Challenges with Appraising in the Secondary/Tertiary Multifamily Rental Market

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Abstract

This article concerns the valuation of investment-grade and non-investment-grade apartments within secondary/tertiary markets. Despite access to increasing amounts of statistical data via the internet through national data sources, values still are primarily derived by local market activity. Outside information, however, can be supportive in some cases in valuation in secondary/tertiary markets. In this article, both local and national trends and patterns are analyzed to demonstrate how trending values and rates can be used to augment the typical valuation. Similarities and differences in local and national data are discussed as well as specific statistics. In the end, opinions of value can recognize both local and national indicators to better understand real estate values in local markets.

Introduction

The apartment market has been white-hot throughout most of the United States since 2010. The statistics are plentiful—from local newspapers, REITs, brokerage firms, accounting firms, and appraisal firms. Nationally, capitalization rates have steadily decreased and per-unit pricing has increased significantly. What is harder to quantify is the market activity in secondary/tertiary markets. Do non-primary markets parallel activity in major cities? And if so, what type of premium or discount is demanded from the market?

Appraisers may be faced with resolving such issues in a local appraisal assignment. For example, suppose an appraiser receives a call from Megga Bank about an appraisal that is needed as soon as possible. A local borrower has a 160-unit apartment complex under contract of sale and the only thing reportedly holding up the sale is the appraisal. The complex is one of the nicest buildings in the local market, and it is located in an area where most of the new commercial activity has occurred lately. The buyer has done his homework; he has gathered market studies and capitalization rates from the region, which point to a capitalization rate range just below 6%. Regional sales are as high as $185,000 per unit. With an indicated price of $190,000 per unit and a capitalization rate of 6.15%, the buyer believes he has a good deal. The bank wants to support this customer and asks the appraiser if he agrees with the buyer's evaluation of the property in this market. The banker asks the appraiser point blank, do you think this deal will fly? This is certainly not an easy question to answer, but it can be a considerably less daunting task with the proper data in hand. Keep in mind that it is not just the data itself, but the nuances that come with the data that are key to providing a meaningful answer to the client.

The national apartment market contains approximately 11.1 million units, with about 200,000 to 250,000 new units added annually.[1] Vacancy levels have remained at 4.5%+/– for several years, with rents increasing 3% to 5% per annum. However, according to the *Emerging Trends in Real Estate 2019* report,[2] vacancies could surpass 5% in the near future.

1. REIS, *3Q 2018 Apartment Report* (REIS Services, 2018).
2. Hugh F. Kelly et al., *Emerging Trends in Real Estate 2019* (Washington, DC: PwC and Urban Land Institute, September 2018), available at http://bit.ly/2019EmergingTrends.

In many larger cities, apartments are the most prevalent housing. Construction and demand have increased in markets but to different degrees. New single-family housing development has gone by the wayside in most urban and suburban markets, though recent hints of its return are evident. The millennials cohort has firmly established demand for upscale housing with uber-amenities, high walkability, and interconnected urban-chic housing in high-energy neighborhoods. This demand continues despite full employment with improving wages, which historically would have redirected young adults toward home ownership and the American dream.[3]

In the current real estate cycle, apartment construction peaked at 386,000 unit starts in 2015 nationally.[4] According to Dodge Data and Analytics, the volume of commercial and multifamily construction starts in the United States was approximately $200 billion annually from 2016 to 2018.[5]

At the same time, the apartment market is a solid investment relative to alternative investment vehicles. The multifamily sector remains popular, with about $153.0 billion in sales in 2017, ahead of the office sector at $132.3 billion in sales for the same year.[6] Only the industrial market of late has shown increased levels of transactions nationally (+22% according to Real Capital Analytics); all other real estate sectors have shown slight declines from peak levels. As the primary markets become saturated with new development, value-added activity, and investments, the secondary markets have seen increased investment activity.

Local and National Data Comparison

The appraisal of an apartment building was once confined to research on local comparables within the same metropolitan area. This task has been transformed, however, into a complex financial analysis. It has been supplanted with the never-ending gathering of new and improved information. Web-based national data sources—such as Reis, CoStar, and Real Capital Analytics—easily provide information that brings investment options in Dallas alongside those in Buffalo. Readily available national data provides another tool for the appraisal of a local apartment building.

Local Valuation

In terms of the local valuation of multifamily property, the analysis is both simple and complicated. Simply put, the national statistics are not directly applicable. Do they support trends in the property type and give direction of local indicators? Absolutely yes. Can they be directly applied to the local property? Absolutely not—a secondary/tertiary market has economic dynamics that do not compare to those of larger, more active markets.

The national overall capitalization rates summarized within surveys have varied as much as 235 basis points during the past two real estate cycles, while the local capitalization rates have varied by only 134 basis points. The national data reflects hundreds of sales and depicts a more detailed picture of the larger market. The local sales data has a more limited base, resulting in a more scattered representation. Clearly, the sales must be dissected individually to create credible comparisons. Those sales with similar-sized complexes and having similar ages, locations, and amenities must be investigated. A 50-unit complex built in the 1960s with a common boiler is obviously not comparable to a modern 200-unit project with pool, dog wash station, in-unit washer/dryer hookups, and individual HVAC units. Data representing average pricing typically includes all types of sales with such amenities; and the smaller the data sample, the greater the impact of a divergent sale.

Despite these differences, the urge to compare numbers is great, especially in the current envi-

3. Kelly et al., *Emerging Trends in Real Estate 2019*.

4. Bendix Anderson, "Apartment Construction Begins to Slow Down," National Real Estate Investor, October 30, 2018, available at http://bit.ly/2qy325G.

