Inner Loop West
Multifamily Investment Brokers
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Opening Remarks

The month of February had an exciting start as the City of Houston hosted an unforgettable Super Bowl. Hats off to everyone involved who put their heart and soul into preparing the city as thousands of people flocked in to witness one of the greatest comebacks of all time! The praise Houston received throughout the two weeks leading up to Super Bowl Sunday says a lot about the promising future we have to look forward to. Our officials and represntatives are more committed than ever to ensure Houston remains a prominent global force that is able to compete with any major city across the country, from both a business and desirability standpoint.

Last month we addressed the state of the market and looked at several economic indicators that influence real estate on a local and national scale. As we approach the tail end of Q1, rising interest rates continues to surface as a hot topic and potential impediment for real estate investors. February's News to Use edition will focus on uncertainty surrounding the debt market and the impact higher interest rates could have on Houston multifamily property values. We'll also take a look at different renovation options that have the highest ROI and how you can determine whether a renovation is justified or not.

Thanks again to everyone who shared their feedback last month. We were thrilled to see all of your responses and hope to continue our pursuit in providing valuable insights to Houston apartment owners! Please keep the feedback and suggestions coming as it will help us cover topics in future publications that align with your interests.

From the Founder, Brian Janak

Lending drives investment real estate. Low rates are there for the taking now and, on a grand national scale, the expectation is that higher interest rates are pending as our economy is changing. Post our national election, the potential for confidence exercised by the Fed to raise rates is widely predicted.

For Houston, fundamentals are trending back to normalization after rising rents and strong job growth since 2010. The winter months are behind us - expect an increase in leasing activity as seasonal trends morph into Spring & Summer months. Flat rents, concessions and oversupply of new development in need of absorption is evident in Houston multifamily over the last year. With that said, multifamily is still the darling of the asset classes due to the short-term leases in a changing economy. Use the short-term leases to your advantage - try a 6 month lease instead of a 12 month commitment. This will give you the ability to revisit rental rate trends around summer time and, if the market is stronger, allow you to capture more rent.

Capital Markets Update

CAPITAL MARKETS	JAN 2017	FEB 2017	CHANGE
10-Yr Treasury (%)	2.47	2.42	-2.02%
30-Yr FRM (%)	4.20	4.16	-0.95%
Fed Funds Rate (%)	0.75	0.75	N/A

FRM = Fixed Rate Mortgage
**Freddie Mac surveys lenders each week on the rates, fees & points for the most popular loan products. The figures above excludes any additional points or fees.*
Sources: U.S. Department of the Treasury and Freddie Mac

Changes are starting to take place at the national and local level as politicians settle in and begin to deliver on their campaign promises. The Federal Reserve, as of last week, indicated once again that we could see multiple interest rate hikes in 2017, and the fed funds target rate could reach 3% (currently at 0.75%) by end of 2019.

The 10-Yr Treasury yield continued to fluctuate throughout the month of February, peaking at 2.51% and bottoming out at 2.34%. Volatility in the debt market is in large part due to the uncertainty linked to a new administration taking office and speculation surrounding the FOMC's ambitious projections. The 30-Yr FRM has been running parallel with the 10-Yr Treasury, trending downward as of mid - February.

The fed funds rate remained constant at 0.75% but, according to Janet Yellen, another increase is on the discussion table for their next meeting on March 14-15. Strong growth in retail sales, low unemployment and steady inflation are the main economic indicators driving the Fed's decision to bump rates in the near term. Yellen has made it very clear that all monetary policy decisions will strictly be objective-based, not speculative. Monitoring these key economic indicators over the next few months should offer valuable insight into which direction the Fed's will go [and at what pace] during their next meetings in March and June.

Rising Rates Impact on CRE

Houston multifamily had an unprecedented run from 2010 to 2014 until the bottom fell out on oil prices. Aggressive rental rate growth came to a halt and higher occupancy rates followed suit as thousands of units were delivered to the market. As Houston continues on the road to recovery, we're now facing a volatile interest rate climate that could have a huge impact on near-term acquisitions and refinancing decisions. The 10-Yr Treasury rate increased more than 65 basis points between the election and Christmas as investors reacted to the prospect for more robust domestic output during a Trump administration, the potential for reduced oil output and more aggressive monetary policy by the Federal Reserve.

