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feature

Arel Capital: Investing in Multifamily Value-Add Real Estate

Why Invest in Multifamily Real Estate?

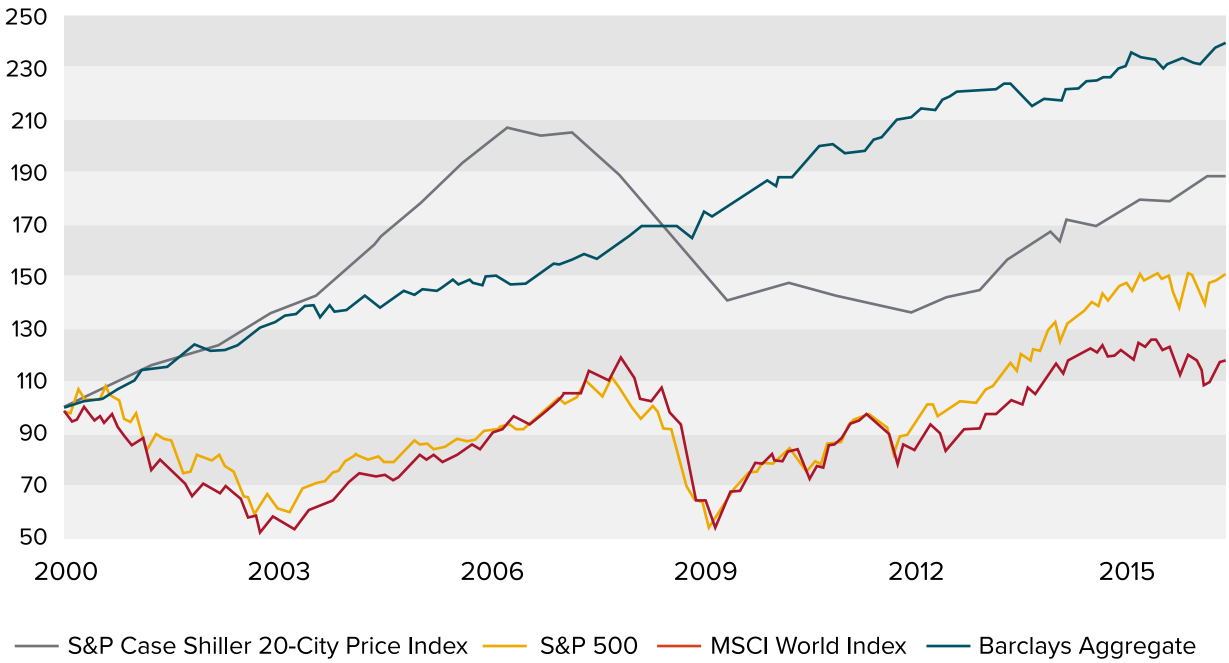
We begin with a discussion on why real estate is an attractive asset class for investment. First, the historical performance of real estate over multiple cycles often compares favorably to other asset classes, including stocks, bonds, hedge funds and private equity. Figure 1 shows the performance of real estate compared to other asset classes since 2000.[1] Second, real estate often provides value protection in inflationary environments. In general, movements in rents and property prices tend to be positively correlated with inflation. As inflationary pressures in the economy increase, rents and property prices both tend to increase as well. Thus, real estate is a good hedge against inflation. Third, as will be discussed further below, investing in older vintage real estate properties (e.g. an apartment community that was built in the 1980s that is fully occupied with renters at the time of acquisition) often offers a stable current income stream. In summary, real estate is an asset class that may offer equity-like returns with bond-like income characteristics that may also act as a hedge against inflation.

Investment in the private real estate markets brings some advantages compared to the public equity markets. The stock prices of REITS, homebuilders, and the like can all be subject to general stock market volatility which may be undesirable. In addition, operators of publically listed real estate companies may face many investment constraints and may not be able to move as quickly as private operators when an opportunity arises.

