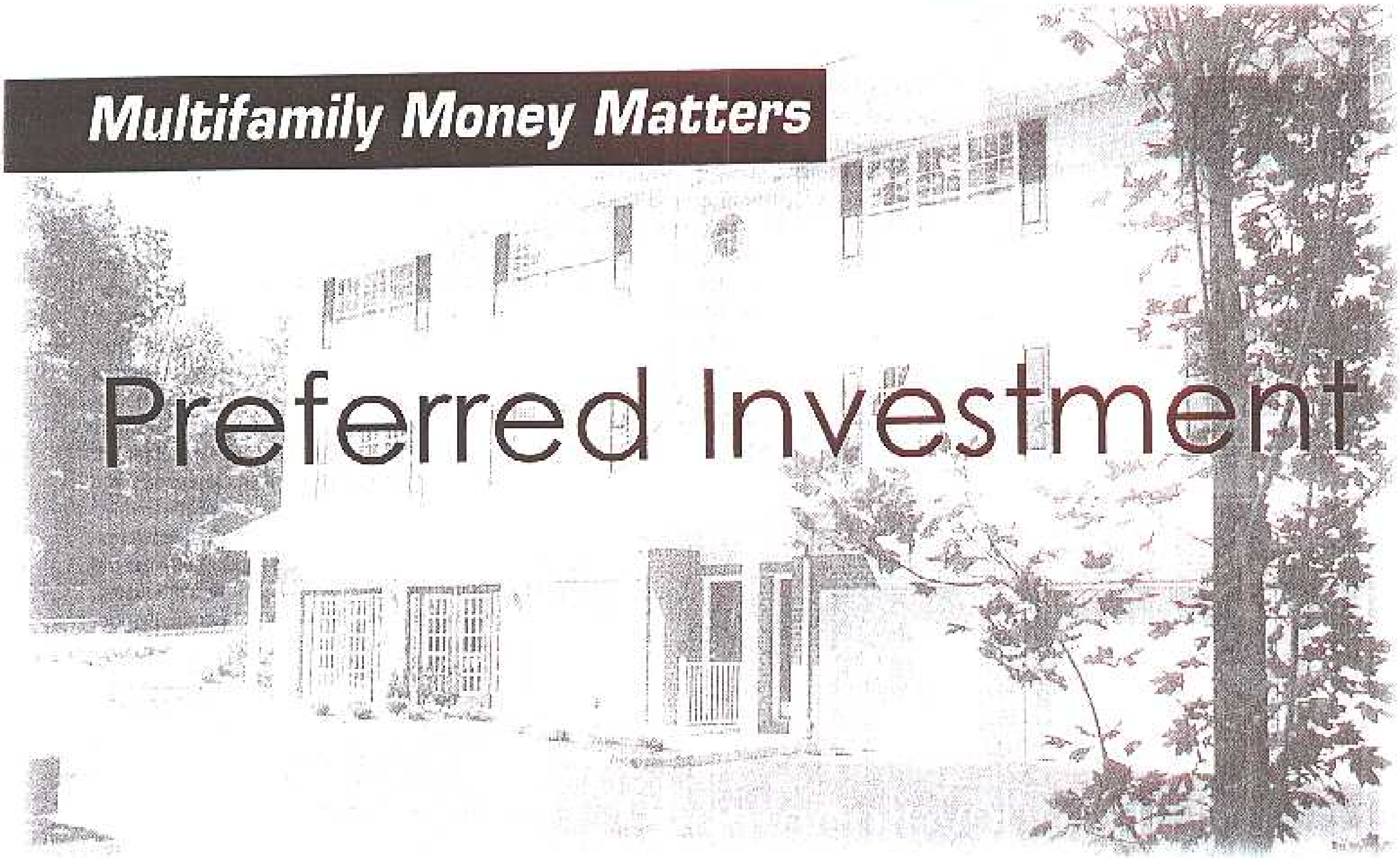


Preferred Investment

By Dora Johnson
Contributing Editor

NEW JERSEY'S MULTIFAMILY SECTOR CONTINUES TO BE THE PREFERRED INVESTMENT among capital sources. Most lenders and investors agree that it's the most sought after property type in the state right now. "It's a very attractive investment," says Martin T. Klebanoff, senior vice president and managing director of the Northern New Jersey office of Northmarq Capital Inc., Parsippany. "When something comes on the market, it goes quick."

"Multifamily is the way to go," emphatically adds Erik A. Kaiser, principal and founder of the Hoboken-based REMI Cos. Over the past 12 years, his firm has bought or built condominiums and apartment buildings in the New York area and Miami. Two years ago, Kaiser launched a new mortgage company, focusing on the conversion of the Hispanic market to homeownership.

Most lenders and investors agree that multifamily residential is the most sought-after property type in the state.

What's fueling this interest? Kaiser points to several variables. "First, it's the suburban sprawl issue and the exclusionary zoning that's been taking place in the suburbs. It's putting a squeeze on development. As a result, developers are starting to look at the urban centers, making them much more popular. There's been a lot of revitalization, especially in Hudson County and Asbury Park, and other places.

