DELAROSA ASSET MANAGEMENT

Multifamily Newsletter – Fall 2017

Delarosa Multifamily Newsletter is compiled quarterly to bring you insights into the multifamily real estate asset class.

ANOTHER RATE INCREASE…BULL, BEAR OR BUST?

Outlook for multifamily real estate for 2017 and beyond

As the economy toils into its 9th year of anemic expansion since the end of the Great Recession, the U.S. Federal Reserve (the "Fed") continues to slowly and steadily raise interest rates. The .25% increase announced at the June 14th meeting is the fourth hike since the latter half of 2015. While many believe that the Fed may be putting a temporary hold on further rate increases in 2017, it's view of future U.S. economic performance is cautiously optimistic. The question looming for real estate investors is what impact will rising interest rates have on income producing property valuations? The answer is not obvious.

A brief summary of how we got here is in order. It has been a harrowing roller coaster ride for those who invested in the stock market and other asset classes before the onset of the Great Recession in December 2007. In a span of 18 months, the S&P plummeted close to 60% and a record 7mm Americans lost their homes. 9mm jobs were lost during that period as the unemployment rate skyrocketed from 4.7% in November 2007 to peak at 10% in October 2009. Economic activity as measured by real GDP dropped more than 4%.

To combat the severe recession, the Fed ultimately cut the federal funds rate to a range of 0% to .25% while simultaneously adopting a policy of quantitative easing to increase the money supply (later referred to as QE1, QE2 and QE3). It was not until the second half of 2009 that the economy began to rebound, albeit at a snail's pace. And while America's recovery from economic malaise has been unusually slow, certain sectors of the economy flourished. In particular, the multifamily housing asset class ("MF"), not only weathered the financial crisis better than most other asset classes, but exhibits continued strength as we enter the latter half of 2017. While the Fed's active monetary policy jumpstarted the MF bull market, other contributing factors have been instrumental in increasing returns to MF investors including increased international investment activity, changing housing demographics as well as capitalization rate compression, all of which are discussed below.

Notwithstanding the gradual rate hikes in a benign inflationary environment, we continue to believe there is room for growth in the Class B/C+ multifamily space. Taking into account the four post recession rate hikes, return on investment in MF continues to thrive.

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In the long term, real returns in real estate have outperformed the investment returns in both stocks and bonds. Since 1970 the real estate market as measured by publicly traded REITS has had an average annual return of 11.42% while the S&P 500 Index ("S&P") has had an annual average return of 10.31%. Surprisingly, even taking into account the recent strong performance in the stock market, the multifamily sector outperformed the S&P 10.6% compared to 8.6% over the last 20 years. Results of a recent Morningstar survey of money managers should raise investors' eyebrows. **The experts expect 5.0% nominal annual U.S. stock market returns over the next five years (See Morningstar survey January 12, 2017).**

In an interview on CNBC this past February, the "Oracle of Omaha", **Warren Buffet**, was asked if he saw any reason for investors to buy 30-year bonds right now. **"It absolutely baffles me who buys a 30-year bond…I just don't understand it. The idea of committing your money at roughly 3 percent for 30 years… doesn't make any sense to me."** Prognosticators predict nominal U.S. bond returns to remain below 3% for the next five years. We believe that the growth drivers discussed below will help MF investors exceed the 5 year marginal returns forecast for both stocks and bonds.

GROWTH DRIVERS

Since 2010, the phenomenal returns in the MF space were influenced by a number of factors including:

- *Historically low interest rates.*
- *Increased foreign investment.*
- *Changing demographics.*
- *Bias toward renting rather than owning.*
- *Declining vacancy rates.*
- *Above average annual rent increases.*
- *Limited stock of apartments.*
- *Compressed capitalization rates.*

Low Interest Rates:

The unprecedented global recession beginning in the latter part of 2007 led financial regulators worldwide to implement monetary policies which dramatically lowered interest rates to historical lows (Some Euro zone countries and Japan for example, had negative rates and certain corporate debt had negative yields). Lower interest rates reduce borrowing costs; this in turn encourages spending and investment, and makes it more attractive to buy income producing assets. The Fed's expansionary monetary policy boosted U.S. asset prices including those in the MF arena.