5. "Commercial and Multifamily Construction Starts in 2018 Showed Mixed Performance across Top Metropolitan Areas," Dodge Data and Analytics, February 12, 2019, available at http://bit.ly/2rqoE4k.

6. See *RCA Insights* for latest information on Real Capital Analytics apartment research, available at http://bit.ly/2CqZ29D.

ronment where investing in real estate has gone beyond trendy. Data comparison is critical to facilitate transactions. Although the data can be plentiful, the application can be complex. The vast majority of the data pertains simply to capitalization rates, which investors strongly rely upon. At the same time, appreciation has become not only investors' friend, but their crutch. National purchasers are rarely satisfied with current cash flow returns for the long term. Regardless, the combination of strong historical trends and appreciation and little recognition of irrational exuberance has become the norm in the current cycle.

Comparison of Capitalization Rate Data

The most common means of apartment valuation is the income capitalization approach to value. The Appraisal Institute describes the *income capitalization approach* as "specific appraisal techniques applied to develop a value indication for a property based on its earning capability and calculated by the capitalization of property income."[7] Investors are typically concerned with the future income potential of a property and the reliability of that income stream. Considerations include the durability, variability, and stability of the income. In addition to supply and demand, the analysis examines risk factors such as vacancy increases in the market, anticipated capital expenditures for the subject property, tenant turnover in the market compared to the subject property's history, changing tides of investors (both local and national), interest rate fluctuations, alternative property investments, economic conditions, and more.

The most common means of converting future benefits to present value is through the application of an overall capitalization rate. Therefore, appraisers need to be aware of the strengths and weaknesses of capitalization rate data and how to make optimal use of this information. To illustrate the similarities and differences seen in apartment sector data, a comparison was developed utilizing market-derived capitalization rates representative of Upstate New York and various national statistics, as shown in Exhibit 1 and Exhibit 1a.

In the exhibits, the national data from the Integra-Syracuse database includes hundreds of multifamily sales per year, exclusive of sales in major markets, such as New York City, Los Angeles, and Philadelphia. The sales span the 48 contiguous states. Sales with 30 or more units are included, with no exclusions based on age of building. Sales with subsidized or rent-controlled housing have been excluded to the extent possible.

The data from the national publications—PwC/Korpacz and *IRR Viewpoint*—focuses more on institutional-grade property. PwC/Korpacz and *IRR Viewpoint* (published by Integra Realty Resources) include data from the major markets that indicate higher pricing; the major market data tends to be superior to the local and national data that includes sales of smaller and older product.

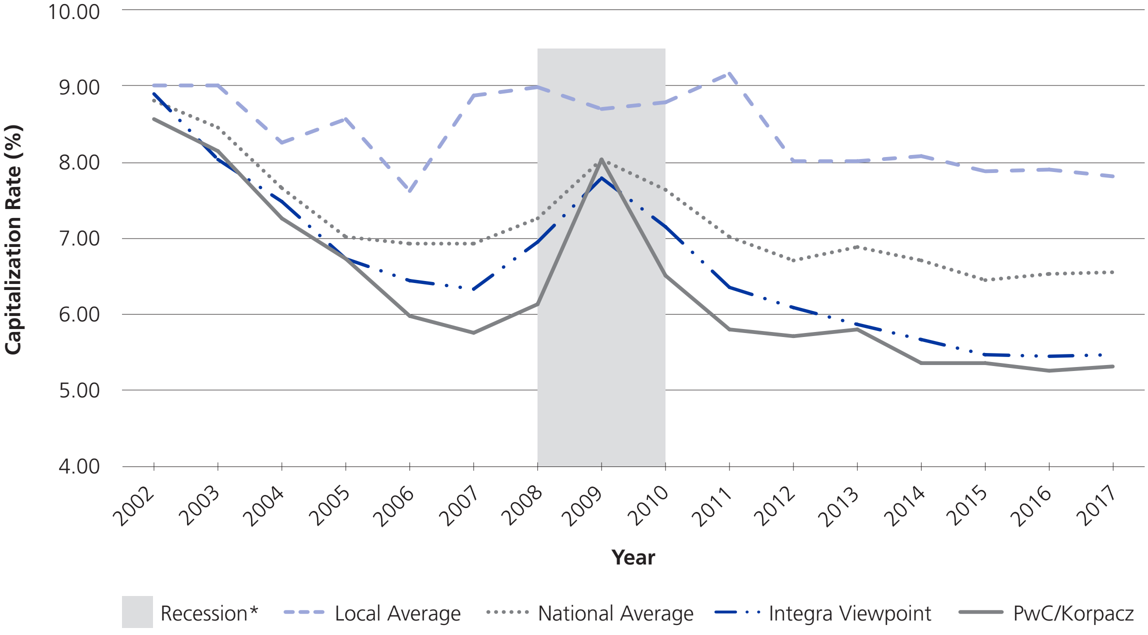
The local data from the Integra-Syracuse database includes dozens of sales per year within the Upstate New York market, inclusive of urban and suburban activity. (The Upstate New York market is loosely defined as that area outside of and north of the New York City metropolitan area.) Sales were found to be valid but were not all fully verified. The data is not represented to be comprehensive, but rather representative of market conditions from a uniform sampling.

