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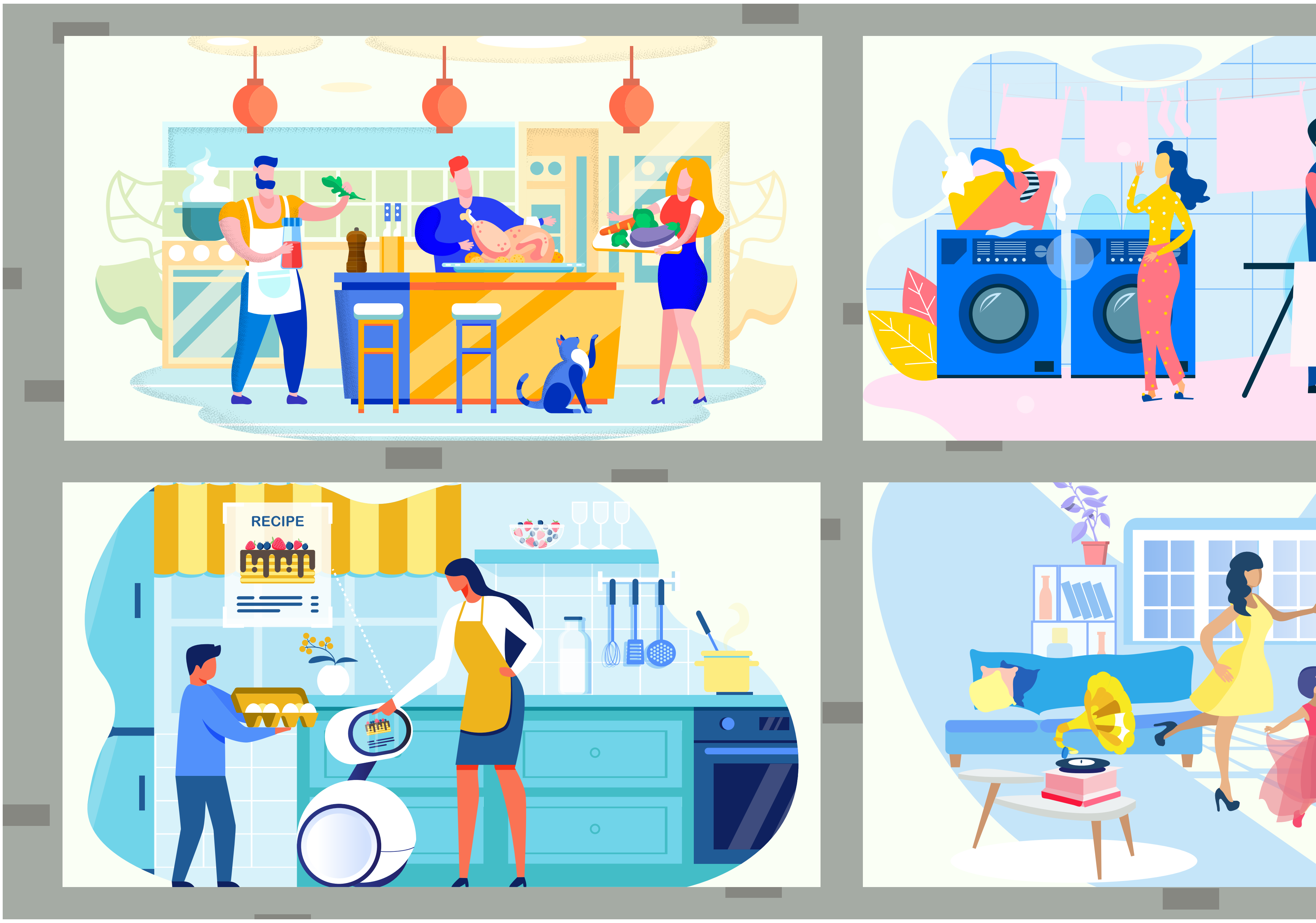

A CONVERSATION ON MULTI-FAMILY REAL ESTATE

Sarah Butts: What are current trends in the multifamily industry in Memphis?

Lea Heilig: We're seeing many positive trends, particularly very favorable multifamily fundamentals. The Metro has seen 4.2% effective rent growth in the past 12-month period, and a 94% average occupancy, meaning the rental market is outperforming historical averages. In downtown, which has historically been the strongest submarket, demand for Class A rentals has pushed average rents to $1.63 per square foot — that's across Class A renovated space or adaptive reuse properties, such as The Chisca on Main, The Commonwealth, or The Tennessee Brewery, and Class A ground-up construction, such as 266 Lofts. In fact, select units are reaching the $2-per-square-foot mark, which the Memphis Metro has never seen.

The most recent Class A delivery in the city's core is The Citizen apartments in Midtown at Madison and McLean. On select units, they have posted $2.24 per square foot on lease rates — not merely asking rates. Coupled with high absorption rates, this shows that Memphians have an appetite for modern 21st-century, well-amenitized apartment dwellings — and that we are really just catching up with demand. At The Citizen, an average of 35 leases were signed per month during the lease-up period. There are a lot of Memphians who are saying: "We love this product; we're here; we're willing to sign. Where's the lease?"

