

What Do Rising Interest Rates Mean to Disposition Timing ?

Believe it or not, the interest rate yield curve is starting to look like the old days, lower interest rates on the left side for shorter maturities and higher rates on the right for longer maturities. To make it even more familiar, you just need to ignore the near-zero yielding rates on the left side of the curve. Historically, the upward slope is a general indicator that investor's expectation is for stronger relative economic growth and/or higher inflation. Recently, the interest rate premium for maturities out one year was hovering around 0.4%. The yield curve on 10-year notes recently steepened to 2.75%, stoking discussion of rising interest rates. Does this mean that TCG knows where rates are heading? Unfortunately, no, but historically low interest rates and the prospect of economic growth has some experts betting on higher rates. Since real estate investments are often structured with 70 to 80 percent leverage, they have bond-like qualities that drive value down when rates go up. In discussing value with our clients, it is increasingly important to analyze the impact of interest rate changes on current asset value since rising interest rates can offset improvements to value sellers hope to realize through improved submarket conditions.

In weighing the myriad of factors that go into a seller's decision to sell, interest rate's significant impact on value is sometimes under analyzed. A scenario we typically encounter is: an asset out of its initial 10-year credit flow period, but not performing to its full potential in the eyes of the owner. The owner has made a strategic decision to

sell, but is hesitant to move forward immediately because the property submarket has trended downward recently and a market recovery could improve NOI. The question is whether waiting will translate into higher seller proceeds? An illuminating analysis is to consider: if interest rates were to increase over the next 3 years, how much would NOI need to improve to keep proceeds even with current levels?

Answering this question requires running some "what if" analysis based on the seller's forecast of future operations and interest rates. (Nobody has yet established a clear correlation between changes in interest rates and the direct movement in cap rates, except to establish that increasing rates put upward pressure on cap rates). Another hurdle is predicting how future lending spreads might change against the benchmarks. Because TCG is not afraid to make a few brave assumptions, we have assumed in this example that the percentage change in cap rates will be 50% of the percentage change in interest rates (there is some evidence that this is in the historical ballpark). In the very simple example below, we hold NOI constant on a sample 150-unit building and calculate the implied loss of value that could result by holding the asset for several additional years. The columns on the right indicate the estimated NOI improvement, or monthly per unit rent improvement, required to make up for the value lost by the increasing cap rate. We ignore the time value of money, changing underwriting standards and focus solely on the gross building value.

>> Continued on Page 3

Disposition Year	Stabilized NOI	Rate Change	Interest Rate	Cap Rate	Implied Value	Loss of Value	NOI Improv. Req.	Avg. Rent Increase Req.
June 2009	\$443,000	0.00%	6.25%	8.25%	\$5,369,697	N/A	N/A	N/A
End of Year 1	\$443,000	1.00%	7.25%	8.91%	\$4,971,942	(\$397,755)	\$35,440	\$20/Unit/Mo.
End of Year 2	\$443,000	1.50%	7.75%	9.24%	\$4,794,372	(\$575,325)	\$53,160	\$30/Unit/Mo.
End of Year 3	\$443,000	2.00%	8.25%	9.57%	\$4,629,049	(\$740,648)	\$70,880	\$39/Unit/Mo.

Welcome to the Section 42 Review

Welcome to the premiere issue of the *Section 42 Review*; a quarterly newsletter from the Tax Credit Group of Marcus & Millichap (TCG). We created this newsletter to provide you a unique perspective on issues related to the disposition of Section 42 Low Income Housing Tax Credit (LIHTC) properties and partnership interests. Our goal is to share insights gathered from working on LIHTC property transactions with our clients and also provide input from industry-leading experts involved in financing, syndicating and regulatory compliance.

Our objective is to provide our clients with unparalleled LIHTC property transaction and advisory services. One way we accomplish this is by providing relevant industry perspective that can only be obtained through our unique position within the industry.

In this first issue you will find two sections that will be reoccurring: Q&A (with an industry leader) and Market Spotlight. As with the entire publication, we hope you find these articles informative and insightful. If you have any suggestions for future articles, please let us know. Our vision is that the *Section 42 Review* becomes a valuable resource for you.

Enjoy!