In the last 2 ½ years, the Fed entered a phase of semi-tightening; it wound down QE3 in October 2014, ending billions in bond buying per month that year. It has since made its intention clear to gradually reduce its portfolio of Treasuries and mortgage-backed securities as part of the effort to wind down its stimulus campaign. Fed Chairwoman, Janet Yellen has been transparent with respect to the Fed's desire to gradually increase interest rates in order to combat any concomitant inflationary pressure.

Inflationary pressure continues to remain benign notwithstanding the gradual increase in the federal funds rate. Presently, inflationary levels remain within the parameter of the Federal Reserve's 2.0% stated target level. The economy is experiencing tepid growth even as the labor force is at full employment. Economists have developed a number of plausible explanations for the anemic growth ranging from the impact of baby boomer retirements in the workforce to a slower pace of innovation and investment in research and development by both corporate and governmental entities. The International Monetary Fund caps its U.S. growth forecast at 2.1% through 2018. The Congressional Budget Office anticipates U.S. economic growth will remain modest over the coming decade.

Economic policy changes promised by the Trump administration were received enthusiastically by financial markets, given the potential for lower taxes, fewer and looser regulations, increased infrastructure spending and domestic production. Adopting stimulative policies would spur price growth and increase lending activity. How much change can really take place remains to be seen, notwithstanding the administration's pro-business stance, and a Republican majority in both the House and Senate. Whether this is a short term phenomenon or permanent in nature is also questionable.

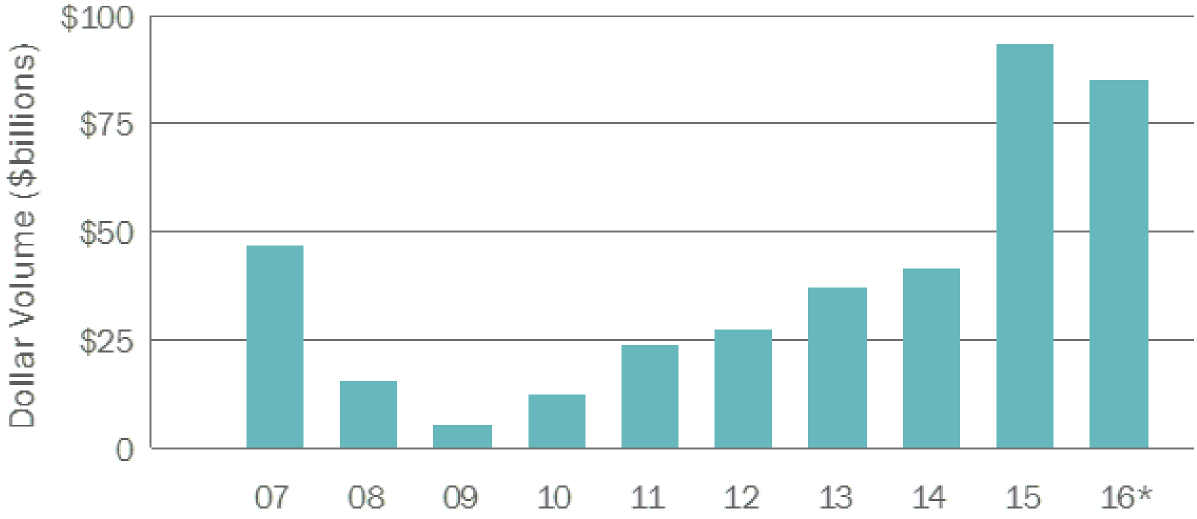
The general consensus post election was that with the swift escalation in 10-year Treasury yields immediately following the November election (rising from 1.83% to 2.60% in a matter of weeks but has since settled in the 2.15%-2.30% range), investors might revamp their financial models, resulting in deals either falling by the wayside or being re-priced. Rising rates would lead to a growing disconnect between buyers and sellers and reduce overall property transaction activity. 1Q2017 MF property sales plummeted 35% to a 3 year low vs. 1Q2016 property transactions, albeit, partially due to a reduction in inventory available for sale. Both average and median sales prices per unit remained mostly in line with previous quarters, reflecting the continued strong interest in acquiring the MF asset class. Clearly the disconnect pundits were looking for has yet to transpire. While interest rates began rising in 4Q16, national capitalization rates actually compressed from 6.0% to 5.9%!

