THE IMPACT OF THE SUB PRIME CREDIT ENVIRONMENT ON BERKSHIRE'S MULTIFAMILY INVESTMENTS

By David C. Quade

As real estate professionals grapple with the impact of the recent sub prime credit environment on real estate, we have investigated how the market is poised to affect our future investment strategies as well. We address many of the concerns that real estate investors have in the discussion points that follow.

Q: How does the current credit environment affect rental demand?

The tightening credit markets are having a positive impact on the demand for multifamily properties. Industry statistics indicate the number of residents leaving apartments for single-family housing has been reduced 10 to 25%, as these residents are now having more difficulty qualifying for mortgage financing. This event is a reversal of the past five years of a relaxed credit environment where resident turnover to single-family home ownership has been a dominant trend. Additionally, the tightened credit environment is in fact pushing some single-family owners back into apartments, as many owners are unable to afford the increasing costs of their adjustable rate mortgages. This trend is expected to continue for several years as adjustable mortgages continue to convert to higher rates.

Q: Has the tightened credit market impacted multifamily owners' ability to obtain financing?

The current credit markets have caused the conduits (investment banks, hedge funds) to shut down or markedly reduce volume, causing many borrowers to now rely upon Fannie Mae and Freddie Mac financing. Berkshire has always done business with the agencies and has a preferred relationship with them that ensures focus on its financing requests. This preferred status stems from the credibility and relationships Berkshire developed through the operation of its Mortgage Finance Company and from its current significant volume of business with these agencies (approximately $500 mm annually). Additionally, Berkshire has a stable of 40 other lenders with whom it works regularly.

Q: How has the new environment impacted the pricing of Berkshire's leverage?

Berkshire has always included increasing spreads in its underwriting models, so the current increasing cost of leverage will have less impact on its business. Spreads have widened approximately 60 basis points from 100 - 105 bps to 155 -165 bps. However, the 7 and 10 year Treasury rates have fallen, negating most of the widened spread on an absolute basis.

Berkshire believes that the increased pricing will eliminate some of its competition for acquisitions due to higher credit standards and the reduced number of financing sources. Specifically highly leveraged buyers, who are often regional buyers looking to finance 80 to 90% of their transactions, are not as competitive in this environment as many of the structures they use (such as second mortgages) now have more stringent terms and covenants.

Q: Would one expect to find opportunities in an increasingly distressed environment?

Berkshire has throughout its history taken advantage of distressed opportunities when available, and about four years ago formally established an acquisitions team focused solely on distressed opportunities on a national scale. Berkshire has proprietary systems that track national loan delinquencies on properties as they move from 30 to 45 to 60 days. Over the last few years, there has been less deal flow from this source than Berkshire would have predicted as loosening credit has alleviated troubled deals. However, Berkshire expects the tightening credit environment will lead to more distressed borrowers who can not find replacement debt making this an attractive source of acquisition opportunities in the future.

Q: How has the financial environment impacted cap rates for multifamily assets?

Cap rates for all property types have been at all time lows for several years. Cap rates for multifamily value-add properties range between 4.5% and 6% versus 4% to 5% for core multifamily assets. Berkshire is expecting multifamily cap rates to rise in the future but not as much as commercial cap rates. This rise has already been fully priced in our acquisition underwriting.

Q: How has the change in the credit environment impacted condo conversions?

High density condo conversions have slowed dramatically. The sale of condominiums has decreased in virtually all previously active markets.

Q: How has the current environment impacted multifamily owners' ability to exit?

Berkshire sells to a broad base of buyers including local and regional property owners as well as value-add investors and REITs. Although the tightening credit market might limit this universe by hampering the leveraged buyers, there remains a substantial group of value-add players and REITs that are attracted to the income profile of Berkshire's assets once they have successfully undergone rehabilitation and conversion to stabilized properties at higher rent levels. Also, despite tighter credit, leveraged buyers for core assets are more able to secure financing for a property after Berkshire has stabilized the property's cash flows.

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