

Large-Cap Multifamily REITs: Diversified, Antifragile, High Cap Rate

Bill Chen of Rhizome Partners presented his investment thesis on large-cap multifamily REITs, highlighting Mid-America Apartment Communities (US: MAA) and Camden Property Trust (US: CPT) at Best Ideas 2024.

The following transcript has been edited for space and clarity.

Bill Chen: This is my fourth time presenting for MOI Global. What I have for you today is a little different. In the past, I have tended to present smaller companies with less liquidity. I think large-cap multifamily REITs – particularly the Sunbelts – offer the best risk-adjusted returns going forward.

Let me start by providing a brief update on some of our past ideas. In 2017, I presented LAACO, which was a very quirky company. It was a self-storage company in an MLP structure, very thinly traded. When I presented it, the stock price was about \$2,200 or \$2,300. It got bought out by a larger public REIT called CubeSmart for \$9,800-plus. There was about \$400 dividends in a roughly four-year period. That one resulted in about 47% IRR and 4.5 times MOIC. For this exercise, we use VNQ (the Vanguard Real Estate Index Fund) as a benchmark – roughly 41.2% alpha there.

INDUS Realty Trust, formerly known as Griffin, is a warehouse company trading at about 9% cap rate when we presented it in late 2019. It got bought out by CenterBridge, backed by the government of Singapore, for \$67. We presented it when it was around \$40. INDUS brought us about \$3.47 in dividends. That's about 1.74 times MOIC and about 18% IRR. The stock reached about \$80 in late 2021, and one of our shareholders essentially asked for the company to be bought out.

At the Wide Moat Conference in 2021, we presented FRP Holdings, which has multifamily holdings in Washington, DC. The idea is up about 9% since then, but the index we measure ourselves against is down about 9%. There is a 7% annual alpha in that idea. We think FRP Holdings is still trading at 60 cents on the dollar. There's a lot of upside from that gap closing, but the company is doing an excellent job growing the NAV 9% to 10% a year. That's still highly attractive.

This year, we are very excited about large-cap multifamily REITs. This will not be the highest absolute upside, but I think it is the best risk-adjusted return. What's also different this time is that we're presenting two ideas – Mid-America Apartments (MAA) and Camden Property Trust. They have very low leverage – 21% to 26% loan to value versus 50% to 80% on the private side. They will likely buy distressed assets in the cycle. These companies are highly diversified and very anti-fragile. Also, they pay a nice 4.5% dividend right now.

I'd like to provide a bit of a backdrop. I launched my strategy in 2013. We've added two more vehicles since then. It's been a tough 10 years for stock-picking within public-traded real estate because by the time 2013 came around, a lot of the total returns had been pulled forward. We went back and looked at data going back to the 1970s, establishing that every single time there's been a 30% drawdown on the FTSE NAREIT All Equity REIT Index (which excludes the mortgage REITs), the next five-year forward returns tend to be quite good. They tend to average 109% gross.

The drawdown from peak to trough is still about 26%. The index is down quite a bit, and there are

companies - like the ones we're presenting today - where the operating metrics have improved from two years ago, yet we are still down 25%-26% from the peak. Obviously, interest rates are higher today, which a big factor. Nonetheless, we believe this is a good setup for portfolio returns.

One of the ideas we are pitching today is Mid-America Apartments. It is a Sunbelt multifamily REIT that owns roughly 100,000 apartment units. I looked at its returns in various scenarios - from the worst to the best returns. If you had bought pre-GFC in late 2006 at a valuation peak and held it till today, you would have earned about 8.9% IRR. This is before the subprime crisis occurred.

If you had bought Mid-America at its IPO in 1994 and held it until now, you'd have earned about 12.6% IRR. That's good for a 35 bagger since 1994 - assuming you reinvested the dividend.

The next scenario is buying it not quite at the bottom of the GFC - which would have been in March, so say May - and holding it until now. In this case, you would have earned about a 13.3% IRR. During that time, you would have enjoyed 6 times MOIC. If you were savvy and realized in late 2021 that it was getting expensive - cap rates came down to about 3.5% - you would have generated about 20.5% IRR in 12 years, and your MOIC would have been 10.5 times.

These kinds of IRRs show that there's something unique about this company and this asset class, that over a long enough timeframe, you tend to do pretty well. You tend to do okay at least. Someone could say, "In 1994, the interest rates were higher than now." This is true. In a normal interest rate environment, you probably would have gotten about 10% or 11% IRR from the IPO till now. The point here is to think through what the long-term return is of owning shares in this company with roughly 100,000 apartment units in the Sunbelt.

