August 15, 2011

RE: Apartments: Rumors of a Bubble Have Been Greatly Exaggerated

Dear Investor,

A few months ago, in our letter titled **Shopping Small for Outsized Returns,** we stated we were at the strongest operational risk-return phase of the multifamily real estate investment cycle, yet we still pointed to the need to focus on smaller "under-the-radar, value-add" opportunities to avoid certain overheated segments of the market. However, in recent meetings with investment professionals it has become clear that some have growing questions about the possibility of values accelerating too rapidly across all segments of the apartment market. In this update, we will briefly outline the factors contributing to these concerns as well as articulate our decidedly positive outlook for apartment investments at this stage of the cycle. Despite some segments appearing overheated, particularly at the high end, strong opportunities still exist in multifamily investing.

The Bubble Thesis

The thought process put forth supporting a general overvaluation of the apartment asset class is as follows: The debt available to apartment owners has not only fully recovered, but is in some cases less expensive than prior to the credit crisis. Much of this capital is provided by Government Sponsored Entities (GSE's), most notably Fannie Mae and Freddie Mac, whose survival and longevity are in question. The bubble thesis goes on to say that cheap debt and the recent strength in apartment fundamentals have made apartments a popular asset class among equity investors. This dynamic has pushed capitalization rates back near, or in some cases below, where they were at the top of the last cycle, which represents a historical low (our highest multiple in decades and perhaps ever). As a result, proponents of the bubble theory believe that a recovery of this magnitude, with such expediency, fueled by cheap and prevalent capital, is unsustainable. When there are no GSE's, and capital has more interest in other real estate asset types, you will see a correction in pricing. This is more or less the crux of the thesis.

While this reasoning is not without merit, it fails to look at the full value equation in a historical context, and ignores perhaps even more relevant data that would argue a different conclusion. The data suggests that even without the GSE's, debt is poised to stay appropriately low, given the low loan loss rates of the asset class. Further, the extraordinary operating fundamentals prevalent today look to continue for the next several years.

Apartment Valuations

Despite the historical low capitalization rates paid for apartments today, these rates are, on average, in line with historical risk premiums once adjusted for the lower interest rates (positive leverage) as shown in the below table. As a result, you can see capitalization rates would have to fall much further to reach peak levels.

Historic Valuations of U.S. Apartments (Jan 2011)

	Cap Rate	Mortgage Interest Rate	*Positive Leverage	**Risk Premium
Peak	6.20%	5.90%	28	160
Present	**6.80%**	**4.60%**	**219**	**395**
Decade	6.90%	6.40%	53	190

*spread between cap rates and mortage rates
**spread between cap rates and 10-year US Treasuries

***Source**: Real Capital Analytics Jan. 2011*

***Note:** Virtú estimates that today's capitalization rates are down on average approximately 50 basis points from when this data was collected in January 2011, and are currently closer to the peak levels noted in this table. This rate compression has been fueled in large part by a similar drop in mortgage interest rates.*

Apartment Valuations (continued)

We also need to remember that different real estate assets, markets, and submarkets tend to move up or down at varying rates. Some are leaders and some are laggards. As a result, opportunity will close in certain segments and accelerate in others. As we have mentioned before, there is often a waterfall effect where Class A assets lead the recovery, followed by Class B and lastly Class C assets. Similarly, primary markets lead the way to recovery, followed by secondary and tertiary markets.

The high end has led the recovery and has seen some of the anticipated overheating. The operational recovery has been strongest in Class A assets in primary markets, with occupancy improvements starting about 17 months ago. Capital flows in this segment have also led the way, with discretionary capital deployed early in the cycle. Debt followed, courting well qualified buyers needing lower leverage loans on real estate located in primary markets. It started with GSE's, but most recently life company lenders have beat out the GSE's on trophy assets. Class B assets, smaller assets and assets in secondary markets have not seen capital flows recover at nearly the same rate or magnitude, which leaves room for opportunistic buying. This is in part because these products have only seen operational improvement in the last six to nine months, and qualified buyers are far fewer. The tertiary, Class C segment has yet to see a significant pickup in either operations or capital flows.

Apartments are the only class to account for the ongoing leasing costs, turnover/tenant improvement costs, and much of the capital expenditures required for operations. As a result apartment capitalization rates are deservedly lower than office, industrial and retail. These asset classes remove leasing commissions and tenant improvements from their NOI, leading to a perception of higher capitalization rates.

Interest Rates: Indexes will Rise, Spread will Fall

Interest rates are indeed set to rise. The two main components leading to our apartment borrowing interest rates today are the indexes and the spreads. Lenders today have a dramatically lower cost of capital than at the top of the cycle, yet rates have not fallen concurrently. In fact, spreads, which can be considered yields to lenders over their cost of capital, have on average doubled since the peak. These spreads can also be viewed as a margin of safety, vis-à-vis higher yields allow for a higher failure rate. The strength of this debt investment is buoyed further by the strong fundamentals of the underlying assets being underwritten at this point in the cycle. As a result, while indexes are indeed likely to climb, there will be a cushion as spreads are likely to fall. Yet as demonstrated in the table above, even if rates went up 1.8%-2.2% to historical levels and cap rates moved slightly, we would still be close to historical averages and not near peak levels.