While interest rates have begun rising from their post recession lows, they are still at historically low levels. MF housing continues to offer yields significantly greater than those offered through the issuance of corporate debt and government Treasury bonds. This relatively low interest rate environment remains appealing for the long term, patient MF investor.

Foreign Investment:

Much of the strength in multifamily housing since the Great Recession can be attributed to the infusion of capital from foreign investors for the highest quality core properties in gateway cities. To date, little foreign capital is allocated for the secondary or tertiary Class B/C+ multifamily class. Deep concerns about the soundness of the economies in China, Canada, Japan and Europe, resulted in heavy outflows of capital into the U.S. apartment sector. While "Brexit" is less than 2 years away, foreign investors want to invest in an environment with low volatility, higher yields and stabilized cash flow. MF housing was the perfect antidote to allay the political and economic uncertainties abroad. The increase in foreign investment during the recovery also amplified returns from MF assets, particularly in the gateway markets. Sales prices for multifamily properties in major markets are 74% higher than the prior peak in 2007, and 52% higher across all markets.

Figure 1: Cross-border Capital Invested in U.S. Commercial Real Estate



*Trailing 12 months through 2Q16; sales of $2.5M and greater

While the dollar index is trading at a discount since the November election, it remains at historically strong levels against most major currencies. This could have a dampening effect on future capital inflows. As the yuan depreciation slows, Chinese investors are redirecting more investments back into the Asian markets. **Chinese investment in U.S. property markets dropped 7% year-over-year to $5.4b in the first half of 2017**. Some foreign investors are wary of President Trump's protectionist platform and may be less inclined to invest in U.S. properties. **Disagreement with the Trump Administration's U.S. political posture toward North Korea may also negatively impact Chinese investment in the U.S.**

Even assuming a short pause in the inflow of overseas capital for the reasons mentioned above, over the long term, foreign appetite to buy real estate in the U.S. remains solid; greater prospects for economic growth, as well as greater liquidity and transparency related to other foreign markets make the U.S. real estate market a favorite destination for foreign capital.

Demographics Impacting Vacancy Rates and Rent Growth:

The number of renter households increased by 9.3 million between 2005 and 2015, while owner-occupied households fell by 2.1 million. At its peak in 2005, homeownership reached 69.4%. Today that percentage of homeowners is 63.7% and falling. HUD estimates homeownership will drop another 1%-3% by 2020, with further declines of 5%-8% expected by 2050.