Our second idea is Camden. It's very similar to Mid-America in size and exposure. We have both in the portfolio. Mid-America has a lot of the typical Sunbelt city exposure - Dallas, Tampa, Orlando, Charlotte, Austin, the Carolinas, Charleston, and Houston. What's truly interesting is that you're buying this at a 6.7% cap rate. Those following the multifamily space will know that there was a time in 2021 when the cap rate went to about 3.5% in the Sunbelt. In layman terms, it essentially means that if you bought an apartment building selling for \$100 million, the net operating income, the cash flow available to service debt and payout to shareholders was about \$3.5 million. Today, you could buy this collection of assets that will yield 6.7% on an unlevered basis. This is trading at roughly double the cap rate at the peak of year-end 2021.

Also, Mid-America is only trading at 21% loan to value versus 50% and 80% for most private deals. We benchmark a lot of the high returns one achieves in a private real estate deal against it because we view our strategy as a better risk-adjusted alternative to private real estate. That's how we try to add value for our investors. We tend to think of it in that framework - we're giving our investors better exposure to real estate with higher quality assets and lower loan to value, but we try to target the same kind of returns they get with private real estate. When we're pitching our ideas, that's our objective.

We're excited about Camden. DC is its largest market, but it has a lot of the same Sunbelt exposure as Mid-America - Houston, Phoenix, Dallas, Atlanta, Charlotte. It's trading at almost a 7% cap rate. As a frame of reference, we've been tracking multifamily for the past decade - post-GFC. For the most part, cap rates throughout the U.S. for assets of this quality have been between 4% and 4.9% in these markets and have been very consistent for over 10 years. True, the interest rate is higher, but a 6.9% cap rate is almost unheard of in my investing career post-GFC.

In short, these are extremely cheap. Another way of thinking about this is if you look at the implied cost per apartment unit - for both Mid-America and Camden - it's around \$200,000 a unit. We think

the replacement cost is likely over \$300,000, and the market value is probably somewhere between \$270,000 to \$300,000. In simple terms, if you stop thinking about stocks and securities and start thinking about what you're really paying for these apartment buildings, you're buying them at roughly \$200,000 per unit when the market is likely in that \$270,000 to \$300,000 range.

Let me go quickly through the math on both Camden and Mid-America to show you how we get to a 6.7% and a 6.9% cap rate. If you think about it, these large REITs should trade at a premium over a one-off private asset because there's instant liquidity, there is diversification, and your G&A cost is lower because there is real scale in these operations. However, what we see lately on the private market is cap rates below 6% - somewhere between 5% and 5.7%. Oftentimes, they're lower-quality than the assets owned by these big REITs.

I'll share a simple four-year analysis on how we underwrite an 18.5% IRR for Mid-America. Our assumption is that rent goes down in 2024 because there are some new suppliers coming onto the market. Then we're underwriting a 2% rent increase in 2025, 2026, and 2027. The company does have some development projects that will be stabilizing, and those will add to the operating income. We start out at about \$1.37 billion of total NOI as of today. By Q3 of 2027, we get to about \$1.47 billion.

The total return - that 18.5% IRR - takes into consideration what we're paying, the dividends we'll be receiving, and the cumulative cash build per share because Mid-America is not paying out all of its cash flow - it's paying out somewhere in the 60s. It's going to build about \$11 free cash per share. It will likely make some distressed acquisitions. It may do developments. If it doesn't do anything, you will have \$11 accumulated on the balance sheet in the out years. The math works out to roughly \$133, which - including total value, all the dividends, and cash build of about \$225 - amounts to about 18.5% IRR.

I want to put some framework around the way to think about real estate returns. Generally, with real estate returns, when you start targeting IRRs of over 15%, you need to be doing some sort of value-add strategy where you're taking a property and maybe renovating some kitchens (which involves moving tenants out and not having net operating income from those units for some time) and doing some sort of ground-up development. You're also using 50% to 80% loan to value. If you look at this kind of return stream, we're using about 21% loan to value. We're not doing a ton of developments. There are some projects the company will finish, but that's not the bulk.

We're underwriting a 2% NOI decrease followed by a 2% per year NOI increase. We're doing day-to-day blocking and tackling - nothing strategic, no high-risk activities. The key thing is that we're using a 5% cap rate as an exit cap rate, which is about 100 basis points higher than what the 10-year Treasury trades at today. Some research papers out there say that's probably irrelevant. I know that's not where the cap rate is. Today, it calculates at 5% or maybe 6%.