Operational Fundamentals are Exceptional

Today, the outlook for apartments is extraordinary. The argument that posits the asset class is fully valued also fails to give sufficient weighting to the operational recovery of apartment occupancies and rents. As a result of entering the most recent downturn without the hangover of oversupply that was seen in past downturns, most apartment markets across the country have seen occupancies recover fully and rents begin to increase, in some cases setting new high-water marks for year-over-year growth. During the three year downturn, the industry delivered less than 10% of the annual supply necessary to accommodate population expansion in a healthy employment environment. As a result, we are witnessing the impact of that development hiatus as rents are rising steadily in an economy that is showing only very limited signs of recovery. With a material acceleration in the apartment development cycle still several years away in most markets, limited competition from single family housing, and strong demographics ahead, Virtú expects to see rental increases continue at robust levels. We believe 20% revenue growth over the next three years in many markets is not unlikely, and 10-15% is almost certain.

The Low Cost of Capital is Well Deserved

The low cost of capital for apartment investors is well deserved, and likely to continue. Many fail to recognize the profitability and stability of well underwritten apartment loans, especially when compared to alternative real estate lending opportunities in the residential, development, office, industrial, and retail sectors. Particularly noteworthy is the performance of debt vehicles associated with well underwritten apartment debt during even the worst of the recent credit crisis and economic downturn. For example, during the depths of the downturn, Freddie Mac, one of the leading providers of financing for traditional apartment properties saw less than a 1% default rate on loans on balance sheet or being serviced. *Importantly, this was a default rate, not a loss rate.* Assuming an exaggerated loss rate of 40% of the loan balance, you would be at a total loss rate of 0.40%. Assuming an average profit spread of 1.5%, and an average term of 7 years, this down market loss rate becomes quite minor.

With spreads nearly double those of five years ago, very low default rates, and even lower loss rates on the horizon, we anticipate competition for apartment loans to drive spreads down for the next several years. Today the trend is starting. Most notable entrants are the regional banks that have very low cost of capital, and see a strong opportunity in apartment lending. The second group to recently move into the competition set is life insurance companies, who have been leading the way on trophy assets. CMBS, following the lead of Fannie and Freddie loan securitizations, are also poised to grow once again.

Fannie and Freddie Aren't Essential Long Term

The bubble argument places a large emphasis on the GSE debt fueling the so called "bubble" and anticipates a collapse if they were no longer in the market. Yet, there is a good argument that the apartment arms of these agencies may likely survive in some shape or form in any break up scenario given their profitability and stabilizing influence in a much needed segment of the housing market. Supporting this is the fact that in recent months both Fannie and Freddie Mac have been able to sell numerous packages of their loans (a version of CMBS) on the open market to investors, foreshadowing a future government-free incarnation.

The Downside Risk

The unlikely, but possible scenario of extreme inflationary pressure on interest rates combined with corresponding increases in cap rates and sluggish rent growth would represent the most challenging environment for apartment investors. This outcome would correspond to an economy that is seeing inflation only in interest rates while the economy remains stagnant and the cost of goods and labor are not inflating. Under the scenario, few investments will prosper.

Though the final outcome is hard to predict, even in this scenario apartments have a relatively favorable position. Equity capital flows will likely still favor apartments. Flexible leases, strong demographics, and favorable supply/demand characteristics should stabilize pricing. Alternatively, bonds would be falling in value and stocks would have weak growth prospects. Further, high construction debt rates will lead to a rise in replacement costs, muting the development of new supply. This will also leave the asset class in a long term favorable operating position that should allow rent growth to outstrip expense inflation.

Conclusion

Virtú Investments believes that the risk of a bubble in the apartment sector as a whole is minimal. The asset class today is fairly valued or even undervalued, given the alternatives. The probability of solid to exceptional returns remains high and the risks to the sector at this stage look minimal. The asset class has many intangibles that allow it to perform well in a number of different economic and interest rate environments. These include the availability to procure fixed rate costs of capital to hedge against rising rates and flexible lease terms that allow for revenue increases in an inflationary environment.

Today, we see the Class A segment in some primary markets as fully priced, given the numerous equity participants who need to place money, ample lending options available, and few assets available to buy. We find the under the radar opportunities, Class B assets in primary markets, and Class A in secondary markets as the most attractive risk return profile.

While any investment carries risk, we are confident that a well executed apartment strategy today offers and attractive opportunity for investors.

Respectfully,

Virtú Investments