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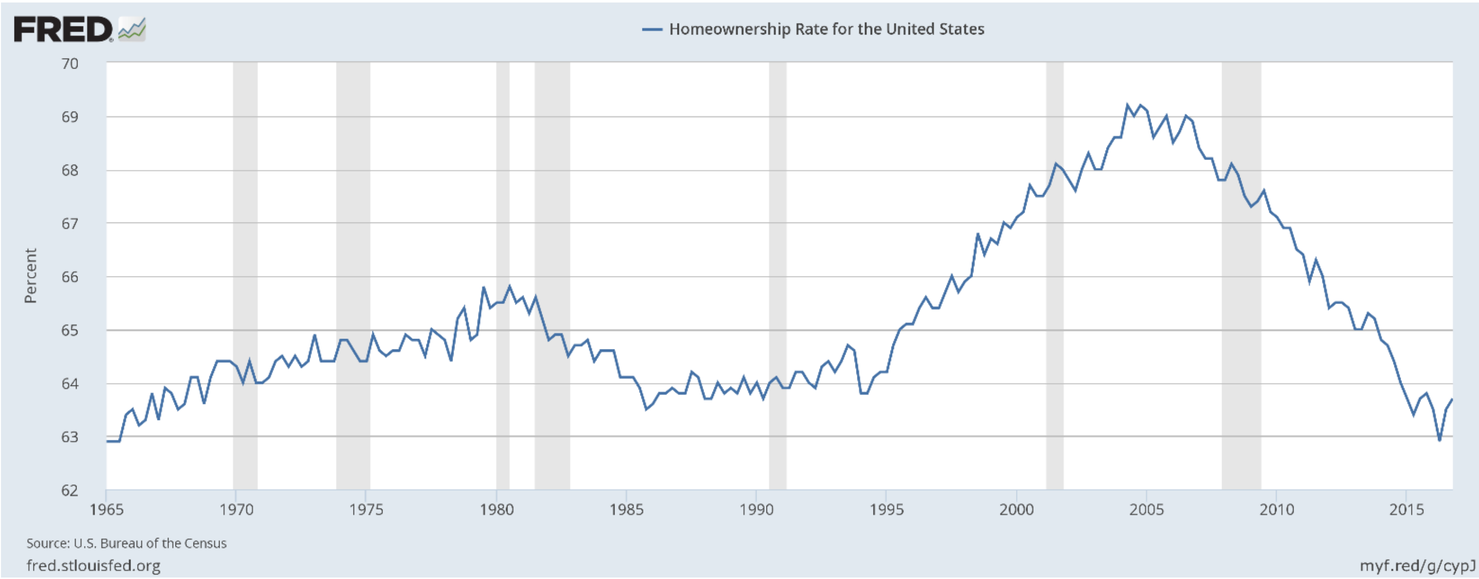
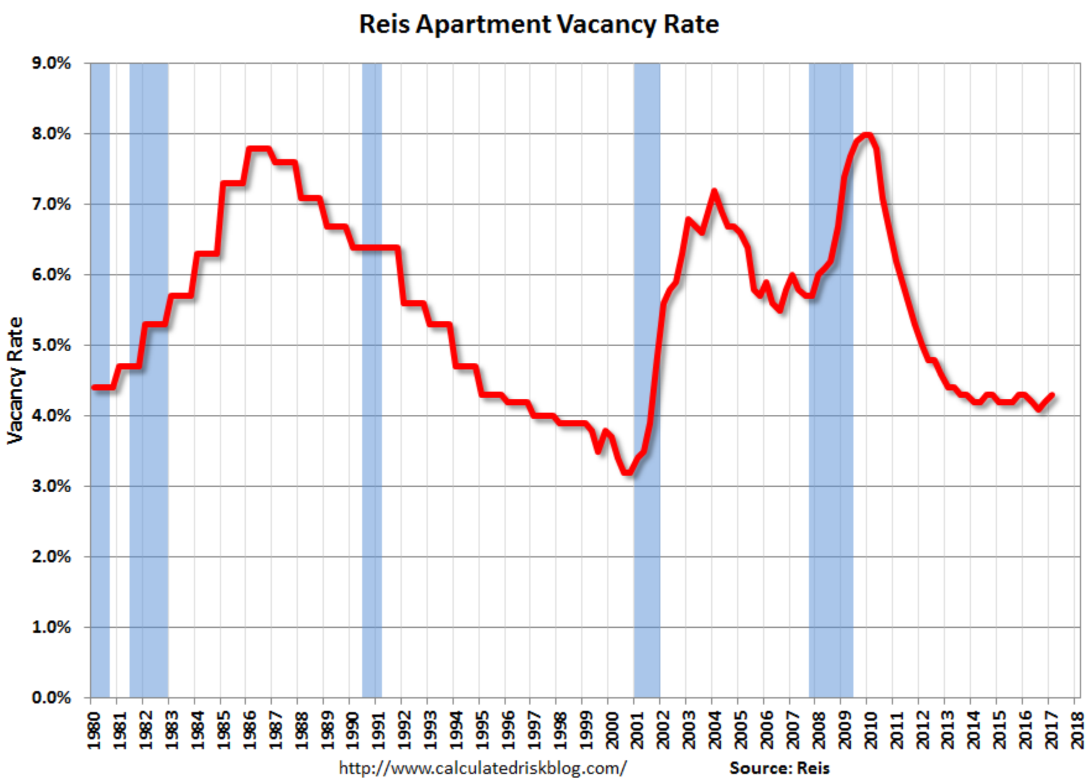


Multifamily occupancy is near an all-time high, reaching 95.7% as of 1Q2017. This is largely due to the shifting demographic landscape from baby boomers and Gen Xers to the millennial generation. **The overall trend for the millennials has been to shy away from homeownership in favor of renting**. Impacted by high levels of student debt and more restrictive lending standards, millennials are compelled to remain in the rental market longer.



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According to the U.S. Bureau of Labor Statistics, millennials remain with the same employer an average of three years; they tend to change jobs three times more often than baby boomers did in their heyday. This suggests a necessity for rentals which can accommodate millennials' need for flexibility.