Of the various subcategories of real estate investment (e.g. residential, office, retail, industrial), multifamily residential, i.e. rental apartment buildings and properties, seems often to offer particularly attractive opportunities. Many investors may find the risk/return profile of multifamily investment more attractive than other categories of real estate. Multifamily tends to exhibit lower volatility in vacancy and higher elasticity in rent levels than other real estate assets. For example, if a shopping mall loses its anchor tenant, the space may remain "dark" for a considerable period of time no matter what reasonable measures the landlord takes (such as dropping the rent dramatically). On the

[1] The S&P Case Shiller 20-City Price Index is a proxy for the overall real estate asset class and cannot be easily replicated through direct real estate investing.

Figure 1



other hand, vacancy for multifamily properties tends to be much more sensitive to changes in rents, i.e. a small drop in rents can often increase demand for apartments from prospective renters.

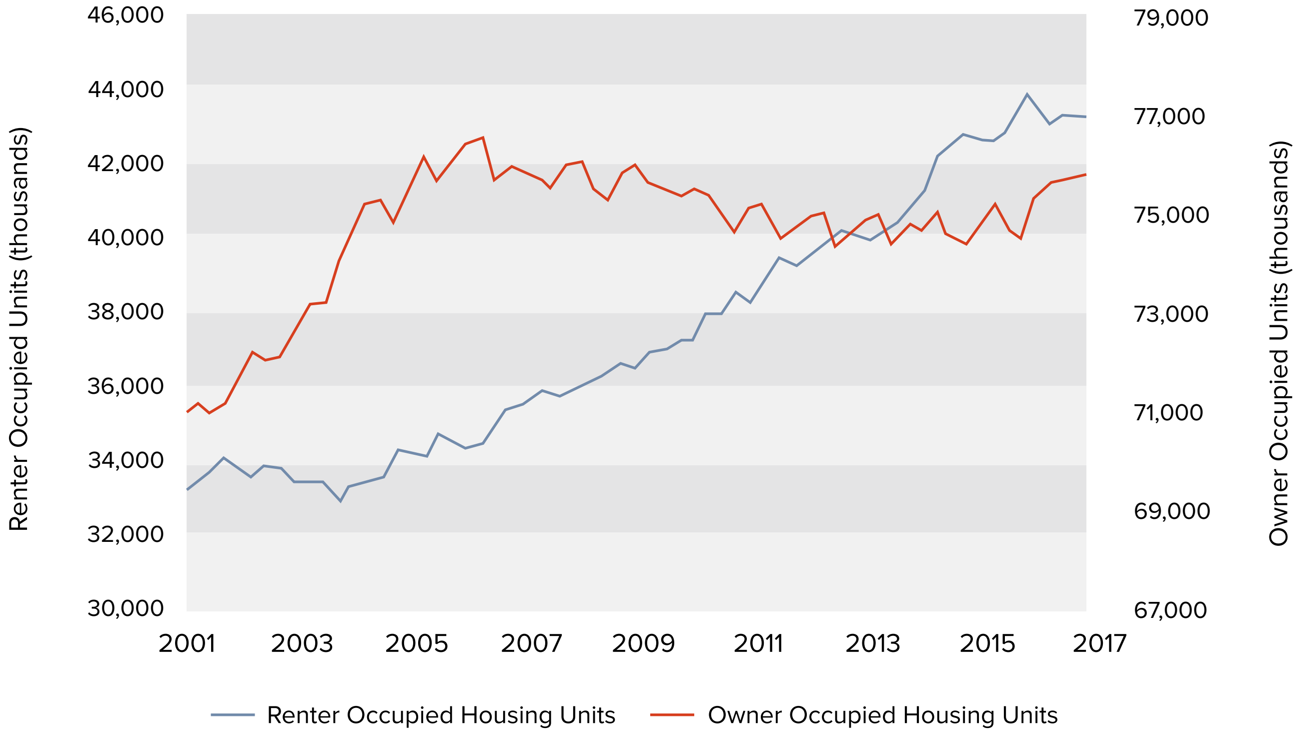
Perhaps more importantly, both macroeconomic and demographic trends in the United States suggest that multifamily investment may be a compelling opportunity in and of itself and also be a preferable alternative compared to other categories of real estate investment. Structural population changes in the United States, in particular, an increase in the 18 to 34 age cohort, will create increased demand for residential real estate. Combined with lower home ownership rates, it has resulted in higher demand for rental properties over the past 15 years, as illustrated in Figure 2. During this same period of time we have seen dramatic shifts in consumer behavior, with online shopping an ever increasing retail segment versus traditional shopping. We have also seen an increase in the number of workers who telecommute and work from home. These trends make the prospect of investing in other segments of the real estate market, such as retail and office, less appealing to many investors.