Since the 10-Year government bond is the benchmark used in the commercial real estate market for pricing debt and equity, it stands to reason that the cost of owning properties will rise and lead to an increase in yields (otherwise known as cap rates in the commercial real estate world). Cap rates are calculated by dividing a property's net operating income (NOI) by the sales price, therefore an increase in cap rates would reduce the value of individual assets. However, pricing real estate is not that simple. Values are derived from a combination of income, expenses (including debt service), investor sentiment and the return buyers are willing to accept given the level of risk.

We're seeing an abundance of buyers that are bullish on Houston right now - investors are willing to pay up for properties [without a yield adjustment] in anticipation of rent growth. Houston continues to show signs of recovery from a market that's been bruised up by sliding energy prices over the past couple years. Even if rising rates leads investors to demand higher yields, lack of class B & C supply inside the loop coupled with continued population growth and positive buyer sentiment should minimize the effect on property values.

Capital Markets vs. Fundamentals

Today's market provides a great lesson in the relationship between property fundamentals and capital markets in determining price appreciation. Capital markets forces (interest rates & investor demand) appear to be a negative drag on prices while fundamentals continue to improve. Yardi Matrix did a study of how the values of different properties would be affected by increases in debt costs and rental income. The study assumes the cost of debt would rise the same amount as interest rates. Continue to the top of page 3 to view the chart:

Change in Value For Class B Multifamily Property (%)

	Revenue Growth				
Interest Rates change	0%	3%	4%	5%	6%
0 bps (Initial estimate)	0.0%	4.2%	6.5%	8.7%	11.0%
50 bps	-5.8%	-1.8%	0.3%	2.4%	4.5%
75 bps	-8.6%	-4.7%	-2.6%	-0.6%	1.5%
100 bps	-11.2%	-7.4%	-5.4%	-3.4%	-1.4%
125 bps	-13.7%	-10.0%	-8.1%	-6.1%	-4.2%

When we maintained the same loan-to-cost and debt service ratio with no change in revenue or expenses, a 50-basis point increase in interest rates produced a 35-basis point increase in the cap rate, which translates into a 5.8% drop in valuation. If debt costs rose 100-basis points, the decline in valuation increased to 11.2%. Keep in mind during this first example that we're assuming all revenue & expenses remained constant.

However, the results wre different when we added rental rate growth into the mix. We identified that moderate levels of rent growth are enough to overcome low levels of interest rate gains, and strong revenue growth of 6% would be sufficient to make up for rate increases of 50-basis points. It should be emphasized that there are many variables that can change the results for individual properties. Running data models and statistical analyses can offer good perspective but it can't predict market sentiment, a significant component in transaction values (which is evident in Houston right now).

Rehab ROI

A few weeks ago I took the time to run a statistical analysis of my own. With class A rents maxed out, I wanted to know the spread between class A, B and C multifamily rents in a particular submarket. The results were enlightening and validated why many investors are starving for class C value-add deals. In The Heights area alone, we found a 25% spread between class B and C 1 bedroom rents. For 2 bedroom units, the spread was even higher at 34%. The spread was roughly 15% between class A and B product for both 1 and 2 bedroom units. What's the significance of these numbers? It shows the huge margin for rental rate growth in one of the most desirable asset classes in Houston. Many of these class C properties offer investors the ability to push rents 20-30% without having to inject substantial capital improvement dollars into the property.

Demand for value-add deals inside the loop should continue throughout 2017, so we'll discuss a few improvements you can make that have the biggest ROI and impact on tenant attraction.

1) <u>Curb Appeal</u> - As the old saying goes, you only get one shot to make a first impression. The exterior of your property is the first thing a tenant sees when they drive by. Here are a few things to focus on that could make or break a tenant's decision to move forward with your property - Manicured grass and landscaping, secured gates/access, ample lighting, visible signage, and a pristine paint job. You could have some of the nicest units in town, but the importance of a presentable exterior should not be underestimated.

2) <u>Flooring</u> - Many owners report that replacing carpet with vinyl, tile or wood flooring offers the greatest return on their investment, not to mention these surfaces are typically more durable and easier to maintain (especially if you're an owner that allows pets!).

3) <u>Kitchen & Bathrooms</u> - Regardless of your tenant profile, everyone spends a decent amount of time in these 2 areas of their unit. Your appliance package and choice of countertops are prominent upgrades that can have an immediate impact on rent growth. Stainless steel appliances and granite countertops are the most desirable finishes from a tenant standpoint but also the most expensive for owners to install. Find a balance between your desired tenant's expectations and the amount you'll be able to increase rents. If you plan to renovate multiple units at a time, check with your vendor or contractor to see if bulk discounts are available.

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