This new generation of renters is largely responsible for the low vacancy rates as well as the escalation in rents. Long term average rent growth annual rent growth was 2.3% through 2011. In the last 6 years, landlords have continuously raised rents an average of 3.8% annually, outstripping both inflation and wage growth. This year there appears to be a deceleration in rent growth which is expected to continue through the latter half of 2018.

Up, Up and Away

Apartment rents have jumped since the recession as vacancy rates have declined.

Year	Vacancy rate	Average effective Rent, U.S.	Change from a year earlier
2015	4.4%	$1,179	4.6%
2014	4.3%	$1,127	3.9%
2013	4.3%	$1,085	3.3%
2012	4.6%	$1,050	3.9%
2011	5.3%	$1,011	2.4%
2010	6.6%	$987	2.3%
2009	8.0%	$964	-2.9%
2008	6.7%	$993	2.0%
2007	5.7%	$974	4.7%

Source: Reis Inc.

THE WALL STREET JOURNAL.

Much of the moderation in rental rates is taking place in the Class A subsector where almost 600k new units have come online in the last two years. An additional 350k units are expected to come online in 2017, almost 35% more than the 20-year average. This is expected to contribute to the continued slowdown in rent growth at least until markets with above-trend supply can absorb their new units.

Year-over-year rent growth as of June 2017, while at a more normalized 2.7%, reflects the impact of excess supply of new Class A inventory coming online. **Above average annual rent increases are expected to begin in 2019** as multifamily development subsides.

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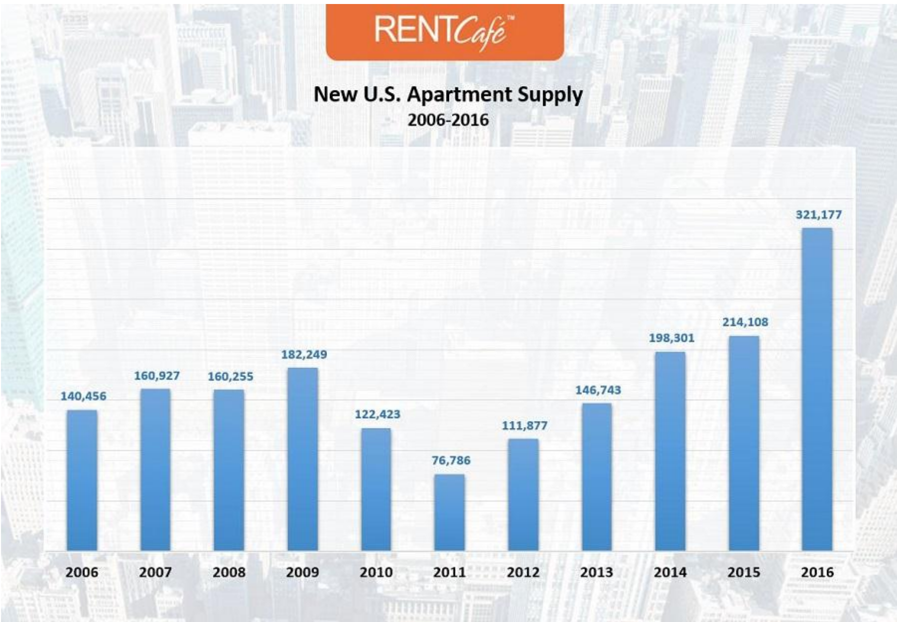
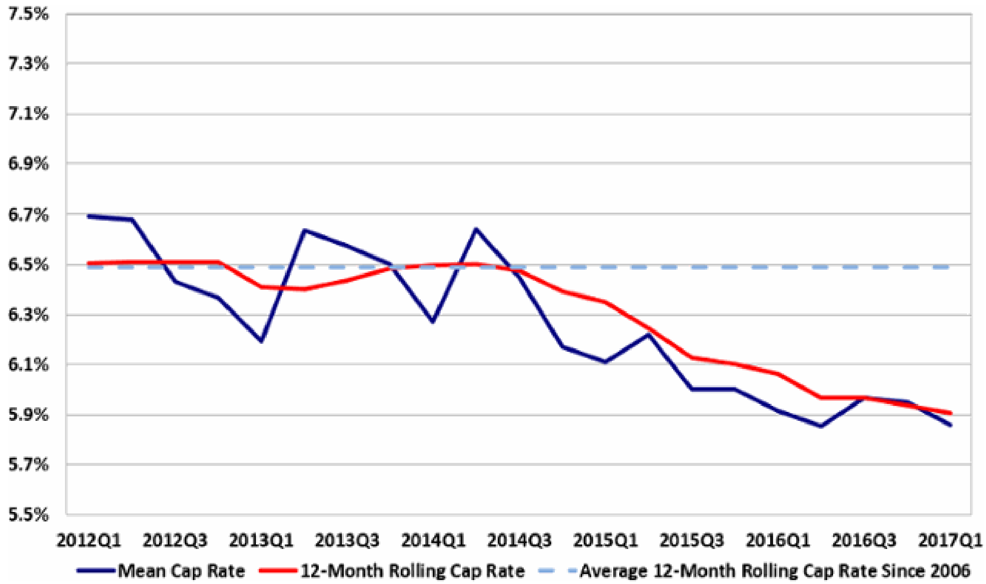


