nest" and the "uncoupling" of roommates. Also contributing to demand are many former homeowners who have become emotionally biased towards renting given the recent housing market declines. As the economy grows and the number of new jobs improves, we expect to see further absorption, and with it significant rent growth. This absorption story going forward fits with the broader demographic shift we have been discussing for a number of years regarding the coming bulge in echo boomers who make up the prime renting demographic.

Pitfalls

Is everything a buy? Our answer: unfortunately not. As with most efficient markets, the pricing of assets tends to lead their recovery in performance. The stock market recovery leading the economic recovery would be a common example. Many assets in multifamily today are fully priced, and we would argue that they may actually be overpriced. The combination of historically favorable interest rates for debt financing of apartments, and the asset class "darling" status for the equity investor, has led us back to historically high multiples corresponding with low capitalization rates on acquisition. This is particularly true in the larger institutional multifamily asset class, typified by transaction sizes of $25 million or larger in core metropolitan areas on both coasts. Most transactions today are seeing double digit numbers of bids and are trading at cap rates we saw at the top of the market cycle. These acquisitions do represent better fundamental values than they did at the top of the market because the high multiples are being applied to today's significantly reduced revenues. They also anticipate the strong prospects of improving fundamentals in a period where that is highly likely. However, the investments themselves may prove to be less appealing than at first blush. In part, at current valuations, market rent growth alone is typically unable to provide enough revenue growth to provide strong returns without significant asset repositioning. As a result, the first major risk is buying assets without a significant repositioning opportunity, and the second major risk is in the execution of those repositioning opportunities that do exist. Buyers that are weak in identifying these opportunities or are not vertically integrated to execute them could see investment returns suffer. Rental increases are the key to any successful apartment investment, particularly where there is risk that cap rates rise (multiple-to-income falls) when it is time to sell. In a very simple illustration, an investor buying a 6% yield today will need to grow net operating income (NOI) by 12% during their hold period to sell at the same price to a buyer seeking a 7% yield in the future. If that future yield demand is 8%, NOI will need to be up 28%. Virtú believes that there is a high likelihood that buyers will require a higher yield in the future based on an inflationary environment, higher interest rates, and weaker prospects for improving fundamentals. *This means that only properties with significant opportunities for growth in Net Operating Income will prove to be outperforming investments.*

The Buying Opportunity

Not all solid assets in the multi-family market have seen complete or even partial pricing recovery. Virtú Investments is particularly focused on assets that are below the radar of many institutional buyers. Today that focus allows us to buy smaller assets, 5M-15M, in fundamentally sound markets and often in the more secondary and tertiary submarkets. Smaller assets, which comprise a significant share of the total multi-family marketplace, are traditionally owned by smaller companies, wealthy families, or even individuals. At the top of the cycle, the combination of the ubiquitous availability of cheap debt and the relative growth of personal wealth and perceived liquidity saw these assets trade at or above the multiples seen in the institutional marketplace. In other words, these smaller investors were more bullish, less cautious, and had an equivalently priced or cheaper cost of capital than institutions. Today this phenomenon is reversed. Debt is only available to the most sound, experienced borrowers with proven track records and a healthy balance sheet. Many individuals who were active at the top of the cycle are now solving balance sheet problems and working out many of their later in the cycle investments that have become problematic. This absence, in conjunction with the fact that these properties are typically too small to encourage institutional interest, results in less competition for these types of assets. Today, we see historically attractive pricing for this asset class, particularly in light of the relatively low cost of debt and our prognosis for healthy recovery in operating fundamentals. Virtú Investments will remain focused on selectively acquiring these assets where we can influence operating income growth through executions of sound value-added business plans over the next 18 to 24 months. We are confident that these types of investments will provide strong cash flows and above average returns over the life cycle of our investments.

Conclusion

Investing in any asset today carries some risk. While apartment fundamentals are poised to be very strong over the next several years, the selection of specific assets, sound financing strategies, and thorough execution of business plans have never been more important to ensure strong investment returns. Virtú continues its on-going effort to perfect each of these critical areas of expertise with the goal of providing our investors with the best risk adjusted returns in the industry.

Respectfully,

Virtú Investments