Subprime Crisis:

A Mixed Blessing for Rental Market

BY DEBBIE SWANSON

The crisis in subprime mortgage lending has had a mixed effect on the apartment owner and developer. While rental properties across Massachusetts began seeing a higher rate of occupancy due to a slowdown of single-family home purchases, the overall concern over credit has caused a tightening of funds available to everyone, including the multifamily community owner.

The rental market has been seeing steady activity, fueled by individuals unable to secure home financing or those concerned about economical recession and future property values. Terry Scott, senior vice president at Apartment Realty Advisors – New England, has observed a steady rate of tenant demand in Massachusetts, observing that there are fewer vacancies now as compared to the same time last year.

No longer are concessions or incentives, such as TVs or a discounted month's rent, required to lure in tenants, Scott adds. "Concessions had been a phenomenon to attract renters for the last three to five years. These have diminished."

An increase in tenant demand is good for rental rates, which Scott observes have remained stable and expects the market to experience upward pressure in 2008. According to the fall 2007 Sunrise Multifamily Rental Market Report, Massachusetts rental rates have shown a healthy growth pattern.

"The credit market crisis is having a positive effect on the rental market," reports Paul Natalizio, president of Cornerstone Realty Consultants LLC, a Malden firm that specializes in multifamily finance. "Rising rents can help offset some of the more conservative underwriting being put in place by lenders today."

Rising rents can help offset the higher debt service coverage ratio put in place by tightened lending. Debt service coverage ratio is a measure of a property's ability to produce revenue sufficient to repay mortgage payments.

In Massachusetts, new construction, which had been keeping pace with increased demand, is beginning to slow down. Scott reports: "New products hit the market in many popular Massachusetts corridors in the last four years, keeping up with, and in some cases surpassing, demand. The delivery pipeline has slowed down to a trickle rather than a steady stream. This is good news for the rental property owner, [because] the slowdown in delivery will help keep occupancy up."

Lending

While an increase in the number of renters puts multifamily owners and developers in a favorable position, securing funding for projects comes at a greater challenge.

Many subprime lenders have left the market and remaining lenders are less aggressive. Banks have tougher lending requirements: all borrowers should expect higher required credit scores, stricter appraisals, higher down payments and an increased scrutiny in general.

"The principal effects of the credit market crisis on the average borrower will be that access to credit will be more difficult and that credit that is available will be more expensive. In addition, development loans will require significantly more equity and only the most experienced developers will be able to obtain these loans," Natalizio states.

"The silver lining for apartment owners is Fannie Mae and Freddie Mac are still providing attractive loans and terms to borrowers," Natalizio reports.

Fannie Mae and Freddie Mac – federally chartered companies that fund the majority of the nation's mortgages – reported strong volumes for multifamily financing for 2007. Fannie Mae reported multifamily purchases totaling $60 billion and Freddie Mac reported multifamily purchases at $44.7 billion, a 55 percent increase over 2006.

Spreads, which represent a measurement of risk on the lender's part for holding the loan, have increased sharply, even for Fannie Mae and Freddie Mac financing. Though wider spreads increase the cost of borrowing, attractive rates are still accessible.

"The apartment owner or developer is in a more favorable position than borrowers in other types of real estate – such as retail, office or industrial projects," reports Brian Sykes, vice president of production at Deutsche Bank Berkshire Mortgage. "Because Fannie Mae and Freddie Mac have remained a reliable funding option, liquidity has remained in the market for apartment owners."

Another option open to developers is bridge financing, Sykes reports. Bridge financing is short-term floating-

rate debt, typically used to finance a property that will be in transition. This is used when the current cash flow from a property is insufficient to meet the required debt service coverage ratios necessary to qualify for permanent financing. "The bridge loan provider hopes the project will successfully increase cash flow in a relatively short timeframe – within one to three years – and the property will qualify for permanent financing," Sykes says.

"The most typical use of bridge financing for the apartment owner is when the borrower acquires a property with below market rents, has a plan to upgrade the property and in turn, increase cash flow," he offers.

"The best multifamily deal right now for financing is one with an upside story: repositioning of a property with a plan to upgrade units and/or common areas, with a strategy to increase rents. Deals with a capital plan involving improvements equal to or in excess of $3,000 per unit, such as upgrades to kitchens, baths or common areas, typically get the most attractive financing at this point," Sykes says.

As with most current lending options, bridge financing remains available, yet "has become more expensive and, in general, more conservative than in the past," adds Sykes.

> **"Industry experts report that the market for affordable buildings remains stable."**

Anticipating Another Record

Industry experts report that the market for affordable buildings remains stable. Both Fannie Mae and Freddie Mac offer a variety of affordable initiatives and products targeting multifamily affordable properties. Freddie Mac defines affordable as meeting low income, which is at or below 80 percent of the area median income and very-low income, as at or below 60 percent of the area median income, and/or products for families living in underserved areas.

Fannie Mae specifies that 20 percent of all units must have restricted rents affordable to households earning no more than 50 percent of the area median income (AMI); or at least 40 percent of all units must have restricted rents affordable to households earning no more than 60 percent of AMI; or there is a compelling public purpose – namely continued affordability – which is furthered by the property.

MassHousing, a local agency that works with investors to finance affordable housing, is another source of financing for rental owners. Spokesman Tom Farmer states, "We'll work with developers who are willing to provide 20 [percent] to 25 percent of their units at rents affordable to lower-income tenants. We had a record lending year last year and plan to continue our mission to help provide affordable housing in Massachusetts."

With foreclosed properties being added to the market and a general slowdown of sales since a year ago, concerns over property values rise.

"The concern about property values and the credit market has indirectly affected the sales of apartments and rentals," Sykes observes. "There is a disconnect between what sellers and buyers believe the property is worth. Many deals have either fallen apart or not consummated because of this disconnect."

Despite concerns over the perceived value, Terry Scott says he has seen local apartment and rental values remaining stable, and predicts a rise in values as 2008 unfolds. "An analysis of the past five to six years would show a steady increase in apartment property values, and almost a doubling of value over the past 10 years," he states.

Though tightened funding options over the last year have left investors much more careful, lending options are available for the multifamily owner or developer. That, coupled with a trend of high tenant occupancy, is the silver lining during an otherwise clouded time. ■

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