"Second, because the state is so densely populated, demand has outstripped the supply needed as we go forward," he continues. Finally, "multifamily cap rates have sunk, and many non-

"So many people are out there wanting to invest in multifamily that the spreads are getting narrower and narrower."

GLENN MILLER
Spencer Savings Bank

real estate professionals have gone into the market as an alternative to keeping their money in the bank.

A lot of newcomers to the market have turned to real estate in general because the alternative is the stock market, observes Michael Simon, president of the Linden-based Simon Holdings Inc.

"Investors who are buying apartments are enticed by the higher returns," Simon points out. "Unfortunately, you're going to see over the next few years a lot of the people who bought apartments at low cap rates, realizing that they are not earning what they thought. They're not always made aware of the true or hidden costs of managing a property. It's a matter of experience."

Most financial experts agree that real estate has been considered a relatively safe bet for investors who've been disappointed with traditional investments. In fact, apartment assets are considered to be better income producers than any other type of commercial space, according to Simon. His privately held company's properties run with less than 5% vacancies and he has a waiting list for most of its buildings. The firm owns and manages roughly 500 apartments in seven buildings in New Jersey and Pennsylvania.

"Consider a 40-year-old apartment complex that's well-maintained vs. a 40-year-old office building which is now antiquated, class C space," he says. "Consequently, creating a state-of-the-art apartment building is relatively inexpensive compared with renovating office space."

A great deal of money is chasing a finite amount of deals, creating a highly competitive race to place capital. Jon Mikula, senior managing director of Holliday Fenoglio Fowler, Edison, says, "It's well-known that multifamily is the property type that debt and equity wants to put their money in. Historically, occupancy rates are north of 95% in the worst of times. In certain pockets, such as along the waterfront, the luxury market has taken a little bit of a hit. Effective rents are down, but overall, any capital source in the country knows New Jersey is one of the best multifamily markets."

As a result, significant investment capital continues to be directed to the multifamily sector. Current financing conditions for commercial lending are ideal. Simon asserts that, "right now is a terrific time to be financing anything."

The properties that have minimal risk, such as fully leased buildings with a strong rent roll and little lease rollover, are in demand.

"Apartments, in general, are the easiest assets to finance," according to Simon, although he admits that "things are overvalued right now."

"You can borrow in the sub-5% range," explains Spencer Garfield, managing director of Hudson Realty Capital, based in Manhattan, with offices in Hackensack. He adds that, "There is some stability to the residential market that other assets don't have. Combined with low interest rates, that makes it an attractive investment."

From a performance standpoint, Garfield sees a sluggish rental market but a very strong condominium market.

"We see residential properties not performing as well as they had in the past," he says. "Occupancy rates are up, rental rates are flat, in some cases with concessions. We see absorption of new product slower than historically."

HRC is the manager to two funds—Hudson Debt Fund I, which does high-yield first mortgages and mezzanine financing, and Hudson Opportunity Fund I, which does preferred and true equity transactions.

"More often than not we're being approached with opportunities to provide mezzanine financing or preferred equity to purchasers who are assuming securitized debt financing, and a debt structure that brings them up the capital stack," he says. "We'll also provide bridge loans to borrowers with credit issues or time constraints."

Borrowers can chose from a multitude of capital sources, and "lenders' goals are greater this year than they were last year," notes Glenn Miller, vice president and director of commercial real estate for Spencer Savings Bank, Elmwood Park. Like many lenders who are jostling for deals in the current market, Spencer Savings has experienced strong activity. Miller's firm is a first-lien lender looking to do $100 million in commercial real estate

"Stability in the residential market, combined with low interest rates, make it an attractive investment."

SPENCER GARFIELD
Hudson Realty Capital

lending in the state this year, with roughly half in multifamily.

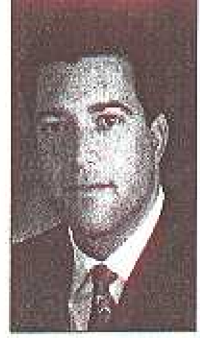
And lenders' appetites are increasing in a market where the competition is unprecedented.

"Lenders are still needing to put money on the street, and multifamily is the number one sought-after property type," Miller says. Because of the unusual competition, "the big problem now is that interest rates are so low. So many people are out there wanting to invest in multifamily that the spreads are getting narrower and narrower."

The spread on multifamily loans—the gap between what lenders charge and the rates on Treasury securities maturing over the same period—are at historically low levels. In the last 14 months, Spencer Savings has closed on a total of 20 multifamily deals, amounting to $38 million worth of transactions.

"It's definitely a borrower's market, and like the competition, we're trying to put more money out there," Miller says. "The biggest and hardest thing that we're encountering are purchases at such low cap rates. Cap rates make it difficult for us to lend at the levels that borrowers want."

"There's a tremendous amount of capital available on the street," says Kaiser, "and there are a lot of different capital sources right now—the banks, mezzanine funds, pension funds, opportunity funds. As a result, these capital sources are competing with one



"You'll see some people who bought apartments o[n] low cap rates realizing that they are not earning what they thought.

