TIMBERLAND PARTNERS
INVESTMENTS

Considerations for Underwriting Multifamily Investments

Introduction

Timberland Partners' three decades of experience investing in and managing multifamily apartment communities provides deep, proprietary data that informs our underwriting process. Instead of relying solely on third-party data, historical and real-time performance data collected across tens of thousands of apartment units and various market cycles help us more accurately forecast occupancy trends, operating expenses, and capital needs when evaluating new multifamily investments. This article outlines key considerations for underwriting multifamily investments, particularly for evaluating investment performance over the long-term.

Evaluating Investment Performance Under Varied Scenarios

Since real estate markets are cyclical and influenced by a variety of external factors, varied scenarios should be considered when projecting multifamily investment performance. For example, new competition or a recessionary environment might portend higher vacancy and slower rent growth. Modifying key assumptions like rent growth or cap rate expansion can help investors understand potential outcomes. The underwriting process includes a rigorous analysis of financial performance based on changing assumptions across different scenarios.

The base case scenario indicates the expected outcome, based on current market conditions, historical property performance, and most likely assumptions for rent growth, vacancy rates, and operating expenses. The upside case illustrates what might happen if market conditions or renovation efforts outperform expectations. The downside case, which could be considered most important for risk assessment, helps to "stress test" the impact of potential headwinds. These could include higher vacancy, flat or negative rent growth, above-trend expense growth, or cap rate expansion. Sensitivity analysis or changing one or two key variables at a time, can help investors understand the potential impact of market fluctuations and identify potential risks.

Base Scenario

- Average rent increases
- Typical vacancy rates
- Normalized operating expenses

Upside Scenario

- Higher rent increases due to demand
- Faster property appreciation
- Lower-than-expected vacancy

Downside Scenario

- Flat or negative rent growth
- Higher vacancy
- Significant cap rate expansion

Underwriting for Long-term Investment Performance

Sustainable Income Growth

The analysis should consider factors influencing income growth and the sustainability of those factors. Ideally, the property's income growth will be supported by solid fundamentals around household formation, a growing employment base, and constraints around future supply.

Capital Projects

Older properties will require more significant capital expenses. Roofs, HVAC systems, windows, and renovations are all expenses that will be necessary to the property's ability to attract and retain tenants. These expenses must either be capitalized at the time of acquisition, or budgeted for through future cash flow.

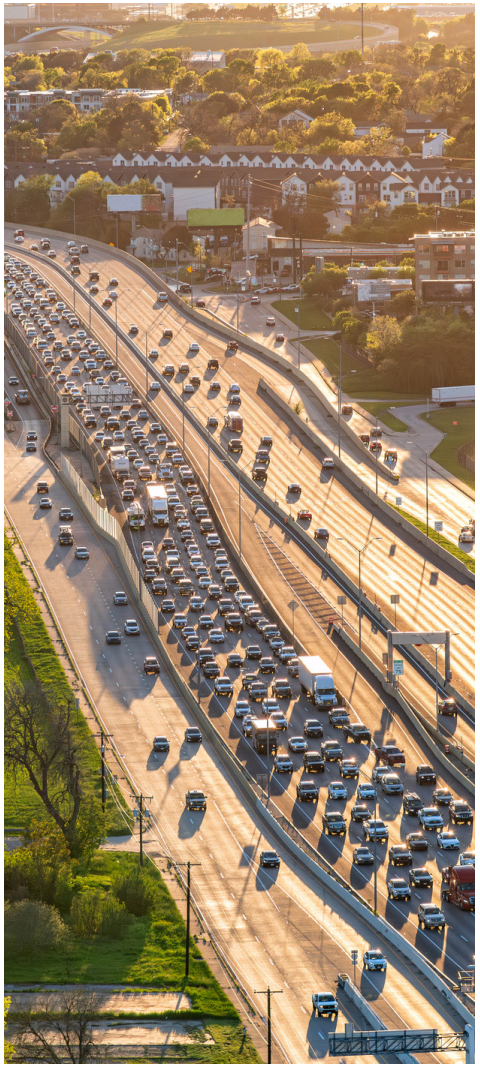
Exit Strategies

Even with a long-term hold, exit options such as refinancing or selling should be evaluated throughout the hold period in relation to interest rates and market cycles. The eventual "exit cap rate" is a key component of the overall return.