As shown in Exhibit 1, capitalization rates in 2002 are fairly similar across the board, with a range from 8.56% to 9.00%, a variance of less than 5%. This period is well before apartment investment became trendy and billions of dollars were raised publicly for such investments. The exhibit also shows that only five years later the market had changed drastically, with a range of capitalization rates from 5.75% to 8.87% in 2007, a variance of over 50%. The range of rates demonstrates the tremendous amount of capital then being allocated to the apartment market sector. The real estate investment trust (REIT) market further reveals the growing interest in commercial real estate. From 2002 to 2006, US REITs grew from $161.9 billion to $438.1 billion,[8] or more than

7. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. "income capitalization approach."

8. Nareit, "U.S. REIT Industry Equity Market Cap," available at http://bit.ly/2Nt2Tt2.

Exhibit 1 Comparison of Local and National Capitalization Rates for Apartments



*Recession dates December 2007–June 2009, National Bureau of Economic Research, https://www.nber.org/cycles/sept2010.html

Source: Integra-Syracuse; Integra *IRR Viewpoint*; PwC/Korpacz Real Estate Investor Survey

Exhibit 1a Comparison of Local and National Capitalization Rates for Apartments—Data Summary

Year	PwC/Korpacz (%)	Integra Viewpoint (%)	National Average (%)	Local Average (%)
2002	8.56	8.90	8.80	9.00
2003	8.14	8.04	8.46	9.00
2004	7.25	7.49	7.66	8.25
2005	6.74	6.74	7.02	8.57
2006	5.97	6.44	6.94	7.62
2007	5.75	6.34	6.94	8.87
2008	6.13	6.95	7.25	8.99
2009	8.03	7.80	8.03	8.69
2010	6.51	7.14	7.63	8.79
2011	5.80	6.36	7.01	9.15
2012	5.72	6.08	6.71	8.01
2013	5.80	5.87	6.88	8.01
2014	5.36	5.67	6.70	8.08
2015	5.35	5.48	6.45	7.89
2016	5.26	5.45	6.54	7.90
2017	5.32	5.48	6.56	7.81

170%, representing one of the fastest-growing periods of real estate investments ever seen.

The data in the exhibits covers various economic cycles, highlighted by the recession of 2008–2009. Although the recession nationally is well depicted with the spike of capitalization rates in 2009, it is not as well defined within the data for the Upstate New York market, where the local reaction is depicted as delayed and muted. While the same trends are apparent locally and nationally, the timing is significantly different. Even the steadily declining capitalization rates from 2002 to 2007 are not as evident in this local market. While national rates dropped 186 basis points in this period, the local market dropped only 13 basis points, with variations in between. The differences between the national and local data continued post recession. Subsequent to the peak of rates in 2009, national capitalization rates dropped 147 basis points through 2017. The local market, however, dropped only 88 basis points, demonstrating similar patterns but different correlations based on the available information.

Also of note are the fluctuating local rates of return in contrast to the neatly ordered returns in the national data. The national data reflects the supply and demand factors of numerous national participants, with statistically more meaningful transactions. The national market is more homogeneous as a whole, with funds chasing relatively similar market conditions that result in similar returns.

The local data is an indication of actual transactions within a relatively small market that is far from standardized in terms of supply and demand or economic factors. (The number of local sales ranged from 12 to 45 per annum, while the national sales ranged from 200 to 500 annually.) Although the data presented cannot be considered conclusive within the market, it is certainly representative. In general, local product tends to be older, due to only a recent spurt of new construction. As might be expected, older projects require greater maintenance, repairs, and capital improvements. In many cases, the older apartments suffer from functional obsolescence, due to inefficient common areas, lack of individual utility meters, and dated design and appeal. Also, the older local data would tend to be inferior to the more-timely national data and therefore would tend to create more risk and uncertainty in a project. The data uncertainty explains, in part, the higher capitalization rates locally and, in turn, lower unit prices. The national market, in contrast, is more conventional and newer with less risk; this is demonstrated by the national market's quicker recovery after the recession.

It is also interesting to note that the range of overall rates created by the PwC survey ranged from 3.5% to 7.5% in 2017. The local sales' capitalization rates averaged 7.8% for the same period, which is well outside of the PwC range, indicating further disparity between the indicators from a national and local investor perspective.

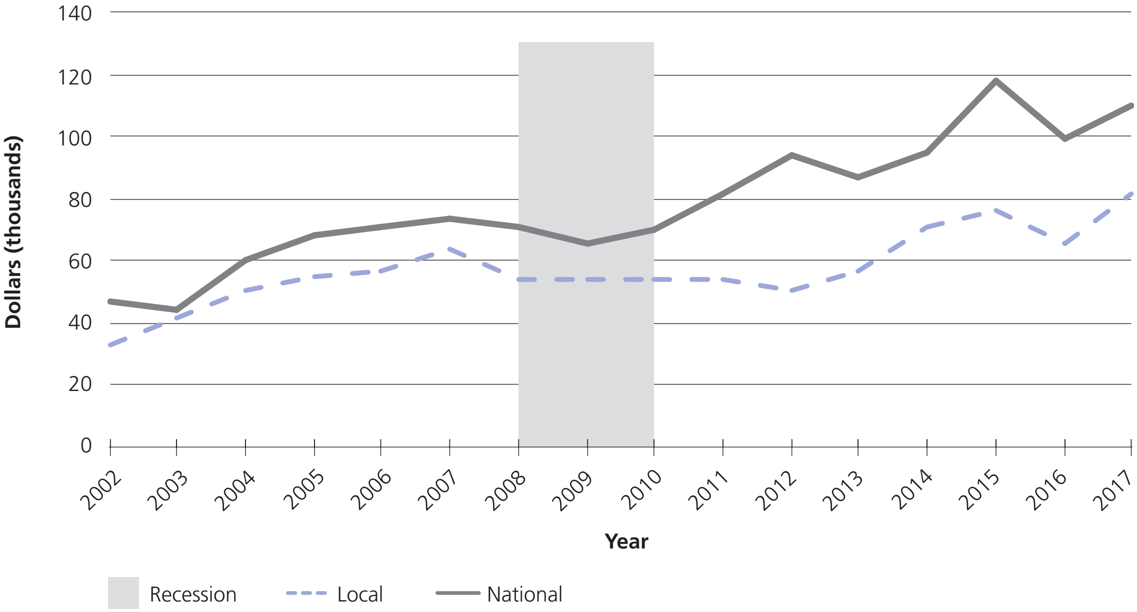
Comparison of Per-Unit Price Data

A comparison of per-unit pricing is presented next to further illustrate the differences in information garnered from national publications and from local data.

