capital region

2010 Hudson Valley apartment market commentary: Consider selling now

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REITs remain sellers in the Hudson Valley market. Private investors, replacing REITs, are now the most active buyers, motivated by access to record low mortgage interest rates and the nonexistent return on their cash. Home properties previously sold the last of the properties in their portfolio in 2009. With few sales in the last year the second quarter 2010 sale of the class A 412 unit Avalon on the Sound in New Rochelle by REIT Avalon Bay for $107.5 million ($261,000 per unit) to buyers from New Jersey gives a good read on the current state of the apartment market here. Further details of the sale show a seller profit of $19.5 million and a reported un-leveraged IRR (internal rate of return) of 6.95% over the approximate ten year holding period.

The internal rate of return is based on all cash flows in and out of the property over the investment holding period including the net sale proceeds. Avalon Bay originally built the property in 2001. This is not a superior result as typical IRR hurdle rates for institutional investors start in the 15% range. A lower than expected IRR, which can only be calculated after the sale is complete, is evidence the exit cap rate was lower than planned. Personal individuals can accept a lower return as they don't incur the additional overhead carried by publicly listed companies and can have longer planned holding periods.

Rental rates have seen small change in this second year of the recession, even as rents have dropped sharply in other markets. Data from HUD shows the market rent for a two bedroom apartment in Westchester County to be $1,610 per month in 2009, little changed from $1,600 in 2007. Avalon Bay's Westchester portfolio averaged 97% occupancy with rents declining 3% in 2009 over 2008. Avalon Bay uses concessions such as a month's free rent on move in to keep the occupancy rate in its complexes above 95%. With average monthly rents of $1.96 per s/f, among the highest in the area, their focus is on the highest end of the market and its apartments are of the newest construction, most were built in the 2000s.

Investors unable to earn even a minimal return on cash are able to find initial starting cash on cash returns of up to ten percent taking advantage of the positive spread between current capitalization rates and mortgage rates; long term mortgage interest rates are at record low levels. In effect taking more risk to earn more return. Fannie Mae offers ten year mortgage loans in the mid five percent range. Unable to compete with these ten year prices banks are active in the five year market with rates at around five percent with defined prepayment amounts. Of course only Fannie Mae is offering non-recourse terms and banks are looking at "relationship lending;" they want borrowers to move all their ongoing business to the bank before offering them mortgages. Conduit lending has not returned.

Buyers have returned to the market, 2011 is looking better than 2010, and owners contemplating a sale in the near future should consider selling now as values will be pressured when mortgage interest rates inevitably rise from their now record low levels.

The uncertain tax and future regulatory environment still burdens the market. Sam Zell speaking at the Urban Land Institute's 2010 real estate summit stated that he must now consider political risk when investing in the U.S., a term usually associated with third world countries. Sale activity should remain subdued until the uncertainty associated with the consequences for business and investment resulting from the expansion of the public sector by the current administration is better understood. Buyers have returned to the market, 2011 is looking better than 2010, and owners contemplating a sale in the near future should consider selling now as values will be pressured when mortgage interest rates inevitably rise from their now record low levels.

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