Multifamily Value-Add Investing

Within the world of multifamily investment opportunities, buying older vintage properties in urban locations with strong demographic trends may be more attractive than building new rental apartment buildings, particularly in high construction cost markets. Older properties offer value and can often be purchased well below replacement cost. Properties built many years ago tend to offer lower rents than newer product in the area, as they often have tired interior finishes and few amenities for residents. In some cases, the gap in rents may be quite significant. Moreover, building a new property carries its own risks (e.g. construction risk, zoning risk, lease-up risk), and the value of a newly built property has inherent downward pressure on it. As an analogy, the value of a new car falls rapidly once the wheels leave the dealer's lot. Similarly, a newly constructed apartment building with the highest rents in town will invariably face competition from other new construction in the future. This in and of itself will serve to put downward pressure on rents and valuations.[2] On the other

[2] This is not meant to suggest that the value of a newly constructed apartment building will necessarily decline. On the contrary, there may be other factors (such as rent growth at the property, cap rate compression, etc.) that far outweigh and will cause a newly constructed building to increase in value.

Figure 2 • Renter vs. Owner Occupied Units



hand, an older property with relatively low rents in a good area may benefit from new construction. It doesn't tend to compete with the newer product directly, but if the submarket is seen as improving given new investment in the area and is therefore more desirable, that may serve to increase rents and therefore increase the value of older communities.

It is often a particularly attractive opportunity to invest in older vintage multifamily communities where the rent gap versus the newest product in the submarket is significant. Such properties often provide significant positive cash flow for investors. Moreover, by making improvements to these properties such as renovating unit interiors and enhancing property amenities it is often possible to provide additional return benefits to investors. Many tenants are willing to pay somewhat higher rents (but still well below the top rents in the market) to enjoy renovated product at such older communities. Consider an older apartment community in which it is possible to raise the monthly rent of an apartment by $200 after spending $4,800 to renovate the unit. Then in two years this value-add improvement will break even. Once the two-year mark has been reached and the $4,800 investment has been paid off, any further monthly rental premiums captured serve to enhance the return to investors.

Of course, an operator will look to do this in many units at the property. Buying an existing rental property with lower rents and implementing renovations so as to raise rents is referred to as multifamily value-add investing. Moreover, in the current interest rate environment it is often possible to finance such purchases with attractive long-term fixed-rate debt available from the agencies (i.e. government sponsored enterprises). By doing so, an investor can lock in historically low levels of fixed interest expense for five to ten years (or longer), promoting long term ownership while maintaining certainty of financing costs. Buying older vintage product (which often produces significant positive cash flow) and further enhancing returns by implementing such value-add strategies is often an attractive investment.

About Arel Capital

Arel Capital, L.P. ("Arel") is a private investment firm formed in 2013 by two former Wall Street professionals, Richard Leibovitch and Gabriel Bousbib, to invest their personal capital in real estate properties. It has evolved into a boutique real estate investment firm with a broad range of investors, including high net worth individuals, family offices and institutional investors. Arel focuses on mid-sized real estate assets, with an emphasis on cash-flowing multifamily residential properties in primary and select secondary U.S. markets. Since its formation, Arel and its investors have committed approximately $600 million of equity in over 30 transactions. Arel targets annualized net returns of 15% to 20% on its equity investments, with upwards of 50% of returns from annual cash flow distributions.

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