



Federated with BOMA International and the National Apartment Association



# APARTMENT VALUES AND CAP RATES:

## A Tale of Two Quarters

“The sense of a ball falling off a table, which is what the economy has felt like since the middle of last fall...”

That's how Lawrence Summers, former Treasury Secretary and now Director of President Obama's National Economic Council, speaking on April 9 to the Economic Club of Washington, D.C., described the dawn of the most extraordinary period of financial upheaval in the lifetimes of most Americans. For anyone involved in commercial real estate, Summers' words could not have rung more true—the velocity of the fall in the last two quarters of 2008 was palpable. What would not be known, until the data were in, was the historic nature of the free-fall.

### The Evidence

In its recently issued Spring 2009 Report, the authoritative Real Estate Research Corporation (RERC) summed up the evidence of what occurred in late 2008: “Declining prices and values have accelerated during this recession much more rapidly than that seen during the 1990s real estate crisis. In the current recession, real estate prices have dropped 20 to 25 percent on a free and clear basis in just a

couple of quarters. Compare this to the price declines in the 1990s, when prices declined 30 to 35 percent over 5 years...<sup>1</sup> Underscoring the point, RERC noted that the National Council of Real Estate Fiduciaries' (NCREIF) Property Index "reflected a capital loss of -9.54 percent in fourth quarter 2008, which significantly outpaced the largest capital loss recorded in NCREIF's history."<sup>2</sup>

Recently released data on commercial mortgage lending by the life insurance industry has provided additional evidence of the precipitous nature of the market's fall. In its February 2009 Investment Bulletin, the American Council of Life Insurers (ACLI) reports that such lending decreased 42.9 percent in the fourth quarter of 2008. Compared to the third and fourth quarters of 2007, total commitments had decreased 38.8 percent and 65.6 percent, respectively.<sup>3</sup>

### Finding Value in Unprecedented Times

While the reactions to a market decline are familiar, they make the task of determining values that much more difficult when the decline has assumed historic proportions. The retreat of capital invariably makes sales more difficult, thus making relevant comparables harder to find (in its' January 2009 Washington D.C. Apartment Report, Cushman & Wakefield reported that "Most of the sales took place in the first half of 2008, as activity in the third and fourth quarter fell off dramatically as investors were bombarded with a steady stream of bad news").<sup>4</sup> Fannie and Freddie guidelines, never previously considered volatile, become moving targets that change weekly—but each

time becoming more conservative, a signal with an immediate ripple effect on those lenders remaining. And buyers, especially those who may be seeing declines in actual income streams, have lower expectations, and so become more aggressive in discounting the NOIs they are capping.

How then, to ascertain the elements of value—capitalization rates, in particular—in such an environment? No matter the jurisdiction, it's hard to argue with the approach embraced in a 2005 decision by D.C. Superior Court Judge Jose M. Lopez. Quoting an earlier D.C. Court of Appeals holding that "the determination of an appropriate capitalization rate for a particular property is a fact-specific determination not susceptible to a singular definition," Judge Lopez went on to say, in regard to the case before him: "[Property owner's] expert developed his capitalization rate by reference to the actual market. Particularly persuasive... is [his] use of actual market data. That is, not only did [he] consult accepted industry publications in determining a capitalization rate, but he also consulted actual investors in the District of Columbia market to understand what rates investors were using as capitalization rates at the time of value."<sup>5</sup>

### The DC Metro Experience

With the words of Judge Lopez in mind, AOBA thought it would be useful to survey major commercial brokers who are active in multifamily transactions, i.e., firms that worked with real-world buyers and sellers in our region last year, to find out 1) what "going in" capitalization rate(s) it was taking to actually get a deal done, and 2) what kinds of changes they saw

in those rates from January 1, 2008 to January 1, 2009. Information was collected on eleven different submarkets in the metro-D.C. area, for both Class A Luxury Apartments and for Class B Apartments, in hopes of identifying a tighter range than the spreads that are often reported in regional and national market analyses. We also hoped to better capture the effects of jurisdiction-specific variations, such as D.C.'s rent control and tenant right to purchase laws, or land use and impact fee programs seen in some jurisdictions, that affect value.

### Tale of the Tape

One glance makes it immediately apparent that the AOBA survey bears out—and then some—what the national firms have reported about cap rates in the period. CB Richard Ellis, in the Washington DC Market Highlights section of its 2009 Capital Markets Multihousing Report, wrote that "Over the past year, capitalization rates have increased approximately 125 basis points (pro forma) and up to 300 basis points (in-place).<sup>6</sup> In its Winter 2009 Report, RERC reported that "required going-in capitalization rates further increased for all property types during fourth quarter 2008 [nationally, to 6.7% for apartments], indicating investors have decreased the amount they are willing to pay."<sup>7</sup> In its January 2009 Washington DC Apartment Report, Cushman & Wakefield wrote that "Cap rate requirements for Class A and B assets have increased 100 basis points or more, depending on age and location, with investors seeking 6.5% to 7% returns on trailing NOI."<sup>8</sup>

Those observations and others may actually have been somewhat shy of

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## DC METRO AREA CAP RATE BROKER SURVEY BY JURISDICTION: Comparing 1/1/08 to 1/1/09