We compared the private real estate syndicate deals to the public real estate, to these multifamily REITs. The key takeaway is that there are a lot of fees for investing in a private real estate deal. The fees are usually charged at the asset level, so you add leverage to even just 60% loan to value. When you buy a deal on day one, a lot of your equity goes away because of transaction costs. When you buy in a public market via a REIT, the frictional cost is extremely low. That's important.

We do try to measure our performance against a lot of private real estate performance. It's an important benchmark for us. First of all, the market is between a 5% and 6% entry cap rate level. There are many scenarios where investors could lose money over a four-year holding period. Because we're buying in at a 6.5% to 7% entry cap rate, we're using very low leverage, and we could sell out at a higher cap rate. If we go in at a 6.5% cap rate and exit at a 7% cap rate today, that's still a 7% IRR. It's not a great outcome, but we likely will not lose money. There's a slim chance of impairment.

If the shares go up further from here, and it trades at a 6.5% cap rate, and then we exit in a few years somehow in an 8% cap rate environment, that's where we start losing money. A money-losing scenario is far more likely for a private real estate deal with higher leverage and higher transaction fees than for these large-cap public REITs where there are a lot of outcomes where you earn higher than 15% IRR and very little chance of a negative outcome.

To use Camden as an example, at today's price, it trades at a higher cap rate (6.7%), with an almost 20% IRR. That's assuming a 5% exit cap rate. If the entry cap rate goes to 7% and you exit at 6%, you're still at 13.8% gross IRR, which is not bad. It's not "shoot the lights out," but it's still quite a good risk-adjusted return using 23% loan to value versus about 50% for the private side.

How have things changed since the GFC? I think a lot of people are throwing out the phrase "the coming CRE crisis" and making a lot of comparisons to the GFC. I lived through the GFC. I was working at Citigroup and covering many of these companies. I had a front-row seat during the GFC. I can tell you that these REITs are in much better shape than they were back then. One way to measure the debt service coverage ratio is to divide EBITDA by the interest expense. If you look at Mid-America and Camden, their coverage ratio is between 6.9 times and 8.4 times today. Even during the GFC they had very adequate coverage at 2.6 and 3.3. Generally, the banks will approve the loan and start lending when the coverage ratio is 1.25. It's totally different. You can measure these coverage ratios as a factor of safety. The GFC factor for these two companies is 2.6 to 3.3. This time around, it is 6.9 to 8.4. Frankly, I sleep very well at night owning these companies.

One way investors can lose money in real estate is if there's some sort of near-term debt maturity a company can't service. This is exactly what happened to General Growth Properties in 2009. General Growth was totally fine, but I believe it had \$5 billion of debt maturing in 2009. The capital markets were not open, so the company had to file for bankruptcy - not because it couldn't service its debt, but because there was a big maturity.

A lot of the REITs have learned from that experience and have done an excellent job terming out their debt. Between the annual cash flow, funds from operation, and what's available in credit facilities, it looks like Mid-America can easily cover the next 7 to 8 years of debt maturity - we worry very little about any sort of debt maturity. To lose money in real estate, you need some sort of triggering event, like a debt maturity. In this case, you probably have to go 7 to 8 years in the future before something happens. The same applies to Camden. The debt of both companies is very well termed.

There is a low probability of these REITs cutting their dividend. They are both currently paying about 1.5% dividend. We try to be as conservative as we can in our calculation. We start with the net operating income and subtract the property management, general admin, and interest expenses. We also like to subtract the maintenance capex - we're using \$1,000 per unit per year as maintenance capex for all of these. This is on a quarterly basis, by the way. We define this as true free cash flow after we budget for maintenance capex.

We got a dividend as a percent of what we think true free cash flow is - 63% for Camden and 66% for Mid-America. These ratios are very healthy. I think Mid-America recently increased its dividend payout per share. In my view, up to 80% is healthy. As some of these development projects come online, the net operating income will increase, which will allow the companies to grow their free cash flow, so we're very comfortable. We sleep soundly at night knowing what the payout ratios are for Camden and Mid-America.

The capital markets are open for these companies. Just a few days ago, Camden priced \$400 million unsecured notes at 4.9%, fixed for 10 years. I think Mid-America's price is 5.1%. These are unsecured notes, so the companies retain the ability to put additional mortgage debt at the property level. This is

unsecured debt at the corporate level. Private debt is probably closer to 6%, with a shorter maturity. That private debt will be secured by the individual property. This is unsecured debt about 100 bps lower. These large REITs are flexing their lower cost of capital in a very tough capital market environment.

