



Investment Recommendation – The Lyric (215 10th Ave E)

We recommend **AGAINST** acquiring The Lyric for \$120 million because we do not believe it is likely to generate a 10% IRR over the next 10 years. Even if rent and expenses rise at 3% per year, with the vacancy / collection loss allowance remaining at 5%, we will not earn a 10% IRR. If there is a decline followed by a recovery – likely, based on the market data – the numbers look even worse.

We are also skeptical that a 70% LTV Ratio can be used because the Debt Service Coverage Ratio (DSCR) drops below 1x in the downside cases; and using less debt will further reduce the IRR and cash-on-cash multiples. The valuation indicates that the property is worth closer to \$100 million. At a \$100 million asking price, it would be significantly easier to achieve a 10% IRR, so we would only recommend the acquisition if the price were closer to \$100 million.

Qualitative / Market Factors

The Seattle metropolitan area and the Urban King / Capitol Hill submarkets are promising regions for multifamily developments. For example, the median household income is 35% higher than the national figure, the unemployment rate is 30% lower, and almost 50,000 new jobs were added in the past year.

Cap Rates have also fallen substantially (5.8% in 2009 vs. 4.5% in 2014), and the average rent per apartment unit has risen from \$1,400 in 2010 to \$1,800 in 2014. The two biggest employers in the region, Microsoft and Amazon, have been expanding rapidly and have added tens of thousands of new employees over the past five years.

However, we believe the market is also ripe for a downturn within the next five years. Cap Rates, currently at 4.5%, have never fallen below 4.5% in the past 15 years, and the number of apartment unit deliveries in the next five years exceeds the number over the past 20+ years. There are 90 planned or permitted projects near The Lyric, many of which will offer similar or better amenities. Also, completions are set to exceed absorptions over the next five years in the Urban King area. The most likely scenarios are a decline in Years 1 – 3 followed by a recovery, or a decline and recovery in Year 3 – 8.

IRR, NPV, Cash-on-Cash Multiples, and Valuation

By any metric, the property seems unlikely to yield the returns we are targeting. In the Base Case, with rent and expenses increasing by 3% per year, TIs, LCs, and CapEx increasing by 2% per year, and a 5.5% Going-Out Cap Rate after ten years (vs. a 4.6% Going-In Cap Rate), the Leveraged IRR is 6.5% and the Unleveraged IRR is 5.1%. The NPV is negative in both cases, with discount rates of 10.0% and 5.8%, respectively.

We believe a 70% LTV Ratio is also too aggressive since the DSCR falls below 1.2x, even in this Base Case. At a 50% or 60% LTV, the IRR falls to 6% or less. Exiting the investment earlier would reduce the IRR in this Base Case, so that is not an option.



In another case, a Decline in Years 1 – 3 with the Vacancy / Collection Loss Allowance rising to 9%, Rents falling by 2-3%, and higher spending on TIs and LCs, followed by a Recovery in Years 4 – 7, the numbers look even worse: a 3-4% IRR and an implied property value of \$100 million via the DCF analysis.

Finally, in the third case, High Growth in Years 1 and 2 followed by a Decline in Years 3 – 5 and a Recovery in Years 7 – 8, the IRR is 3-4% with a ~\$100 million implied property value from the DCF.

In none of these cases does a 2x cash-on-cash multiple seem likely; the multiples are 1.2x – 1.4x in the second and third cases, and up to 1.85x in the first case. Apartment sale comps indicate a valuation in the \$90 – \$100 million range when measured on a \$ per unit or \$ per SF basis, though Cap Rates produce values closer to \$120 million.

What Would Make the Deal Work?

If there were not so much apartment oversupply, or if we had more faith that rents would rise at 6-7% before declining back down to 3% growth, the IRR would exceed 10%. Alternatively, if the asking price were closer to \$100 million, the deal would be more feasible.

A renovation or other enhancement to the property, such as converting 2-BR units into studios or 1-BR units, might also reduce the risk of higher vacancy rates and declining rents. Finally, if we were contemplating this deal 2-3 years ago right after the property had been developed, the acquisition would have made more sense.

Conclusion

In short, the acquisition is unlikely to result in a 10% IRR under plausible scenarios. To achieve a 10% IRR, Cap Rates would have to fall even further, rents would have to grow at a 6-7% clip, or the vacancy rate would have to decline, all of which are unlikely. Furthermore, the market data indicates a high chance of a rent decline and a vacancy rate increase within the next ten years, in part due to apartment oversupply in the region.

Additional Information

We addressed questions #1 and #2 above. The key downside risks include the vacancy rate rising to the 7-9% historical high, Cap Rates increasing to the ~6% level, and the vast new supply of apartment units making The Lyric less competitive. We could hedge against these risks with longer-term contracts to incentivize tenants, a renovation or other value-added strategy, or by cutting operating costs.

We would perform additional due diligence on completion and absorption data by region, demographic data such as median per capita income, anticipated future hiring by major employers in the area, and the property's historical financial performance going back to 2012.