ALSO IN THIS ISSUE

Rise of the HUD Loan: Evaluating the 223(f)	2
Q&A With a Fannie Mae Lender	3
Market Spotlight: Washington D.C. Metro	4

Rise of the HUD Loan: Evaluating the 223(f)

Over the last seven months the Department of Housing and Urban Development (HUD) has insured over \$2.5 Billion in volume across all loan types. At this rate, HUD is on pace to close over \$6 Billion in loans by the end of the fiscal year, the highest HUD loan volume since 2004.

The reason for the increase in HUD activity is directly connected to the nation's credit crisis. The demise of CMBS and constrained local lending sources, combined with Fannie Mae and Freddie Mac's more restrictive lending standards, have escalated HUD to a primary option in multifamily lending. In turn, LIHTC and other multifamily buyers are turning to HUD in record numbers for competitive financing.

When purchasing for cash flow, buyers of LIHTC properties are increasingly choosing the 223(f) HUD loan program. This acquisition/refinance product is a good alternative for properties and/or buyers that do not fit the typical Fannie or Freddie box. The following are some pros and cons of the 223(f) program to consider while shopping for financing.

Best Practices for Securing a HUD Loan

- **Make sure your third parties have professional HUD experience. This will help you avoid any potential problems down the road.**
- **When selling a property, allot time in to your purchase and sale agreement to get HUD approval. Make sure all parties are realistic about the timeline.**
- **Make sure your HUD lender is Multifamily Accelerated Processing (MAP) certified. A lender with this designation is capable of underwriting the loan themselves and will have more control over the amount and timing.**
- **Choose a Government National Mortgage Association (GNMA) certified HUD lender. This will lower your overall interest rate by a net of 25 basis points.**

223(f) PROS

Underwriting

Underwriting standards for this program are more flexible than most competing loans. Both the Loan to Value and the Debt Service Coverage Ratio are less restrictive than Fannie and Freddie standards, especially in struggling markets.

Comparable Interest Rates

Even including the required Mortgage Insurance Premium, HUD rates are competitive with Freddie and Fannie rates.

35-Year, Fully Amortizing

HUD 223(f) loans offer full 35-year amortization, making it possible to lock in a favorable interest rate for the duration of the loan. Under the 223(f) program, both the amortization, and the loan due date are synchronized. Other comparable loan products usually offer a maximum 30-year amortization, with the full amount of the loan due in 7 to 10 years.

Non-Recourse

The 223(f) is a non-recourse loan; a personal guarantee is not required. Should you default on the loan, HUD would not be able to pursue your personal finances except in cases of fraudulent activity. Other loan products are also labeled non-recourse, but require more stringent carve out language, which include "gross negligence."

Inexpensive to Assume

The cost of assuming a 223(f) is only 0.05% of the total value of the loan and does not trigger prepayment. Even though HUD must approve a Transfer of Physical Asset (TPA), this usually makes for a more cost effective transition.

Will Lend on Future Value

Within certain constraints, HUD will lend on proforma numbers. This is important if the buyer is considering some element of renovation, which the 223(f) allows for.

223(f) CONS

Length of Time to Close

A HUD loan will take 60 to 90 days longer to close than Fannie or Freddie products.

Mortgage Insurance Premium (MIP)

The required MIP insurance will run you 0.45% of the outstanding balance annually.

Annual Audits

Adding to the additional costs, you will be required to submit an annual audit.

REAC Inspections

HUD's Real Estate Assessment Center (REAC) will take a proactive role in assessing the physical condition of your project on an annual basis. HUD uses a 100 point system. If a property scores below 60, HUD will implement a "correction plan" and the property will probably be exposed to more frequent HUD scrutiny. REAC inspections apply to any property with a HUD loan, there is no inspection cost to the owner.

Surplus Cash Rule

HUD limits cash distributions to twice per year; don't let this come as a surprise to your investors.

Determining which loan is right for you depends on many factors. Put simply, if you are acquiring a performing asset, and do not require much leverage, Fannie and Freddie will probably edge out HUD when it comes to the timeliness, and overall cost of the loan. If you are not in a hurry, and are capable of enduring all of HUD's procedural requirements, the 223(f) program is definitely something to consider.

	HUD	FNMA/FHLMC
DSCR	1.176%	1.250% +
LTV	85%*	80% Max
AMTR	35 Yrs.	30 Yrs.
Maturity	35 Yrs.	7-10 Yrs.

