# Market Update

From the desk of Robert Fransen, *President*

TIMBERLAND PARTNERS INVESTMENTS

**Q1 2022**

## *Portfolio Valuations*

In the first quarter of the calendar year, we estimate the value of each of the properties in our portfolio. We review the prior year's financial statements as well as the budget for the current year. We apply appropriate metrics, primarily capitalization rates, prevalent in the current market to arrive at an estimated value. For those partners not active in real estate investing on a regular basis, the capitalization rate (cap rate) is the return an investor would receive if he or she paid all cash for a property (no debt). Assume a property produces $560,000 of net operating income and the market capitalization rate is 5.6%; the value of that property would be $10,000,000 ($560,000 divided by .056 equals $10,000,000).

Investor demand for apartments has increased quite significantly in the past 12 to 18 months resulting in cap rates dropping considerably, depending on a property's quality and location. This means the values of our properties have increased considerably since our last valuation in Q1 2021. Adding to the increase are rising rent levels and higher net operating incomes.

Last year, our average estimated cap rate across the portfolio for our valuation purposes was 5.6%. This year, the average across the portfolio was 4.95%, which is likely conservative based on the strong market conditions we are experiencing. In the example above, if the net operating income increased by 5% to $588,000 and market cap rates dropped to 4.95%, the value of the property would increase to $11,900,000, an increase of 19%. This example is typical of how values increased in the past year, at least on paper.

Using the same example, let's look at how debt can result in even more reasons for exuberance (you can decide whether any exuberance you feel is rational or irrational).

| | | | % Increase |
|---|---|---|---|
| **Value** | **$10,000,000** | **$11,900,000** | **19.0%** |
| **Less: Debt** | **$6,000,000** | **$6,000,000** | |
| **Equity** | **$4,000,000** | **5,900,000** | **47.5%** |

On average, we estimate the properties in the portfolio increased in value by 22.18%. But there was much variation, with our Twin Cities area properties much lower on average. Our downtown St. Paul property lost 6.41% of its value and our single Minneapolis property was flat. Some properties in Tennessee and Florida saw 50% increases (in part due to overly conservative estimates last year). In our 30-year history, this is clearly the largest average value increase we have seen in a given year and it will not continue. As interest rates increase, look for values to increase only as net operating incomes increase.

Some interesting facts regarding our overall portfolio valuation:

- **Portfolio Value Q1 2021: $2,333,956,000**
- **Combined Cost of Acquisitions*: $459,010,000**
- **Combined Price of Sales*: $103,950,000**
- **Average Percentage Increase in Property Value: 22.18%**
- **Portfolio Value Q1 2022: $3,188,240,000**
- **Debt: $1,746,335,000 (overall loan-to-value ratio is 54.8%)**
- **Equity: $1,441,905,000**

*Q1 2021 to Q2 2022

At an overall loan-to-value ratio of 54.8%, we are well positioned to take on any future economic headwinds.

## *2022 Forecast*

All indications are that 2022 will be a strong year, overall, in the apartment market. On the investor side, capital flows remain strong. Interest rates will likely increase somewhat, but debt remains readily available, and values will likely continue to increase but at a much more moderate rate than in the past year. On the operations side, demand remains strong with high occupancies and rising rents; however, there is a lot of new construction occurring which could be a concern in the future if the added supply coincides with an economic recession.

Some targets we set for the year are as follows:

- ***Maintain portfolio occupancy of 96% throughout the year***. Today we stand at 97.0%.

- ***Same-store sales growth of 8%.*** This reflects average revenue growth for our portfolio, excluding new acquisitions or properties under renovation. In January, our same-store sales growth was 11.07% above January 2021. For the year 2021, we achieved same-store sales growth of 5.29%.

- ***Maintain an average star rating of 4.3 or higher***. Reputation scores have become increasingly important to attract residents to our communities. Our portfolio-wide average star rating of our properties is now 4.4. The industry average is 3.9. In the past, we paid little if any attention to our "corporate" star ratings, thinking that we'd personally address issues when they came up. This was a mistake. People who had a complaint, often a resident or disgruntled employee, occasionally posted it online. People, including partners, who were happy told us so but didn't post it online. We're hoping to increase our corporate star rating to at least the same level as our site teams have achieved.

- ***Keep the average number of open positions to 25 or fewer***. This is a very ambitious goal in today's highly competitive labor market. It requires that our compensation package be attractive and our company culture strong and winning. A property's financial performance is highly dependent on positions being filled and a consistent on-site team. Twenty-five open positions represent about 5% of our workforce. Today, we have 27 open positions.

- ***Acquisitions and Development goals -*** We'd like to acquire 2,000 units this year, but that will be very dependent on availability of product as well as competition from other buyers. We don't want to overpay. Our development team would like to start four new projects in 2022.

## *Final Thoughts*

30 years ago, on February 7th, 1992, Timberland Partners was formed. Our only vision at the time was to turn our acquisition of the 46-unit Bronson Apartments in Mounds View, Minnesota into a profitable investment for my three partners and me. We succeeded. Little did I know on that day in 1992, when I plowed my life's savings into that venture, where it would lead. What an interesting and rewarding journey it has been.

We succeeded through 30 years of ups and downs, through terrorist attacks, wars, a great recession, and a pandemic. We succeeded through Republican and Democratic administrations. In 1992, George H.W. Bush, Sr. (Republican) was President, followed by eight years of Bill Clinton (Democrat), then eight years of George W. Bush (Republican - remember the hanging chads?), then eight years of Barack Obama (Democrat), four years of Donald Trump (Republican), and now Joe Biden (Democrat). It didn't seem to matter which party was in charge. We continued to build and to grow and to prosper.

Why, despite the ups and downs and changing political winds, were we able to continue to grow? Well, demographic tailwinds added to the demand for apartments and interest rates remained quite low through it all. And, we've certainly had our share of good luck – where the right people and the right ideas seemed to show up at just the right time. Some other thoughts:

- ***We specialized***. We fill a very fundamental need - quality rental housing. We found our lane and we focused on our race.

- ***We care***. We care about our partners, our team members, and our residents. You can find smarter people and companies in our business, maybe even some who work just as hard or harder. But you'll be hard-pressed to find a company that cares about its stakeholders more than we do.

- ***We have a vision***. It started small, but it kept growing and developing as our confidence developed and grew. Our vision attracted the high-quality team members we now have who go to work every day to create a better future. I'm very pleased with what this company has become, but I am not surprised.

In our first 30 years, no partner ever lost money investing with us. We've haven't always done as well with some of our investments as we thought we might, but no partner has ever lost principal. And we've never missed or been late on a mortgage payment.

From that first partnership of 46 units to the 19,511 units we have today, our first 30 years have been an incredibly rewarding experience. I'm grateful for every partner and team member that placed their trust in us and invested their time, talents, and money. Hopefully the feeling is mutual.

That's the beginning of our story. Wait until you see what the next 30 years bring.

Onward and upward,

Bob