NM Apartment Advisors Client Update September 2022

OR Why the IRR (Internal Rate of Return) is the measure to track

Market Dashboard

Craigslist Avg. rent	$1,083
Fourplex appreciation 2021	30.6%
Fourplex appreciation YTD 2022	12.6%
# of active investors in market	1,647
Increase in investor interest since 1st week of pandemic	507%

"Many of the sophisticated out of state buyers we are representing currently aren't as concerned with rising interest rates. Instead, they're focused on the high level of demand, massive rent growth, and long term appreciation"

-Kyle Deacon

What is the impact of interest rate increases on apartment investments?

NM Apartment Advisors - impact of interest rates on IRR model

v7 - 8/27/2022

Assumptions:

Going in CAP rate	5.00%	
Exit Cap rate	5.00%	
Net Rents	$50,000	
Net Rent increase	3.50%	
Price		$1,000,000
Down Payment	25%	$250,000
Loan Amount	75%	$750,000
Loan Amortization	30	
Cost Recovery Improvement Allocation	80.00%	
Cost Recovery Time period	27.50	
Federal Income Tax Rate	35.00%	
Cost Recovery Tax Rate	25.00%	
Capital Gains Tax Rate	20.00%	

Before Tax IRR

	100% cash		Loan at 3.00%		Loan at 3.50%		Loan at 4.00%		Loan at 4.50%		Loan at 5.00%		Loan at 5.50%		Loan at 6.00%	
	n	$	n	$	n	$	n	$	n	$	n	$	n	$	n	$
Down paymen	0	-$1,000,000	0	-$250,000	0	-$250,000	0	-$250,000	0	-$250,000	0	-$250,000	0	-$250,000	0	-$250,000
Cash flow	1	$50,000	1	$12,056	1	$9,586	1	$7,033	1	$4,398	1	$1,686	1	-$1,101	1	-$3,960
Cash flow	2	$51,750	2	$13,806	2	$11,336	2	$8,783	2	$6,148	2	$3,436	2	$649	2	-$2,210
Cash flow	3	$53,561	3	$15,617	3	$13,147	3	$10,594	3	$7,960	3	$5,247	3	$2,460	3	-$398
Cash flow	4	$55,436	4	$17,492	4	$15,022	4	$12,469	4	$9,834	4	$7,122	4	$4,335	4	$1,476
Cash flow + S:	5	$1,245,062	5	$540,320	5	$531,920	5	$523,739	5	$515,776	5	$508,033	5	$500,507	5	$493,195
IRR =		**8.50%**		**20.44%**		**19.43%**		**18.40%**		**17.36%**		**16.30%**		**15.23%**		**14.14%**
Delta/Change in IRR						4.94%		5.29%		5.67%		6.10%		6.58%		7.13%

After Tax IRR

	100% cash		Loan at 3.00%		Loan at 3.50%		Loan at 4.00%		Loan at 4.50%		Loan at 5.00%		Loan at 5.50%		Loan at 6.00%	
	n	$	n	$	n	$	n	$	n	$	n	$	n	$	n	$
Down paymen	0	-$1,000,000	0	-$250,000	0	-$250,000	0	-$250,000	0	-$250,000	0	-$250,000	0	-$250,000	0	-$250,000
Cash flow	1	$42,682	1	$12,056	1	$9,586	1	$7,033	1	$4,398	1	$1,686	1	-$1,101	1	-$3,960
Cash flow	2	$43,819	2	$13,508	2	$11,336	2	$8,783	2	$6,148	2	$3,436	2	$649	2	-$2,210
Cash flow	3	$44,997	3	$14,514	3	$13,147	3	$10,594	3	$7,960	3	$5,247	3	$2,460	3	-$398
Cash flow	4	$46,215	4	$15,555	4	$14,351	4	$12,469	4	$9,834	4	$7,122	4	$4,335	4	$1,476
Cash flow + Sales Proceeds	5	$1,161,262	5	$463,622	5	$456,471	5	$449,553	5	$441,876	5	$434,132	5	$426,606	5	$419,294
IRR =		**6.49%**		**16.90%**		**16.04%**		**15.03%**		**13.93%**		**12.80%**		**11.65%**		**10.48%**
Delta/Change in IRR						5.10%		6.25%		7.34%		8.14%		8.98%		9.99%
Investors Effective Tax Rate =		23.67%		17.32%		17.46%		18.30%		19.74%		21.48%		23.50%		25.87%

I spend a lot of my day on the phone with investors, as an ambassador to our market and a recruiter who wants them to come here and do well.

Recently, Many of these investors want to make a comparison between cap rate comparisons to interest rates with the idea that it will lead to decreasing property values. I share with them we are having the wrong conversation. For most sophisticated investors the conversation is all about **financial leverage** and for **commercial real estate, tax re/deduction.**

With the Federal Reserve working hard to tame inflation, interest rates have been on a continual uphill increase that is likely to remain on that path through the balance of 2023.

This has led to an increase in vulture investors who call me indicating that my sellers will now need to decrease their offering prices.