*80% For Equity Withdrawals

Q&A With a Fannie Mae Lender



Jeff Stuart is a Senior Vice President of Alliant Capital LLC where he has originated over \$500 Million in apartment loans since 2001.

Knowing that value in today's market is driven by what financing a buyer can obtain, what would you consider "best practices" for those looking to sell properties?

I think the best thing a property owner could do before selling their property would be to look at their management and scrutinize their collections. These are the key drivers to get a loan done - so it's really important to focus in on management and collection trends.

How would you describe the current multifamily lending environment?

I would describe the current lending environment as thin - as opposed to the preceding environment in 2006 and early 2007 which was awash in liquidity. Now there are very limited sources of liquidity.

What are some lessons you have learned from loans you have recently closed?

Address problems up front. Before you even start processing a loan, look at it very hard and ask yourself, "What problems are we going to have?" Whether they are structural problems, Fair Housing issues, collections issues, or anything that could potentially be perceived as a problem from the lender's standpoint, look at it hard up front and get it fixed. It's always easier to identify your problem up front and say "Hey, is this a threshold issue that we can get over, and can we still get this deal done?" Versus being 60 or 90 days down the road and all of a sudden realize, "Oh this is a problem." It's much easier to address these things up front - that way you know what you're dealing with.

How frequently is Fannie Mae changing underwriting standards?

We typically see both Fannie and Freddie even though we are not a Freddie originator. I would say on average they are changing quarterly. In the past they would change semi-annually to reflect the fact that they were losing business to conduit lenders, so underwriting was actually getting easier. Now that the market has turned and the landscape, as far as our competition, has changed, we are seeing quarterly revisions to underwriting.

What are the most common loans you see borrowers asking for?

The most common loans are definitely 10-year fixed loans. I think the mind set of "I'm going to go in and improve operations then sell the property in 5 years" is a thing of the past. People aren't thinking along those lines anymore. They want the security of a longer duration loan.

What is Alliant's forecast on interest rates?

We as a company don't forecast interest rates. I will tell you that the Fed is printing money like they've never printed money before, and they, along with the Administration, have a keen desire to keep long-term treasury rates low in order to heal the housing market. A huge uptick in Treasury yields would absolutely undermine the government's desire to get us out of the "recession" that we are in. From the amount of monetary stimulus we've seen, one can certainly presume that there are a lot of players out there putting pressure on keeping that rate as low as possible.

How does your current Fannie Mae volume compare to last year?

Alliant, and GSEs in general, are doing record volumes. Our volume in the first quarter will be double what it was in 2008. There are fewer shops to go to now, and because of that we have expanded our footprint and brought on other originators to expand our volume in markets nationwide, so consequently, we are growing tremendously.

Will Fannie debt continue to tighten?

I think they will react to the overall macro economy. For instance, as other markets show material deterioration, they will certainly reexamine a market and really scrutinize what they are putting in their portfolio there. As an example, Fannie Mae added Atlanta this last month. In markets where they have a heightened awareness of issues, they are being conservative, which makes all kinds of sense.

What kinds of transactions are getting done in the current lending environment?

Transactions that are getting done are those that have stable to improving collections, stable to improving NOI and that are fairly well maintained.

Is there still an exception process?

It can happen... but if the trajectory of collections at a property has a southerly arrow to it - probably not going to happen. You may have a favorable NOI this month, but if your collections have declined in a material way, which we define as greater than 3%, then what is the NOI three or six months from now? It can be done, but there needs to be some stability in the collections.

>> *Interest Rates Continued from Page 1*

The conclusion in this simplified example: if an owner has determined that they believe interest rates will rise by 2% over the next 3 years, and that rise will translate to a 1.3% cap rate increase, then postponing a disposition only makes sense if NOI can be improved by at least \$71,000, or improved effective rent of \$39/unit/month. Achieving this improvement is very difficult in a down or flat submarket or if the property is in need of capital improvements.

There is rarely one factor controlling a decision to sell an asset. However, low rates, and the possibility of higher future rates in an expanding economy, suggest that interest and cap rate sensitivity on asset value should be a core part of the hold/sell analysis.