Summarized in Exhibit 2 and Exhibit 2a are average national apartment prices on a per-unit basis compared to average local market prices. In both sets of data, the general trend is upwards. The data is never fully adequate to explain all movements but is reasonable to depict trends. As with the previous comparison of capitalization rate data, there are concerns related to the more limited data set for the local sales as well as the differences of building types, ages, and conditions, but the trends are well in-line with one another. The clear takeaway again is that the local market responds in a more muted manner than the national market. Also, this data is raw and cannot be used for any type of direct comparison.

The initial pricing for all sales in the market in 2002–2003 indicates only a 22% difference between the national and local data; however, by the end of the period depicted, the difference increased to 43%, as shown in the 2016–2017 averages. The fundamental cause of the difference is supply and demand. In those areas where the income levels and job growth are below

Exhibit 2 Comparison of Local and National Average Price Per Unit for Apartments



Source: Integra-Syracuse

Exhibit 2a Comparison of Local and National Average Price Per Unit for Apartments—Data Summary

Year	Local ($)	National ($)	Difference ($)
2002	32,832	46,725	13,893
2003	41,296	44,037	2,741
2004	49,942	60,164	10,222
2005	54,362	68,048	13,686
2006	56,583	70,787	14,204
2007	64,112	73,297	9,185
2008	54,344	71,058	16,714
2009	53,960	65,864	11,904
2010	53,556	69,612	16,056
2011	54,009	81,311	27,302
2012	50,347	93,815	43,468
2013	56,144	86,717	30,573
2014	70,666	95,026	24,360
2015	76,416	118,104	41,688
2016	65,152	99,386	34,234
2017	81,101	109,919	28,818

average—such as the Upstate New York blue collar market—demand is more moderate. This caused the local market to improve more slowly than the fast-moving national market. Although the general trends are similar, the pricing in one market does not lend itself to direct application in the other market. Again, this can be attributed to a number of variables, including average age, condition, project amenities, rental rates, and size of the properties.

The 160-unit project postulated at the beginning of this article is under contract for $190,000 per unit, or $30,400,000. For that transaction, a 43% variation in per-unit pricing equates to a swing in value of approximately $13,072,000. As the difference in national and local sales widens, the room for error widens as well.

Comparison of Average Capitalization Rates and Ten-Year Treasuries

Capitalization rates can be summarized to provide value indicators. A *capitalization rate* is "the ratio of one year's net operating income provided by an asset to the value of the asset; used to convert income into value in the application of the income capitalization approach."[9] The current, historically cheap, financing is a national phenomenon that has positively affected markets. Buyers have been able to pay higher prices for real estate due to the low cost of capital. Per-unit apartment pricing has increased dramatically due to just this one factor, without consideration of any increases in apartment rents. Investors have been comfortable with this situation since 2002 until the recent upticks in rates. In Exhibit 3, ten-year Treasury bond rates have been summarized to give a broad indication of mortgage rates, and the graph shows a slightly erratic decline. The Treasury rate is also compared to national capitalization rates, where a more steady decline is demonstrated. Exhibit 3a shows the raw data used to develop the graph's trend lines.

In Exhibit 3, the graph shows that although the trends are similar, the Treasuries' movements are more erratic. From 2002 to 2017, Treasuries dropped 261 basis points, while national capitalization rates dropped a still substantial 224 basis points. More telling is that from the peak of the last real estate cycle in 2007 Treasuries dropped 233 basis points, while local capitalization rates, after fluctuating, dropped only 106 basis points.

The conundrum is with the local sales—why a drop of only 106 basis points, or less than one-half the drop in the national capitalization rates and Treasury rates? The obvious answer is, because that is what the market indicates. And ultimately, that is what every appraisal should do—reflect the market.