CLASS A LUXURY APARTMENTS							
1/1/2008				1/1/2009			
JURISDICTION	Class A - New or Newer Stabilized; Rents at Market Going-In Cap Rate as of 1/1/08			MEAN BASIS POINT INCR.	Class A - New or Newer Stabilized; Rents at Market Going-In Cap Rate as of 1/1/09		
	MEAN	MEDIAN	RANGE		MEAN	MEDIAN	RANGE
<b>NW DC</b>	5.2%	5.0%	4.8% to 5.9%	<b>140</b>	6.6%	6.6%	6.3% to 7.3%
<b>Virginia</b>							
Arlington County	5.3%	5.3%	4.8% to 6.1%	<b>140</b>	6.7%	6.6%	6.3% to 7.3%
City of Alexandria	5.3%	5.3%	4.8% to 6.0%	<b>150</b>	6.8%	6.8%	6.3% to 7.3%
Fairfax County	5.5%	5.4%	4.8% to 6.2%	<b>140</b>	6.9%	7.0%	6.3% to 7.3%
Loudoun County	5.8%	5.8%	5.0% to 6.5%	<b>130</b>	7.1%	7.0%	6.5% to 7.8%
Prince William County	6.0%	5.9%	5.0% to 6.9%	<b>140</b>	7.4%	7.6%	6.5% to 8.3%
<b>Maryland</b>							
Montgomery County	5.4%	5.4%	4.8% to 6.2%	<b>140</b>	6.8%	6.7%	6.5% to 7.3%
Prince George's County	5.9%	5.9%	5.3% to 6.7%	<b>130</b>	7.2%	7.1%	6.8% to 7.8%
Charles County	6.0%	5.8%	5.5% to 6.8%	<b>150</b>	7.5%	7.4%	7.0% to 8.0%
Howard County	5.7%	5.8%	5.0% to 6.3%	<b>140</b>	7.1%	7.2%	6.7% to 7.5%
Anne Arundel County	5.8%	5.8%	5.3% to 6.3%	<b>140</b>	7.2%	7.3%	6.7% to 7.5%

CLASS B APARTMENTS							
1/1/2008				1/1/2009			
JURISDICTION	Class B Stabilized; Rents at Market Going-In Cap Rate as of 1/1/08			MEAN BASIS POINT INCR.	Class B Stabilized; Rents at Market Going-In Cap Rate as of 1/1/09		
	MEAN	MEDIAN	RANGE		MEAN	MEDIAN	RANGE
<b>NW DC</b>	5.8%	5.9%	5.3% to 6.5%	<b>130</b>	7.1%	7.1%	6.8% to 7.5%
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Fairfax County	5.9%	5.9%	5.3% to 6.6%	<b>130</b>	7.2%	7.4%	6.8% to 7.8%
Loudoun County	6.2%	6.1%	5.7% to 6.9%	<b>120</b>	7.4%	7.5%	7.0% to 8.0%
Prince William County	6.3%	6.3%	5.7% to 7.2%	<b>130</b>	7.6%	7.6%	7.0% to 8.0%
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Anne Arundel County	6.0%	6.1%	5.4% to 6.4%	<b>140</b>	7.4%	7.4%	7.0% to 7.8%

the mark: the AOBA survey confirms that cap rates in the region did, in fact, rise dramatically in 2008—but by at least 140 basis points, in almost every instance. The sharp increases occurred in every jurisdiction reported on, and for both Class A and Class B properties in every jurisdiction.

The survey offers, in sharp relief, one significant measure of how 2008 was, indeed, an extraordinary year. Not surprisingly, valuations of many multifamily properties may not yet reflect just how extraordinary a year it was.

Regrettably, it is also evident that the cap rate upturn in 2008 was not an aberration, but rather was the start of a longer market trend. RERC's Spring 2009 Report advises that "[F]irst quarter 2009 results indicate that the draconian outlook for commercial real estate continues. In fact... the last two quarters reflect the worst quarters ever experienced in NCREIF's reporting history, which dates back to 1978... The required going-in capitalization rate increased by 60 basis points, while the terminal capitalization rate increased by 50 basis points during first quarter 2009."<sup>9</sup>

The painful, but pragmatic reality is that limited access to financing will likely result in cap rates staying up for the foreseeable future; loan-to-value ratios are now typically lower (banks require the buyer to put down more cash), and equity returns are clearly higher than the interest rate to the debt. Since the higher cost of capital must be reflected in higher cap rates, the resulting depressing effect on property values should probably be expected for the next couple of years.

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<sup>1</sup> Real Estate Research Corporation, Spring 2009 Report, April 2009, p. 4

<sup>2</sup> Ibid., p.12

<sup>3</sup> American Council of Life Insurers, Investment Bulletin No. IB09-001, February 9, 2009, p. 1

<sup>4</sup> Cushman & Wakefield, VIEWPOINT – Washington DC Apartment Report, January 2009, p. 4

<sup>5</sup> Square 345 Limited Partnership v. District of Columbia, Superior Court of D.C. Tax Division, March 25, 2005, pp. 37, 43

<sup>6</sup> CB Richard Ellis, Capital Markets Multi-Housing 2009 Annual Market Report, p. 51

<sup>7</sup> Real Estate Research Corporation, Winter 2009 Report, January 2009, p. 11

<sup>8</sup> Cushman & Wakefield, VIEWPOINT – Washington DC Apartment Report, January 2009, p. 4

<sup>9</sup> Real Estate Research Corporation, Spring 2009 Report, April 2009, pp. 12, 20