Market Spotlight: Washington D.C. Metro

Washington, D.C. metro's still-resilient job base will mitigate losses in property revenue, with leasing activity remaining healthiest near large, established clusters of employers. The Dupont Circle/Adams Morgan and Kensington/Wheaton submarkets, for example, are situated near key office districts and major companies and are among the few areas in the market to record rent and vacancy improvements in the past year. With many tenants shuffling to more affordable Class B/C units, those communities should fare well, while newer luxury apartments will witness increased vacancy and the need for concessions.

Buyers have shown an interest in Class B properties located along or near major thoroughfares, as tenant demand is expected to be most resilient in these assets. Consequently, cap rates for mid-tier complexes are averaging in the low- to mid-7 percent range, with Class A properties trading just 50 basis points to 75 basis points less. Initial yields for lower-tier buildings or assets in tertiary locations, however, may need to rise to near 8.5%.

ECONOMY

- Job growth continues in some employment sectors; education and health services and leisure and hospitality segments have generated 22,000 positions during the past year.
- Enticed by a \$4.6 million incentive package, Hilton Hotels Corp. announced plans to relocate to Fairfax County, creat-

ing more than 300 jobs in the submarket.

- Total job loss in 2009 is projected to amount to a 0.6% reduction in the workforce.

HOUSING & DEMOGRAPHICS

- Falling home prices have created a gap between the cost of homeownership and local rents. Currently, the mortgage payment on the area's median priced home is \$1,477 per month, \$160 below the average Class A asking rent.
- **Despite retreating home prices, rental housing will remain the most affordable option for residents and families earning less than the area's median household income.**

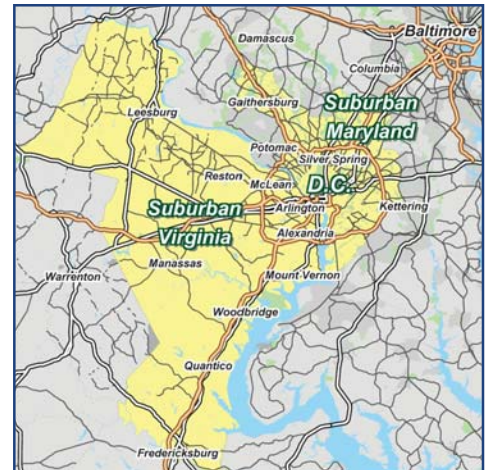
VACANCY

- The need for affordable housing has kept the average Class B/C vacancy rate tight, increasing just 10 basis points to 4.8% over the past 12 months.
- Employment losses will hamper housing demand this year. Vacancy is forecast to rise 100 basis points to 6.4% , after ticking up 30 basis points in 2008.

RENTS

- Lower-tier asking rents increased 3% to \$1,174 per month. Though rent growth persisted among Class B/C properties in the first quarter, Class A asking rents fell 0.6%.
- This year, asking rents are projected to decline 0.3% to \$1,360 per month, while effective rents will retreat 1.5% to \$1,287 per month. Asking and effective rents rose 3.6% and 3.3%, respectively, in 2008.

- **Important to note: A large gap still persists between market-rate and affordable rents on similar product type. Thus indicating the long-term stability of affordable housing.**



SUBMARKET VACANCY RANKINGS

1	Dupont Circle/Adams Morgan	2.6%
2	Takoma Park	3.0%
3	Woodley Park/Cleveland Park	3.2%
4	Kensington/Wheaton	3.4%
5	Hyattsville	3.9%
6	Silver Spring	4.0%
7	Anacostia/Northeast D.C.	4.2%
8	Northwest D.C./Georgetown	4.3%
9	Falls Church/Annandale	4.3%
10	Loudoun County	4.5%

The information contained in this report was obtained from sources deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guarantee, express or implied, may be made as to the accuracy or reliability of the information contained herein. Note: Metro-level employment growth is calculated using seasonally adjusted quarterly averages. Sales data includes transactions valued at \$500,000 and greater unless otherwise noted. Sources: Marcus & Millichap Research Services, Bureau of Labor Statistics, CoStar Group, Inc., Economy.com, National Association of Realtors, Real Capital Analytics, Reis, TWR/Dodge Pipeline, U.S. Census Bureau.

Tax Credit Group: Current LIHTC Activity

	Closed	Escrow/Mktg.	Total
Properties	223	45	268
Units	31,991	7,653	39,644
States	34	20	-
Dollar Volume	\$1,385,729,219	\$325,966,079	\$1,711,695,298

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