Assessing Market Risk and Competition

The performance of a multifamily property is inherently linked to the health of its physical surrounding market and competition from other properties. It is important to consider the macroeconomic conditions, demographic trends, and supply & demand fundamentals at play in the metropolitan statistical area (MSA) and within the local submarket. The diversification of the local economy and direction of job growth are key drivers of market risk. An economy with major employers diversified across industries with growing high-wage jobs poses less risk than an economy reliant on a single, stagnant industry. Population growth is another important consideration. Positive net migration and favorable trends such as an increase in educated young professionals will support demand for rental housing. The local and state regulatory environment, particularly rent control and eviction policies, should also be assessed as potential risks.

The submarket or specific neighborhood where the property is critical to long-term performance. In recent years, changes in perceived quality of life and crime rates have played a larger role in supply and demand dynamics between submarkets within the same MSA. The submarket's accessibility and amenities such as proximity to employment centers, transportation corridors, quality schools, parks, restaurants, and entertainment support strong demand and rental premiums. It's also important to evaluate current multifamily projects under construction, and zoning and land conditions that would allow for future development nearby.



Key Metrics Used in Multifamily Underwriting

"All models are wrong, but some are useful."

George Box, British Statistician

Underwriting not about estimating what will happen with an investment. It is fundamentally about understanding the range of potential outcomes given varied assumptions around future revenue, operating expenses, financing costs, capital requirements, and terminal valuations.

The metrics listed below are outputs from the financial cash flow model, and will change based on the assumptions in the model. Quality underwriting uses both realistic, and conservative assumptions.

Ultimately, investment managers seek to deliver the highest risk-adjusted returns, meaning the projected returns relative to the risk of the asset delivering the projected cash flow.

Key Metrics Used in Multifamily Underwriting

Net Operating Income (NOI)

A crucial profitability metric calculated by subtracting all operating expenses (excluding debt service and capital expenditures) from the EGI. It represents the property's income-generating capability.

$$\text{NOI} = \text{Effective Gross Income} - \text{Operating Expenses}$$

Capitalization Rate (Cap Rate)

A key metric for evaluating a property's potential return relative to its market value. It represents the unleveraged rate of return.

$$\text{Cap Rate} = \frac{\text{Net Operating Income}}{\text{Purchase Price or Market Value}}$$

Internal Rate of Return (IRR)

The discount rate at which the net present value of all cash flows from a particular project equals zero. It represents the total return expected over the investment period, considering both cash flow and the property's sale.

Occupancy Rate

The percentage of occupied units in a property. A higher occupancy rate generally indicates a more stable income stream.

$$\text{Occupancy Rate} = \frac{\text{Occupied Units}}{\text{Total Units}} \times 100\%$$

Key Metrics Used in Multifamily Underwriting

Equity Multiple

The total cash distributions received from an investment divided by the total equity invested. It indicates how many times the initial investment is returned.

$$\text{Equity Multiple} = \frac{\text{Total Cash Distributions}}{\text{Equity Contribution}}$$

Cash-on-Cash Return

The annual cash flow divided by the total cash invested, representing the percentage return on the investor's equity.

$$\text{Cash-on-Cash Return} = \frac{\text{Annual Pre-Tax Cash Flow}}{\text{Total Cash Invested}}$$

Debt Service Coverage Ratio (DSCR)

A measure of a property's ability to cover its debt obligations with its NOI. Lenders use this to assess loan risk; a DSCR greater than 1.0 indicates sufficient income to cover debt payments.

$$\text{DSCR} = \frac{\text{Net Operating Income}}{\text{Total Debt Service}}$$

Loan-to-Value (LTV) Ratio

The percentage of the property's value that is financed by a loan. A lower LTV generally indicates less lender risk.

$$\text{LTV} = \frac{\text{Loan Amount}}{\text{Property Value}} \times 100\%$$

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If you have any questions regarding this document,
please don't hesitate to contact us.

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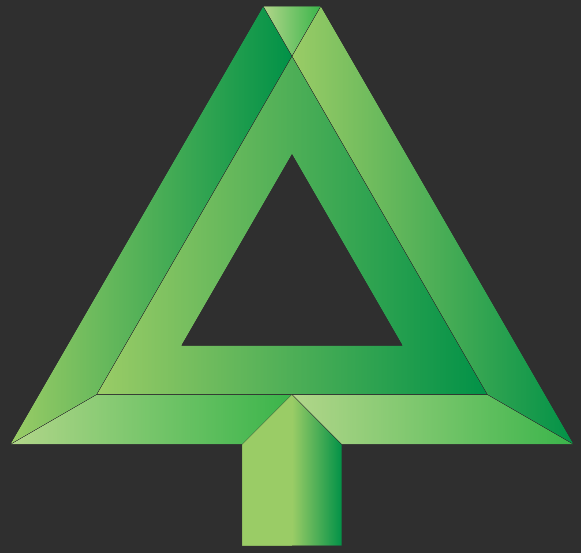
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