MICHAEL SIMON
Simon Holdings Inc.

another, and that has brought down their interest rate charges.

"Basically they're competing on rate," he continues. "Financing opportunities for projects in the $30 to $50 million range are even greater because you can get traditional financing and there is a lot of mezzanine financing.

"As a result," Kaiser says, "you see very few of these transactions getting done without a mezz slice. The mezz players are less onerous with their terms and conditions. They're still stringent, but there is so much competition."

Mezz financing has become much more competitive in the process, and borrowers are benefiting because of it. Hundreds of new mezzanine lending programs have been launched in the past couple of years, and they are deluging the market.

Kaiser adds that, "The mezzanine market has gotten very, very sophisticated, and there are a lot of different products out there right now."

At the same time, Fannie Mae and Freddie Mac have also been active.

"They controlled two-thirds of all the financing that was done last year, and we have seen other lenders trying desperately to cut into that market share," Mikula says. "What they're doing to cut into that share is offering flexibility and competing on the pricing of loans.

"In certain areas, effective rents are down, but any capital source knows this is still one of the best multifamily markets."

JON MIKULA
Holliday Fenoglio Fowler

"We've seen a lot of unique structures to beat the agencies," Mikula adds.

Looking ahead, Klebanoff believes multifamily product will remain a favored investment, but "the concern is the economy. There is some softness in North Jersey's rental markets.

"But that's relative," he points out, "because softness in New Jersey may be 94%, and that's why the tri-state area is a favored market."

According to Garfield, "You can buy a multifamily asset at a 6-1/2% cap and leverage the return to 11% or 12% with relatively strong stability, little downside, and some good upside. Add it to the inflation hedge, as interest rates go up, it makes less sense for people to purchase a condo or single-family home, and that pushes rental rates and occupancies up."

While the market fundamentals for real estate in general are relatively negative, especially in the office sector, multifamily is positive, says Mikula. But change may not be too far down the road, he cautions.

"Interest rates can't stay this low, and that directly impacts cap rates. So cap rates can't stay this low," he says.

"The only thing that is going to change, in my mind, is where the Treasury is going to be," Mikula says. "Right now, we're at a 40-year low. Also, we're in an election year and generally, REITs will stay low through the year.

"But next year, I'd put my money on it that the Treasury is not going to have a free handle on the 10-year Treasury," he concludes. "As a result, cap rates are going to go up. But New Jersey is going to continue to be a solid multifamily market."

Indeed, that's likely to be the case as long as the population keeps growing, the aging housing stock isn't being replenished at a comparable rate and the state itself tries to rein in so-called "sprawl." —REN another, and that has brought down their interest rate charges.

"Basically they're competing on rate," he continues. "Financing opportunities for projects in the $30 to $50 million range are even greater because you can get traditional financing and there is a lot of mezzanine financing.

"As a result," Kaiser says, "you see very few of these transactions getting done without a mezz slice. The mezz players are less onerous with their terms and conditions. They're still stringent, but there is so much competition."

Mezz financing has become much more competitive in the process, and borrowers are benefiting because of it. Hundreds of new mezzanine lending programs have been launched in the past couple of years, and they are deluging the market.

Kaiser adds that, "The mezzanine market has gotten very, very sophisticated, and there are a lot of different products out there right now."

At the same time, Fannie Mae and Freddie Mac have also been active.

"They controlled two-thirds of all the financing that was done last year, and we have seen other lenders trying desperately to cut into that market share," Mikula says. "What they're doing to cut into that share is offering flexibility and competing on the pricing of loans.

"In certain areas, effective rents are down, but any capital source knows this is still one of the best multifamily markets."

JON MIKULA
Holliday Fenoglio Fowler

"We've seen a lot of unique structures to beat the agencies," Mikula adds.

Looking ahead, Klebanoff believes multifamily product will remain a favored investment, but "the concern is the economy. There is some softness in North Jersey's rental markets.

"But that's relative," he points out, "because softness in New Jersey may be 94%, and that's why the tri-state area is a favored market."

According to Garfield, "You can buy a multifamily asset at a 6-1/2% cap and leverage the return to 11% or 12% with relatively strong stability, little downside, and some good upside. Add it to the inflation hedge, as interest rates go up, it makes less sense for people to purchase a condo or single-family home, and that pushes rental rates and occupancies up."

While the market fundamentals for real estate in general are relatively negative, especially in the office sector, multifamily is positive, says Mikula. But change may not be too far down the road, he cautions.

"Interest rates can't stay this low, and that directly impacts cap rates. So cap rates can't stay this low," he says.

"The only thing that is going to change, in my mind, is where the Treasury is going to be," Mikula says. "Right now, we're at a 40-year low. Also, we're in an election year and generally, REITs will stay low through the year.

"But next year, I'd put my money on it that the Treasury is not going to have a free handle on the 10-year Treasury," he concludes. "As a result, cap rates are going to go up. But New Jersey is going to continue to be a solid multifamily market."

Indeed, that's likely to be the case as long as the population keeps growing, the aging housing stock isn't being replenished at a comparable rate and the state itself tries to rein in so-called "sprawl." —REW