If you're a bond investor, you're probably thinking, "Do you get the credit for the 10 years at a 4% yield from the U.S. government, which is very high quality and will not default, or do you buy debt that has 21% loan to value on 100,000 apartment units spread over a dozen metro markets in the United States, which is very healthy?" Some investors want to get 100 extra basis points of yield.

In private real estate deals, there are many GP sponsors that are potentially losing their assets. They call in investors for more capital and a lot of LP investors are now finding out that when you write a check to invest in a private real estate syndicate, it may not be the last check you write. You may be subject to additional capital calls. If you look at the earnings calls of these large multifamily REITs, they're trying to go on the offensive. They're trying to pick up assets. The developers need to sell, and they're looking to buy. They're looking to upgrade their assets or swap them for new ones.

Let's talk about why this opportunity exists. Why are we so lucky to earn an 18% or 19% four-year IRR owning Mid-America and Camden? One, it's no secret that a record delivery is expected in 2023, 2024, and 2025 in the Sunbelt. After 2025, however, a lot of these markets will plummet. Investors are worried about the incoming surge in supply. If I have learned one thing about public equity investing, it is that investors don't want to own something when rent and NOI may go down year over year. We think the valuation these assets are trading at more than compensates for the risk we are taking on.

This is an asset class we've been tracking for over a decade, probably two decades for me if you include the private side. There's a capital cycle dynamic to this thesis in that it takes three to four years to bring these assets to the market. We already see that a lot of new deals in 2022 and 2023 are getting shelved. There's going to be a falloff. Starting in 2026 and maybe parts of 2025 in certain markets, we are going to see delivery go off a cliff, then it's going to be multiple years before they could start delivering assets again.

The way to think about this is hold it through 2024, use the dividends to buy more shares, then the price gains will likely come in 2025 or 2026 and afterward. In 2026 and 2027, you may wind up in an environment where rent growth is 4% or 5% a year because there aren't a lot of new buildings being delivered. Then investors could get bullish about owning multifamily. Maybe interest rates are lower, maybe not, but I think people could get bullish because they could look out at 2026, 2027, and 2028, and there's not going to be a lot of new supply in those years.

We measure our returns against private real estate syndicate deals. There are two scenarios: The multifamily cap rate goes to 7% or it goes to 4.5%, which is what they were trading at in the past decade.

If you own large-cap public REITs, should the multifamily cap rate go up to 7%, you're likely going to get somewhere between mid- to high-single-digit IRRs. The positive is that they can't justify new construction. Generally, the new construction business model entails the developer building to a 6% unlevered yield and selling at 4.5%, and there's nice 30% or 40% unlevered upside. When you combine it with some leverage, you get over 20% IRRs in that kind of model.

Now, multifamily cap rates go to 7%. You can only build to 6%. You're going to have negative IRRs development. We can see that a lot of development activities have stopped. In a very high-cap rate environment, there's going to be scant supply, and public REITs could enjoy strong long term rent growth. On the private side, if multifamily cap rates go up to 7%, there will probably be a lot of

bankruptcies. We already see a lot of distress. We hear that a lot of private multifamily GPs are hiding the bad news. It's going to be extremely difficult if multifamily cap rates go to 7%. For both developers and private real estate GPs, we use a buy-and-hold strategy.

The multifamily cap rate could go to 4.5%. This is where you start getting into that high-teens IRR. If the cap goes to 4.5%, the IRR could even go into the low 20s, and it will likely be a 40% to 70% upside in the next few years. Because these two companies are large and liquid, you could quickly get that liquidity and get out.

I think the only scenario where private real estate deals today beat the large-cap public REITs is if cap rates go to 4.5% and the privates are using more leverage. Leverage is a double-edged sword. It works great when it's going in the right direction. That's the only scenario where the privates will do better than public REITs.

In summary, we're not pitching this idea as the best absolute return, but if you look at the historical returns of these large-cap multifamily REITs, even when you pick the wrong entry point, you still do pretty well. We're now getting the opportunity to buy these after a meaningful sell-off. Both Mid-America and Camden are down at least 40% from their late 2021 peak. Mid-America was at \$220 or \$230 per share. We're buying it at \$133. Also, rent and operating income have been up 15% to 20% since then. We're getting a unique opportunity to buy these. If you use a three- to four-year holding period, as we do, I think you're going to come out with a very nice risk-adjusted return.

The following are excerpts of the Q&A session with Bill Chen:

Mihaljevic: Could you tell us how you think about owning these types of assets in the private versus the public markets?