The temporary MF inventory glut has had little impact on the Class B/C market. High construction and land costs in primary and secondary markets make Class B and C construction difficult and impractical financially. This limited supply of older more dated units allows landlords to seek above average rent growth, as demand for lower-cost units remains strong.

The MF market will remain desirable to investors going forward, especially given that the **millennial generation will make up 46% of the workforce by 2020 and the number of millennials reaching the "prime renter ages" of 20 to 34, is expected to peak at almost 70 million in 2024**.

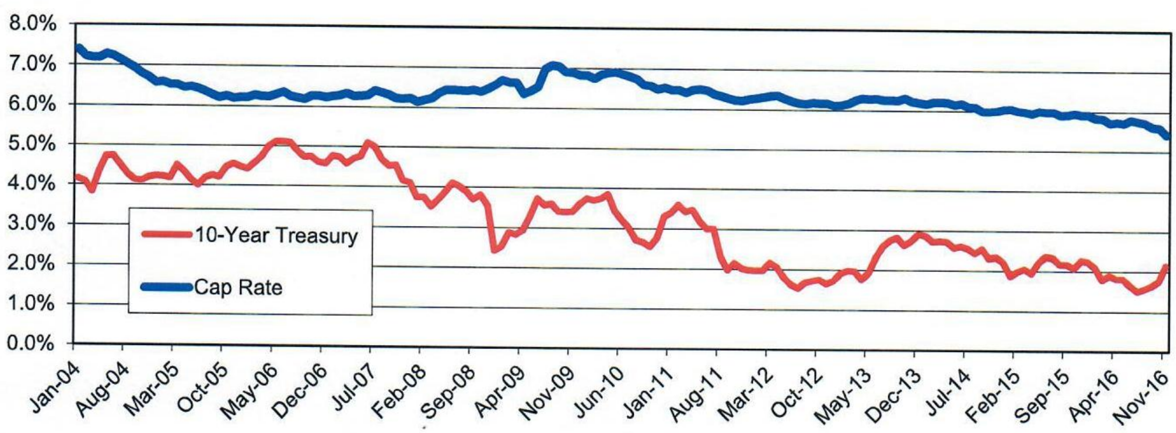
CAPITALIZATION RATE COMPRESSION:

Capitalization rate ("cap rate") measures the net operating income of a property against a property's overall value. The 10 year average for cap rates in the overall MF sector is 6.5%; they are currently hovering around 5.9%. Cap rates for Class A apartment communities in major metropolitan areas average 4.4% (Some New York City Class A property cap rates trade under 3.0%). The cap rate compression is the result of a number of factors; relatively low cost of long term financing, lack of yield in other industries, and the disequilibrium in the demand/supply relationship for MF assets. After a multi-year trend of cap rate compression, rates seem to have bottomed and should remain fairly steady for the foreseeable future.