My response to them is simple:

1. Capitalization (Cap) rates have limited to no correlation to Interest rates.
2. Pricing, whether it's rent pricing, or sales pricing is determined by the supply of investments and demand level of investors.
3. During the last year, the market has experienced 18-24% annual rent growth (18%- all residents, 24%-lifestyle residents),
4. The expansion of employment in the Albuquerque area is unparalleled in the last 30 years with all of the new Netflix, Amazon, Facebook/Meta, Intel and other jobs creating a rental housing shortage of over 14,000 units
5. Today, the number of investors far outstrips the level of sellers/listings, many of them are chasing 1031 exchanges, and a substantial number of those are all cash transactions.
6. While appraisers will use a band of investment methodology to determine a cap rate, this process is generally only used when there is a lack of comparable sales indicating a

CCIM Investment Definitions

ACTION!
ULI NM is hosting a housing conference on 9/16/2022 at 11am to develop solutions for the acute housing shortage.

Lunch is include. Come prepared to break into teams to help community leaders develop solutions.

Register at www.nmapartment.com/housingshortage

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market cap rate.

7. The correct comparison for interest rates st not cap rates, but rather internal rates of return.
8. Those investors who bought in the last couple of years have a current competitive advantage in having secured vastly below market interest rates.
9. Those investors who invest today, will also have a competitive advantage against an investor a few months from now who acquires with even higher interest rates.
10. Market values are set by the intersection of number of buyers and number of listings on a demand/supply curve. (I was recently at CCIM instructor training and one of our consultants is Dr. Glenn Mueller. In addition to being an instructor at Denver University, he advise CCIM, Stewart Title he advises institutional investors as well as large family held investment funds. At our training session, he confirmed that from a long term perspective interest rates are low and that market values are not determined by interest rates, but by the number of buyers and sellers in the market place at any given point in time.

Knowing this, NM Apartment Advisors developed the IRR to interest rate comparison table spreadsheet that is summarized on the proceeding page. This is also available with a video at www.nmapartment.com/IRR .

This table demonstrates a fictional investment of $1,000,000, with a going in and exit cap rate of 5.0% and compares the before and after tax rate of returns for an all cash, or financed transactions. The financed transaction demonstrates the investors yield, or **IRR** based on interest rates ranging from 3.0% to 6.0%. As you can see, if an investor is motivated by the overall yield from cash flow and appreciation, the after tax IRR ranging from 10.48% to as high as 16.90% is very attractive. In all circumstances, the investor is better off using financing to obtain a higher level of tax advantages (i.e. mortgage interest deduction, cost recovery/depreciation, and a multiplier effect on their level of equity).

What other American investment could you make where you can decrease your effective tax rate from the top federal rate of 35.0% to something in the range of 17.46% to 25.8% and still have an attractive return on your investment?

What this means for the short term cash flow investors is that they will continue to lose out on deals against the long term investors chasing rent growth, appreciation and tax benefits.

Additional thoughts on increasing interest rates include:

1. It does not matter where the market was, it matters where it is going;
2. Current competitive advantage;
3. Increasing rates furthers that competitive advantage;
4. Increasing rates means fewer residents move into single family housing;
5. Increasing rates means single family housing is even more expensive;
6. The inflation index includes rent levels;
7. While interest rate increases have slowed the refinance market, it has helped the all cash investor;
8. Most of the inflation causes related to the global pandemic, supply chain issues and unparalleled increases in American savings accounts related to the stimulus.

Knowing the above, we remain excited about the market, its potential and are putting our money into action by expanding our own personal investment portfolio of rental properties.

Thanks,

Todd Clarke
CEO
NM Apartment Advisors Inc.

Definitions from the CCIM 104 textbook:

Cap Rate and return on investment:
While calculation of the cap rate is relatively quick and simple, investors should know and recognize some important assumptions implicit in the calculation. A common misconception when using the term cap rate is that some investors assume the overall cap rate to be equal to the return on their invested capital. This rarely is the case.

IRR = Internal Rate of Return
The IRR for an investment is the percentage rate earned on each dollar invested for each period it is invested. IRR is another term for interest, or i. IRR gives an investor the means to compare alternative investments based on their yield. IRR isolates the return on the portion of the total amount of money received from the investment over the holding period. To have a return on investment, dollars received must exceed dollars put into the investment. This return on rate depends on both the amount of the excess and when the excess is received.—CCIM Institute (104 textbook)

The effective tax rate is a measure of reduction in yield due to federal taxation. In real estate this rate is usually lower than the investor's ordinary income tax bracket due to the benefit of cost recovery and the lower capital gain tax rates.

Financial Leverage:
Financial leverage measures the degree to which debt is used to finance an investment. This usually is done by investors in an attempt to increase their expected return on equity. As leverage increases, the investor is using more debt relative to equity.

Leverage can be favorable, neutral, or unfavorable. When leverage is favorable (positive), investors expect a higher return on equity than if they purchased the investment on an all-cash basis. When leverage is unfavorable (negative), investors expect to receive a lower return on equity than if they had paid all cash. Neutral leverage exists when the expected unleveraged internal rate of return (IRR) on the property (i.e., all cash) is equal to the cost of debt.

Thus, the IRR on the equity equals the IRR on the property. In such a situation, both the investor and the lender expect to receive the same rate of return.