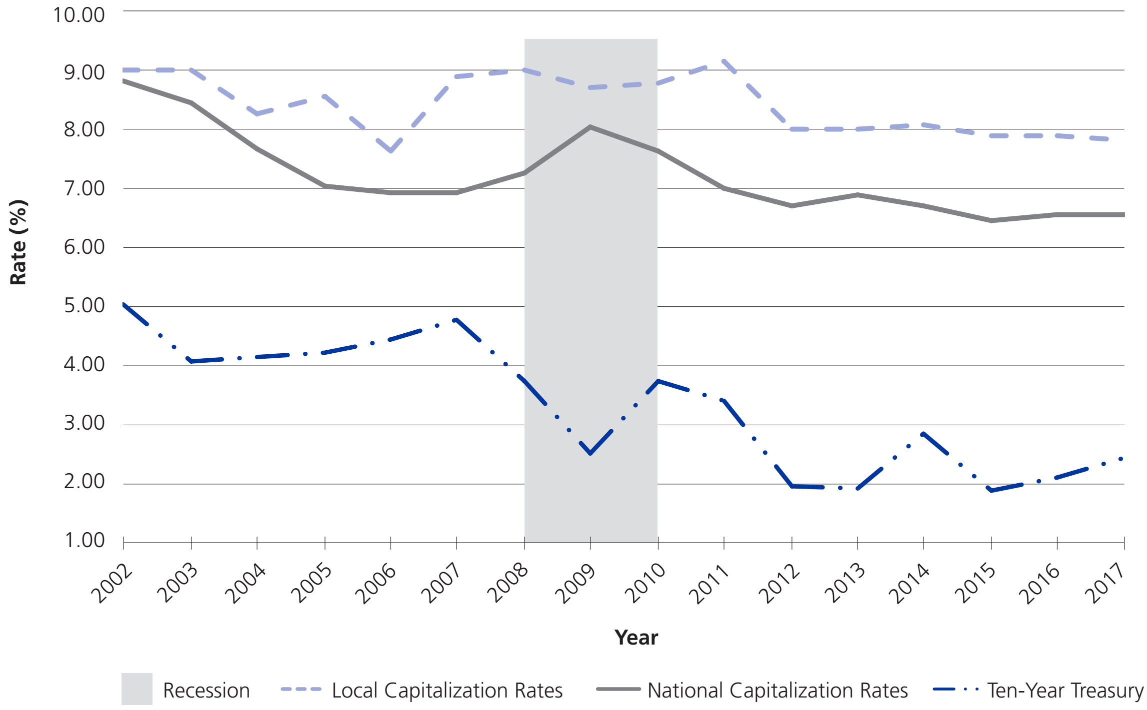
The more difficult explanation concerns the comparison with the larger, national market. The national statistics are more widely available and the starting point for potential valuation. If capitalization rates can be less than 6% in neighboring New Jersey, how much different can they be 200 miles away in Central New York? As it turns out, they can be very different. To fully understand the apparent discrepancies, one needs to look back further in the local market as well as the national market.

Overall capitalization rates in Central New York were historically higher in the years prior to 2002. The market was considered to be very soft. In a soft market, transactions are less frequent, more erratic, and harder to quantify. In fact, in Central New York prior to 2002 the overall capitalization rates were well into double digits. In such a market, the statistics become less meaningful and use of judgment becomes much more critical. This is the case in any market where change is significant or where there is a real weakness that is demonstrated by a lack of active market participants.

For the project postulated at the beginning of this article with a $30,400,000 contract, the difference in capitalization rates can be tremendous. Based on the 6.15% contract capitalization rate, the net operating income (NOI) is $1,869,600. A difference of only 25 basis points creates a value change of more than $1 million ($1,869,400 / 6.4% = $29,212,500), which may be enough to make or break the deal.

9. *The Dictionary of Real Estate Appraisal*, 6th ed., s.v., "capitalization rate."

Exhibit 3 Comparison of Local and National Average Apartment Capitalization Rates and Ten-Year Treasury Rates



Source: Integra-Syracuse; Federal Reserve

Exhibit 3a Comparison of Local and National Average Apartment Capitalization Rates and Ten-Year Treasury Rates—Data Summary

Year	Local Capitalization Rates (%)	National Capitalization Rates (%)	Ten-Year Treasury (%)
2002	9.00	8.80	5.04
2003	9.00	8.46	4.05
2004	8.25	7.66	4.15
2005	8.57	7.02	4.22
2006	7.62	6.94	4.42
2007	8.87	6.94	4.76
2008	8.99	7.25	3.74
2009	8.69	8.03	2.52
2010	8.79	7.63	3.73
2011	9.15	7.01	3.39
2012	8.01	6.71	1.97
2013	8.01	6.88	1.91
2014	8.08	6.70	2.86
2015	7.89	6.45	1.88
2016	7.90	6.54	2.09
2017	7.81	6.56	2.43

Economic Factors

The national and regional economies play an important role in most real estate purchases. As *The Appraisal of Real Estate*, fourteenth edition, states, "The economic health of a region depends on the status of its economic activity, which in turn encompasses the economic activities in individual areas and communities within the region's geographic boundaries."[10]

Population and employment trends tend to be the most critical in identifying the economic health of a market. While the national trends have been steadily positive, Upstate New York has seen steady declines in these indicators, which is also common to the Northeast region as a whole. Upstate New York's stagnant population growth reflects the slow population growth generally in the Northeast—the result of a simultaneous movement of jobs and people to the South and West regions of the United States. Over the past hundred years, there has been a gradual exodus of people from the densely populated Northeast, where population historically centered around a few key port cities.

More recently, the simultaneous shift of population and employment out of the Northeast has accelerated. People have been moving to locations that offer desirable amenities, such as a favorable climate, and to areas where employment opportunities abound. At the same time, employers have been moving to lower-cost areas and to locations with large and growing populations. As people pursue jobs and employers pursue workers, the population and employment forces have become intertwined and have gained momentum.

The loss of employment in the Northeast has, in part, tracked the fate of manufacturing, historically an extremely important source of jobs. In 1950, nearly 40% of the nation's manufacturing jobs were in the Northeast; today, only 20% of manufacturing jobs can be found there. The loss in manufacturing employment in New York has been greater than the national average; while US manufacturing employment fell by 24.3% from 2001 to 2017, in New York manufacturing fell by 36.5%.[11] Service sector employment that supports manufacturing, such as transportation and warehousing jobs, has followed suit.

