

NATIONAL REAL ESTATE  
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LAST WORD

## Smart Investors Sniff Out Apartment Deals

Infill opportunities in select submarkets hold the key to successful growth in this volatile market. **By Bob Hart**

Players in the real estate industry are operating in a challenging new environment. This includes those of us in the multifamily sector, which has had a long run of strong operating fundamentals, an abundance of liquidity and competitive equity investment.

Every day we tune in to see how the financial news and economic indicators are affecting the real estate capital markets. The changes influence acquisitions and our ability to capitalize transactions.

We want to believe there are opportunities in all sectors to buy deals at distressed prices. However, the multifamily sector, particularly in the West Coast's infill markets, is still showing persistently low cap rates of 5% to 6%. Consequently, more discipline is required in underwriting in this new age of turbulence.

As we underwrite value-added opportunities, we need to be aware of the trends 12 to 24 months down the road. That could mean slower job growth, less leverage for buyers upon exit, fewer equity partners willing to gamble on higher market rents, and exiting cap rates that are stabilized above 6.5%.

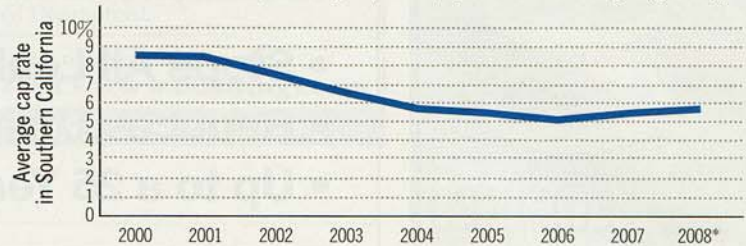
### Multifamily setbacks

Despite these shifts, there remains a disconnect between the perceptions of buyers and sellers, and the realities of today's multifamily operating fundamentals. In certain cases, this has led to deals coming back to the market and sellers unable to pull the trigger.

Markets like Las Vegas, Phoenix and the Inland Empire in Southern California have been negatively affected by the "shadow market" supply of condominiums and homes available for rent. This will likely affect vacancy assumptions and the ability to grow rents. Other factors that will dog multifamily include interest rates and the availability and cost of mortgage financing.

### APARTMENT CAP RATES SLOW TO RISE IN SOUTHERN CALIFORNIA

Investors looking for bargain-basement prices in Southern California may be sitting on the sidelines for awhile. Between 2007 and 2008, the average cap rate is projected to rise from only 5.4% to 5.7%.



\* projected

Sources: CoStar, The Harris Group of Marcus & Millichap

With regard to interest rates, we anticipate that the Federal Reserve will continue to favor liquidity over inflation-fighting measures. Thus, we see short-term interest rates remaining at less than 6% over this period. While mortgage rates will also remain low, lenders have returned to fundamentals. Debt coverage ratios need to be 1.10 at a minimum, while loan to values range from 65% to 70%. Lenders have also begun to implement rate floors on quotes.

### How to get deals done?

For Kennedy Wilson Multifamily, the answer is to focus on infill transactions in submarkets such as Seattle and Koreatown in Los Angeles.

In the last year, Kennedy Wilson has purchased three properties from REITs that decided to move their profits to newer buildings that didn't require rehabilitation. In Seattle, where Kennedy Wilson has bought or contracted to buy more than 2,500 units in the past 24 months, we have focused on value-added opportunities at properties where the renters have low to moderate incomes.

We have achieved higher rents through careful repositioning of interior units, spending between \$6,000 and \$7,000 per unit, and upgrading property amenities to create lifestyle communities for moderate income working families.

We used bridge debt from GE Real Estate, Deutsche Bank, Fannie Mae and Wachovia Bank to capitalize our deals, along with equity from Japanese financial institutions. The latter are seeking higher yields in U.S. real estate investments with only moderate risk and yield expectations of 15% to 17% over three- to five-year holding periods.

By offering our partners a strong track record of sponsorship and vertical integration between regional assets and construction management, we can underwrite and execute value-added plays even in turbulent times.

Our best advice is to be flexible and realistic in establishing underwriting parameters and return requirements. Expect that equity partners will demand higher yields, leverage will be lower and rent growth assumptions will be more conservative. Capitalize deals with extra reserves because holding periods are likely to be longer than anticipated. Don't expect that everyone will look at your deal in the same way you do. Above all, be persistent and remain positive. ■



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