Chen: Which specific aspect would you like me to talk about? There are so many different angles.

Mihaljevic: Generally, the attractiveness of one versus the other, how that ebbs and flows, and the advantages and disadvantages.

Chen: There is this debate over whether real estate is passive or not. You could go out and hire a property manager to take care of leasing and all the rest. At the end of the day, there is also some capital to make. The public REITs solve a huge issue for you. You buy them and then sit around and wait for your dividend check. It's truly passive. I do all the work upfront for my investors - conduct the analysis, assess the management team, etc. There is a constant staying on top of the investment thesis. That's the work you do when you own these public REITs.

When you own it in private form, a tenant calls you when the toilet's broken or the light bulb is out. You have to either go there yourself or send somebody to fix it. Then, there are the bigger problems, like "Are we going to put a new roof in?" It's more active than people think. That's one thing.

The second part is the transaction costs. We bought \$5 million to \$10 million worth of REITs, and I think the trading commission - through an interactive broker - was \$3,000 to transact with \$10 million. All the fees are probably 2% going in and 2% coming out, so 4% gets taken away because of frictional costs on the private real estate transaction. On the public side, that cost is miniscule and manifests itself in the form of corporate G&A and having an NYSE or a NASDAQ listing (there is a certain cost to keeping a company public). That essentially gets spread out on an annual basis, which makes the trading of the REITs very low-cost. That's a big difference. There's generally much less leakage from buying the REITs.

Another part that doesn't get talked about a lot is diversification. When you buy Mid-America, you get exposure to a dozen Sunbelt markets. It's very hard to create that level of diversification when you're investing in a private deal. There's a good chance you're putting a good chunk of your net worth in a single deal, and that's a single asset. Just the other day, a tornado touched down in Florida. There are also earthquakes and sinkholes - think of the famous Joel Greenblatt sinkhole risk. That gets largely diversified away when you own Mid-America or Camden - there are hundreds of properties spread out over dozens of states.

Liquidity is another consideration. You have this joke that the Blackstones of the world are in the business of laundering volatility for the LPs. I think it was Cliff Asness who coined the term "volatility laundering." David Swensen coined "liquidity premium." These should trade at a liquidity premium to the private market, but here we are in 2024, and these REITs trade at a large discount. I find it a bit ironic that this is the world we live in. You should get a premium for being able to trade this in an instant, for being able to put \$50 million to work in a day buying shares in Mid-America and Camden because putting capital to work does have its limitations.

You have this wonderful investment opportunity here. It's instantaneously liquid, but because it's marked to market on a daily basis, it introduces a potential risk into a portfolio. I think it's all kinds of funny, but that's where the opportunity lies. I consider these are much better investments at much lower frictional costs, and we can get them cheaper.

Finally, I should note that we've looked at a lot of deals being pitched by private real estate syndicates. If you look at Tides Equities, which is in the Wall Street Journal and Apple's Way, many of those assets are of much lower quality, and they're generally in worse markets. I will say that public REITs are A assets. The private stuff is probably B-minus, sometimes C-plus, and the assets are generally not in as good markets. They tend to be a little more secondary or tertiary on the private side.

I think these are wonderful instruments for people to compound their wealth, so I find it unusual that these very large market caps are being shunned at the moment. At the same time, I'm not surprised because when these companies are trading at a 3.5% cap rate - which I consider to be very expensive - the near-term fundamentals look great. Rent was going through the roof in the Sunbelt, but they were priced to perfection. However, that's also when investors want to own them. On a risk-adjusted basis, I think this is the best opportunity for the next few years.

Mihaljevic: Bill, as always, thank you so much for this in-depth presentation and all the terrific insights. You add tremendous value to the community, and it is very much appreciated.

About the instructor:

Bill Chen is the founder and managing partner of Rhizome Partners (2013), Rhizome Real Asset Opportunity Fund (2020), and Rhizome Hard Asset Opportunity Fund (2023). Prior to forming Rhizome Partners in March 2013, Mr. Chen traded and invested his own assets, utilizing strategies that focused on deep value investments and event-driven strategies. From August 2009 until January 2011, he was the Director of Research at New York Global Group, a private equity firm that invested in growth companies in mainland China. From October 2006 to March 2009, Mr. Chen was an Analyst in Citigroup's real estate investment banking group, a group that focused on M&A transactions of up to \$1 billion. From October 2005 until October 2006, Mr. Chen was a mechanical engineer for Bladykas Engineering. Mr. Chen received his B.S. in Mechanical and Aerospace Engineering from Cornell University in 2004.