This overly simple analysis provides enough evidence to demonstrate the significant difference in local markets and their divergence from the overall national scene. Drilling down further would reveal additional factors such as neighborhood trends, planned development, adjoining/neighboring properties, and a host of other considerations that can directly impact a property's value. Even within a regional market, pockets of growth may be readily evident as a result of nearby colleges, recreational centers, and developing businesses.

What Is the Value?

To answer the question of the banker who pointedly asks whether an investment transaction will fly, the appraiser should give a "maybe" or "possibly" or even "it is not out of the question." Without direct knowledge of the property and its historical financial statements, it is guesswork to provide a specific opinion of value at that point.

An alternative is to provide the client with market information that can assist it in evaluating value. The potential problem here is the same as the initial problem. The familiarity with the market—and in turn the specific data—can be limited. A property may fall into the very bottom of the market value range, where only certain comparable sales would apply. Conversely, the project may truly be superior to all of the buildings that sold and actually command rates that are beyond what the immediate data indicates. In those cases, a greater amount of judgment is required.

The example's apartment complex was described as one of the nicest and newest buildings in town, so it should command premium pricing. The difficulty in the valuation is to locate comparables that are truly comparable. This is no small feat when appraising in a suburban community such as this, which did not see new construction in earnest from the 1990s to 2010. Therefore, the analysis is a process of inclusion—with a wide net for ample information—and then exclusion

10. Appraisal Institute, *The Appraisal of Real Estate*, 14th ed., 102–103.

11. Ken Pokalsky, *Manufacturing by the Numbers* (Albany, NY: Public Policy Institute of New York State, November 2018), available at http://bit.ly/2X44qsY.

Exhibit 4 Summary of Comparable Apartments and Subject Market Data

Summary of Comparable Improved Sales								
No.	**Name/Address**	**Sale Date; Status**	**Yr. Built; # Stories; % Occ.**	**# Units; Rentable SF; Avg Unit SF**	**Effective Sale Price**	**$/Unit; $/SF**	**NOI/Unit; NOI/SF; Exp Ratio**	**Cap Rate**
1	Clare Court 313 Clare Court Upstate NY	1/8/18 Closed	2008 3 96%	144 135,993 944	$25,800,000	$179,167 $189.72	$10,079 $10.66 46%	5.62%
2	Betz Apartments 5589 Elizabeth Street Upstate NY	12/15/17 Closed	2016 3 100%	78 97,083 1,245	$14,500,000	$185,897 $149.36	$11,154 $8.96 48%	6.00%
3	TMK Mansions 103 Marie Lane Upstate NY	2/17/17 Closed	2016 2 95%	64 72,000 1,125	$7,500,000	$117,188 $104.17	$7,910 $7.03 N/A	6.75%
4	Bridgemar Landing 415 Bridgemar Road Upstate NY	4/15/16 Closed	2005 3 89%	220 277,049 1,259	$32,500,000	$147,727 $117.31	$8,734 $6.94 49%	5.91%
	Subject	Under Contract	2018 3 98%	160 198,400 1,240	$30,400,000	$190,000 $153.23	$11,685 $8.92	6.15%

of those sales that are not meaningful. To better understand the local market dynamics, a summary of local comparable sales is developed as well as a brief summary of the data for the subject property under contract (Exhibit 4).

As noted in Exhibit 4, the subject is newer than all the comparable sales, and it has an NOI per unit that exceeds the market range. The four listed comparable sales range from $117,188 to $185,897 per unit, averaging $157,495 prior to adjustments; the subject contract of sale is outside of this range. The indicated capitalization rates from the market bracket the subject's indicated capitalization rate of 6.15%, ranging from 5.62% to 6.75% and averaging 6.07%. The subject indicators are outside of, or at the top end of, the market's value indicators. It can be difficult to convince a client that such peak numbers are valid and within the realm of reason.

Data on newly built multifamily housing sales would be more representative value indicators for the subject. One problem is that these transactions were only a small portion of all the sales that could be included. With the number of sales reduced greatly, the fluctuation of pricing is more evident, and in turn, not as statistically meaningful. This data is still a valuable indicator of value in the market, however.

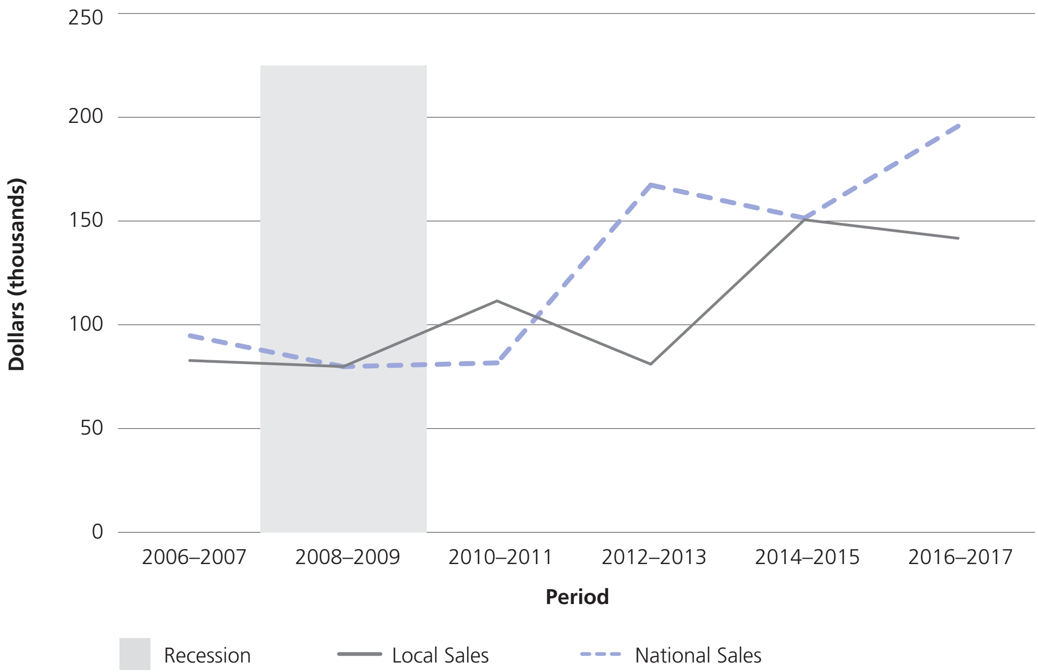
Comparison of Local and National Per-Unit Sale Prices for Newer Apartments