While cap rates are not directly correlated to interest rate fluctuations, investors typically look at the spread between the cap rate and the 10 year Treasury. The spread is in essence compensation for "investor risk" relative to investments in risk-free government securities. Since 2001, the average spread between MF cap rates and Treasuries has been approximately 320 basis points. Current spreads are trading in the 350-370 range (as of September 1, 2017). The current spread is wider than the 100 basis point spread experienced during the 2005-2007 market cycle peaks. Wider spreads indicate that the market is more disciplined in underwriting deals and building in expectations for interest rate increases ahead. This above-average spread can be viewed as a protective buffer from the expected rise in interest rates in the coming months

Treasurys and Multifamily Cap Rates



Source: Real Capital Analytics, and Federal Reserve, Selected Interest Rates H.15, per Moody's Analytics

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CONCLUSION

The Class A apartment space is currently fully valued and will remain so until the excess inventory is absorbed. The story is quite different in the Class B/C+ space. Tailwinds that should contribute to continuing solid returns going forward:

- *Interest rates remaining below historical norms;*
- *Steady GDP expansion as a result of continued economic, wage and job growth;*
- *Less competition from international players;*
- *Favorable demographics suggest that the millennial generation will lead to an increase in household formations, fewer homeowners, low vacancy rates and steady rent growth for years to come;*
- *Above-average yield spreads between cap rates and 10 year Treasuries;*
- *Limited new supply as a result of exorbitant land and construction costs.*

Class B/C+ multifamily apartments afford investors opportunities to generate cash flow and generous yields during periods of depressed economic activity and appreciation during periods of economic growth. ***With steady rent increases, solid occupancy and low volatility, apartments offer investors the potential for superior returns in a safe investing environment***.

THE DELAROSA INVESTMENT PHILOSOPHY:

"BORING IS BEAUTIFUL…SEXY IS SCARY"

A recent article in the Wall Street Journal discussing the growth of "family offices" captures the essence of what we are trying to convey. These family offices are entities set up to manage the fortunes of the wealthy. In discussing the advantages of the family office, **one money manager aptly noted that the way to "capture outsize returns and protect their capital is in the private world." They participate directly in "deals designed not to perform in lockstep with the stock market."** We believe Delarosa offers a conduit to pursue these types of opportunities.

Anyone with capital can buy property. In the last 3 years, we have seen many transactions selling well above intrinsic value. Delarosa is not in the business of acquiring property for the sake of increasing its portfolio; our goal is to take aging assets (30-50 years old) that are in private and often, family partnerships, that are in need of physical, cosmetic, and management upgrades. We carefully assess potential acquisitions utilizing extremely conservative investment criteria; taking into consideration the cost of upgrades, allowing for increased rents, increasing appreciation and ultimately, greater returns.

Delarosa sees opportunities in the Class B/C+ where units are predominately garden-style, low-density apartment communities with value add opportunities in both secondary and tertiary markets.

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The household incomes for "grey/blue collar" tenants range from $40k-$75k; They are cost conscious and cannot realistically spend more than 35% of their income on housing (yet 28% of renters spend 50% of their disposable income toward rent).

Representative professions include:

- *Assistant managers*
- *Sales Representatives*
- *Teachers*
- *Paralegals;*
- *Civil service professionals (including police and firefighters)*
- *Government employees*
- *Construction workers*
- *Mechanics*

Competition from the Class A stock oversupply is minimal. Even with reduced rents and rent concessions from the Class A segment, tenants in the Class B/C+ segments would be hard pressed to afford moving to Class A units. Furthermore, these renters are less likely to flee for home ownership. As a result, **rents for Class B/C+ housing is more price inelastic than for Class A during recessionary periods as there are minimal substitutes available to this segment of renters**.

Supply and demand is more aligned for Class B/C+ as new supply is limited as these older units do not face the same uncertainty concerning competition from new construction. There was very little Class A construction in the 1990s and as a result, little in the way of aging Class A inventory on the horizon.

Patience will ultimately yield wonderful investment opportunities for the long term investor. Interest rates remain agreeable with little indication of imminent inflationary pressures. The multifamily asset class continues to benefit from the ongoing, secular shift in U.S. demographic trends. Delarosa intends to take advantage of the current economic stability and changing demographic dynamics by acquiring properties that meet our strict criteria, and applying our proven winning business strategies.

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ABOUT DELAROSA ASSET MANAGEMENT LLC

Delarosa Asset Management LLC ("Delarosa") mission is to identify, acquire and manage select Class B/C+ multifamily units offering superior returns, capital appreciation and significant tax advantages unavailable for other investment vehicles. Our primary goal is to provide to our investors, opportunities to invest in apartment buildings that supply principal safety, current/increased cash returns, and equity growth throughout their holding periods.

Visit our website for more information: www.delarosallc.com

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