

MULTIFAMILY INVESTMENT



Anatomy of a Deal

A Marin County apartment complex weathers the downturn.

By Joe Gillach

A comedian once said that love has the power to make you believe what you would normally treat with the deepest suspicion. Unfortunately, as we are all learning again today, even professional real estate investors and seasoned lenders can fall prey to a property's charms or a compelling story and fail to perform the due diligence that should distinguish a profitable from a money-losing venture. My firm has invested in commercial real estate since 2001, primarily buying multi-family communities ranging from 100 units to 500 units. Roughly a year ago, we bought Sherwood Oaks, an 84-unit apartment complex in Fairfax, twenty miles northwest of San Francisco, in conjunction with San Francisco-based Westbridge Properties. We paid \$170,000 a door.

Though we, along with nearly everyone else, failed to anticipate the precipitous decline in the U.S. economy, much to our relief, our relatively conservative, unflashy investment formula has held us in good stead. Here is the story of how we got to where we are today, and where we expect to be going.

Sherwood Oaks epitomizes several of our investment rules: Look for lemons that can be turned into lemonade; Make your money on the real estate, not the financing; Buy at a significant discount to replacement cost; Forget about glitz and invest in markets where jobs are plentiful, employers strong and not much competition is getting built.

Typically, we target B or B- properties that might be called apartments for the perpetual renter. We accept B or B+ locations and seek properties that require value-add improvements. We have found that landlords suffer too much attrition to home ownership with A-class assets and that C-

class properties are too risky and management-intensive. We especially like properties that require cosmetic improvements because they often offer the best return on investment. Conversely, we shun properties with bad foundations or functionally outdated architectural details such as flat roofs in wet climates.

Sherwood Oaks is a dated complex that sits in the heart of affluent Marin County. With about 7,000 residents, Fairfax is primarily a residential village with a broad mix of people at all points on the socioeconomic spectrum, including a visible contingent of former hippies. Despite the Bohemian backdrop, Fairfax, like most of Marin, suffers from exceptionally high home prices. The town's median home value shortly before we made the purchase was \$779,000. The high prices preclude even people with solid employment from homeownership.

Ironically, Fairfax also suffers from a limited pool of rental apartments. Significant land constraints, high construction costs and vociferous anti-development forces have deterred the construction of large multifamily communities over the last 25 years. Despite the challenging housing market, Marin is one of the most sought-after places to live and work in the Bay Area. The county has sizable employers, including Fair Isaac Corp., Lucasfilm Ltd., BioMarin Pharmaceutical Inc., Sonic Solutions and AutoDesk Inc. It is within easy commute of job-rich San Francisco, Berkeley and Oakland and is a beautiful setting. As a result, the county's average apartment occupancy rate has held steady from 92 percent to 97 percent for many years. Yet, at the time of our purchase, Sherwood Oaks was 55 percent occupied because of significant deferred cosmetic maintenance and noncom-



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petitive leasing practices that we believed were easy to fix.

The property came to us as an off-market transaction. As nearly everyone in real estate understands, off-market investments are typically difficult to find and often a function of personal relationships. The reward for these efforts is an occasional opportunity to purchase a property at a compelling valuation. Our analysis showed that our purchase price was approximately 20 percent below market, and we believed replacement costs for comparable units would likely approach \$300,000 a door. Purchasing a property at a price far below the cost to replicate is a key metric for us as it allows us to undercut our competition based on a lower cost basis than newer competitors whose higher land and construction expenses obligate them to charge elevated rents.

Sherwood Oaks also cleared our financial stress-test hurdles. On paper, most real estate investments can be made to look compelling with optimistic going-in

assumptions about interest rates, employment growth and other factors—a lesson that many in the real estate and banking communities are learning painfully today. In practice, it is far more prudent to plan for future rainy days than bet on uninterrupted sunshine.

In our underwriting, we assumed that the exit market capitalization rate would be higher in five years. We also tested our assumptions regarding future rent growth, vacancy and changes in operating expenses to ensure the property would remain profitable or break even in a significantly worse market with lower rental rates and increased vacancy than the one that existed at the time of our purchase. Lastly, we locked in a fixed-rate, five-year amortizing note and borrowed only 70 percent of the property's value. These decisions, along with a conservative \$15,000-a-unit rehab budget, turned out to be good ones, particularly as the economy and rents softened at the end of 2008 and our ability to raise rents as

much as we had hoped fell away.

Finally, we've also found that a significant part of the profit in a real estate investment is determined by the talents of the team flying the plane—the onsite property manager. One of the glaring deficiencies at Sherwood Oaks was the historic leasing practice that required a potential tenant to produce two years of income tax returns as well as restrictive operating hours for potential new tenants to tour the property. Under our ownership, we moved to industry-standard leasing and credit requirements. The property is now open seven days a week, including evening hours.

Today, leasing activity has increased fourfold. Occupancy has risen to 92 percent and continues to nudge up each week. We are achieving our target net rents and, most importantly, we are 10 percent ahead of our original financial pro forma.

Our conservative underwriting and the flexibility of our value-add program have thus far allowed us to weather the current storm. No matter how optimistic you may feel about the future, when investing in real estate, you have to discount the compelling story and charm and follow the path of due diligence and discipline to ensure profitable returns. That is the only way to insure that money will be spent wisely and returns can be generated even when the market goes through a shock. ■

Joe Gillach can be reached at 415.435.8055 ext. 302 or joe@ratelinvestments.com.



Opposite page:

Small cosmetic changes such as new siding make a big difference.

This page:

A contemporary palette combined with new balconies brings this apartment building into the 21st century.