As previously mentioned, sales from larger primary/urban markets, such as Boston, New York, Chicago, and Los Angeles, were not included within the national sales data; in other words, the data reflects only sales from suburban/secondary markets. For the per-unit price sale analysis shown in Exhibit 5, only improved sales that were ten years old or less were included. For instance, in 2006–2007, sales of buildings that were constructed from 1996 to 2007 were included; and for 2016–2017, sales of buildings that were constructed from 2006 to 2017 were included. Due to the limited pool of sales in

Upstate New York, the comparable sales over two years were grouped together. Data from earlier years was nonconclusive for new multifamily construction in the market. This data is not presented as inclusive of all sales, but it was found to be representative of the market an appraiser might find available for an assignment.

In four of the six periods, the national sales data indicates higher per-unit pricing than the local sales and it predominantly represents the higher price bracket; nonetheless, the local sales trend in the same direction. Note should be made of the limited local data available for such an analysis. The number of local sales ranged from 1 to 8 per two-year period, while the national sales ranged from 40 to 110 per two-year period. The case can easily be made that the national sales from larger markets are reflective of value and/or value trends in the local market for newer product. In the absence of sales in the immediate local market, there is strong support for utilizing the parallel value trends to support conclusions.

Exhibit 5 Local and National Average Price Per Unit for Newer Apartments



Source: Integra-Syracuse

Exhibit 5a Local and National Average Price Per Unit for Newer Apartments—Data Summary

Period	Local Sales ($)	National Sales ($)
2006–2007	82,777	94,749
2008–2009	79,861	79,816
2010–2011	111,495	81,641
2012–2013	81,005	167,329
2014–2015	150,580	151,387
2016–2017	141,669	195,712

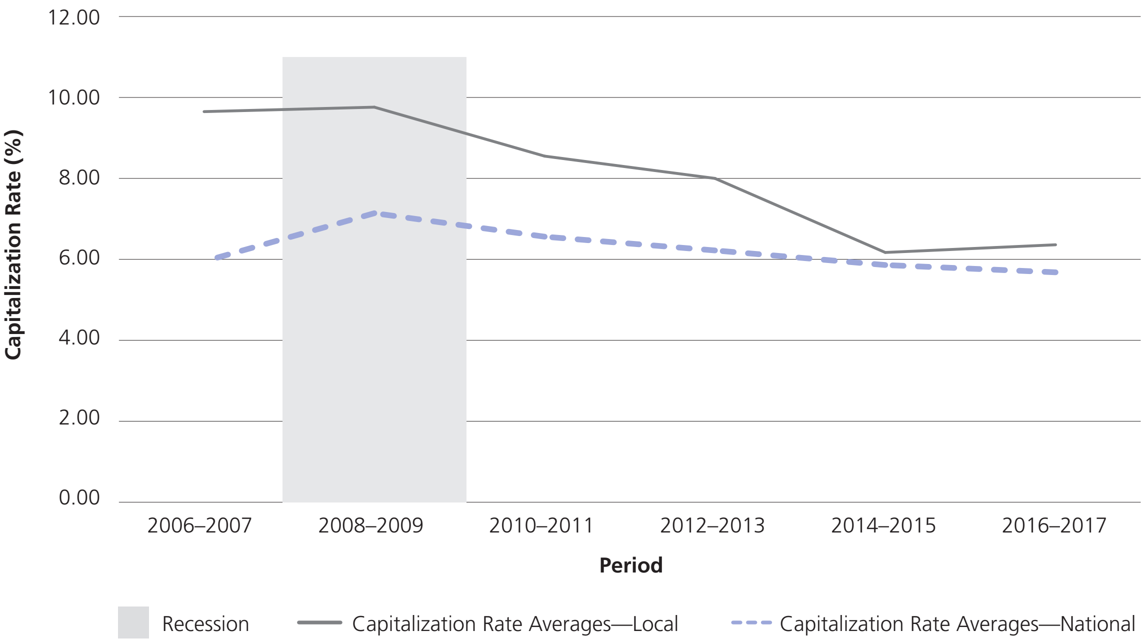
There is certainly greater risk in relying on 1 to 3 local sales; the national sales can give significant and direct support for value in such as case. Note, it is not just the fact that the national sales buildings are newer; they are also more similar to the subject than those in the "all apartment sales" database in terms of condition, unit sizes, rent levels, and even project size.

In smaller markets, without ample sales, additional information from outside of the market is obviously needed. Options for supplementary data include information on national averages of similar product or sales from similar markets/economies outside of the subject market. In the end, greater reliance is likely to be placed on fewer sales than some would prefer.

Comparison of Local and National Capitalization Rates for Newer Apartments

The historical capitalization rates from the markets offer a glimpse of changing investor patterns. Bifurcated local and national capitalization

Exhibit 6 Comparison of Local and National Capitalization Rates for Newer Apartments



Source: Integra-Syracuse

Exhibit 6a Comparison of Local and National Capitalization Rates for Newer Apartments—Data Summary

Period	Capitalization Rate Averages—Local (%)	Capitalization Rate Averages—National (%)
2006–2007	9.65	5.95
2008–2009	9.76	7.14
2010–2011	8.55	6.56
2012–2013	8.00	6.22
2014–2015	6.17	5.86
2016–2017	6.36	5.68

rates slowly converged (Exhibit 6) as pricing in the multifamily sector escalated and investors who were priced out of primary markets sought higher returns in secondary or tertiary markets. Capitalization rates in the local markets dropped to the levels seen in the bigger markets as competition increased. Until there is a market change, this trend is expected to persist as investors continue to seek higher returns. For example, GlobeSt.com has reported, "In 2016, almost half of our survey respondents saw the greatest opportunities going forward in urban markets, but this number dropped in our next two surveys to around 20 percent. During the same period, those seeing the greatest opportunities in secondary and tertiary markets rose from 20 percent to 40 percent."[12]

As the larger market moves, so moves the local market; the national capitalization rates can provide direct or indirect support for a local valuation, as shown in Exhibit 6. Since the Great Recession, there has been a strong market for multifamily properties. Prices have continued to increase in the face of ample demand and a dearth of product. Capitalization rates have compressed in most markets to where risk premiums are mitigated to the point where Class A and Class B properties might be viewed the same. But as the economic cycle plays out and interest rates increase, there will be upward pressure on capitalization rates, and investors will at some point return to greater discretion in the market. Until then, the appraiser can merely reflect the market.

Case Study Conclusion

Market change is constant; appraisers need to be students of the market. Market contradictions will forever face appraisers and investors. Reportedly, $266 billion of private investor "dry powder" is targeting real estate, increasing expectations that both debt and equity capital will become oversupplied.[13] Conversely, decelerating transaction volume has been in place since 2015 and investors report the highest level of "sell" interest since 2006. Given the differing signals, the question of whether the market will strengthen or weaken is not simple to answer.

In our example involving Megga Bank's potential loan, the appraiser should apply the indicators from the market as best, and as carefully, as possible. Does the bank have a great deal with a value of $190,000 per unit based on a capitalization rate of 6.15%? Only through additional due diligence can that be determined. The appraiser can provide support for the value parameters that apply to this deal. Yes, the given numbers are not out of line with the market and could be a market transaction that is typical. The national data bolsters the local data, because there are more transactions, and the transactions are generally more similar to the subject. While the $190,000 per-unit pricing appears to exceed the local market range, in fact it is actually below the national average for the 2016–2017 period. The indicated capitalization rate of 6.15% is below the average within the local market but is actually above the average of the national data.

Summary

While the national apartment market is widely recognized as having been extremely strong, there can be risk in applying overall trends to individual properties. However, trends and values based on similar attributes can in fact prove helpful in valuing a building where local comparable sales are wanting, either from a smaller market size or the uniqueness the subject property in the specific market.

Low interest rates have stimulated the multifamily market, but the positive effects can vary drastically from one location to another. Capitalization rates for newer multifamily housing have compressed in a uniform manner nationally, but that may not be the case locally. In the early 2000s, the market showed signs of uniformity; greater fluctuations and variations are now evident locally and are harder to quantify. In the fight for continued higher returns over the past ten years, investors have turned to the secondary markets. Without question, the valuation issues are best addressed by local information. If the local market is thin, regional and then national

12. Brian Sykes, "Where Multifamily Investors Are Seeking Opportunities," GlobeSt.com, January15, 2019, available at http://bit.ly/2NCOPx9.

13. Kelly et al., *Emerging Trends in Real Estate 2019*.

market information can be relied upon in some instances. The answers to the questions in the market are derived from direct involvement with a number of transactions to determine the appropriate tool or tools to apply to a specific property. Overall capitalization rates are heavily relied upon by investors, as discussed in this article. However, the judgment and experience of the local appraiser is always critical to the outcome of the analysis.

About the Author

William J. Kimball, MAI, is senior managing director of Integra Realty Resources–Syracuse, which is part of one of the largest national appraisal groups in the United States. With Integra, he has been involved with challenging portfolio transactions, including apartment complexes. Kimball was previously vice president within the Manhattan-based banking industry. He has been engaged with appraising all types of institutional-grade real estate in the New York region for over thirty years. Kimball is past president of the Upstate New York Chapter of the Appraisal Institute. He has previously published articles with *The Appraisal Journal* and the Urban Land Institute. He is a graduate of the University of Connecticut, where he majored in finance/real estate. **Contact: wkimball@irr.com**

Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

- **Education**
- **Lum Library External Resources Knowledge Base [Login required]**
  - Information Files—Economic data
  - Information Files—Residential properties
- **Professional Practice**

Builder Online—Local housing data
https://www.builderonline.com/local-housing-data

CoreLogic Insights—Perspectives on housing economies and property markets
https://www.corelogic.com/insights-index.aspx

Federal Reserve of St. Louis

- **Economic Research Publications**
  https://research.stlouisfed.org/publications/
- **FRED Economic Data**
  https://fred.stlouisfed.org/

National Association of Home Builders—Housing economics
https://www.nahb.org/research/housing-economics.aspx

National Real Estate Investor—Multifamily property news, information, and analysis
https://www.nreionline.com/multifamily

US Census Bureau Center for Economic Studies—Research
https://www.census.gov/programs-surveys/ces/research.html