We also have a well-balanced equilibrium on the deliveries and supply/demand side. Unlike other markets in the nation that have overbuilt and are experiencing a softening, new Class A deliveries have stayed within a healthy margin of our historical average of 1,300 units per year. For 2019, the Metro is getting about 1,900 new units. In terms of current properties under lease-up, we have about 1,000 units coming online, and those are mostly large suburban garden-style communities. About 800 units countywide are under construction, and roughly 1,000 units are in planning stages or proposed. This excludes multi-phased, multiyear mixed-use developments, such as Union Row, which drive up future pipeline statistics but are not slated for delivery any time before 2021.

Another important trend that we see here is the sustained and growing investor appetite for multifamily product in the Memphis Metro.

Jerry Martin: There's very little difference with regard to the insurance trends nationally, as far as the rate structure or a rate perspective for multifamily in Memphis. In the past six months, we have seen a significant hardening of rates in the multifamily world — prices are going up significantly, coverages are being limited, and deductibles are being increased.

Memphis, specifically, has challenges with earthquake insurance. Most lenders have been relaxing the earthquake requirements in previous years. They're now on top of that a little bit more and requiring it on most of their loans. And, there are crime issues that cause liability rates and premiums to increase for properties that are in higher crime

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areas, especially in Memphis and major metropolitan areas.

In general, the trends for Memphis are very similar to the trends in the Southeast, with rates going up locally and throughout the entire country — more so in affordable housing areas versus the conventional housing space. But in general, a significant hardening.

Drew Raines: In the property tax world, what we've seen is that the current assessments are low on multifamily, generally, compared to the market. That's good for now, but we do think the Assessor is going to catch up to the market in the 2021 reappraisal. Right now, by and large, for the sales that we see — we regularly see sales of multifamily property with assessments at about 50% of actual market value. Part of that is the appreciation that we've seen in the multifamily market in the last three or four years.

The other part of that is that we think that the Assessor came in a little low in 2017. If your property sold prior to the 2017 reappraisal, the new value came in close to the purchase price, but that wasn't extrapolated across the board. So that created a lot of inequity. If your property sold, you were valued at about market value. If your property didn't sell, then you were increased some nominal amount. Right now, things are unequal but low.

Spencer Earnest: From our perspective, we're doing a lot of great business, and we're excited about it. The biggest thing for us when we go to one of these properties is that we want to know about the HOA and those types of questions. So, we try to cover the clients as well. Some HOAs will cover certain parts, but the exterior is excluded on all the properties, for example. So those are some of the things that we have to take into consideration.

Butts: How will the countywide reappraisal in 2021 for tax purposes impact multifamily?

Raines: The 2021 reappraisal in Shelby County could be the most challenging for multifamily owners in Shelby County history for this reason: The County Assessor is aware that multifamily values are low, and we expect they plan to catch up. We're routinely seeing sales where the Assessor's value is at 50% of the market value. We think that they're going to catch that up and, depending on what they do, they may catch that up not only with properties that recently sold, but across the board.

By doing that, they restore equity, and if they do that across all property types, then the tax rates should drop significantly. So, what you could end up having is an assessment increase and still pay less taxes than in the previous year. The tax rates in Tennessee by law are revenue neutral. So if the overall level of assessment in Shelby County increases, then those rates have to drop. In the 2017 reappraisal, we did see that happen — rates dropped 5%. So, depending on how close to market the Assessor gets, we could see some pretty significant rate drops.

Butts: What's the impact of lender requirements on insurance coverage and replacement costs of property valuations?

Martin: As the market has begun to firm up, and insurance companies are paying a whole lot more attention to what's going on in the multifamily world, lenders are ramping up their requirements and the due diligence that they're doing with regard to the loans that they're making on these properties. We spend an inordinate amount of time in our office dealing with lender questions and making sure that certificates of insurance are properly documented for them. Quite frankly, every I has to be dotted and Ts have to be crossed these days. The whole market has begun to firm up. As far as valuation is concerned, lenders are again paying more and more attention to cost per square foot with regard to insurance.

We deal with replacement cost, which is obviously different than what realtors deal with when selling a property — because most of the time, there's a big difference in what it costs to replace a property versus what it could sell for. So, what has typically been in the $60–$65 a square foot replacement cost area has skyrocketed to about $85 a square foot for the typical framed construction, two-story garden-style built in the 70s and 80s type of inventory that we see a lot of here in this area. In addition to the rates firming up, owners are having to deal with their lenders requiring them to increase their values as well. It's kind of a double whammy.

Heilig: Represented on this panel, we have the insurance world and the property taxation world. Both are line items on a Profit and Loss statement for every property owner under Operating Expenses. And we are discussing the anticipation of higher taxes, higher replacement costs per square foot, and higher rates. These costs certainly can fluctuate, but interestingly from our perspective, this has not deterred sales velocity. Meaning, we think that the offsetting factors to increases in these operating expenses are continuously improving multifamily fundamentals — and that is driven by growing demand for rental housing, caused by systemic shifts among the renter demographic.

Researchers are finding that the U.S. is turning into a Renter Nation. It is considered a phenomenon that is here to stay, which fuels a high level of interest on the part of investors. Sales velocity has not slowed, and values continue to rise because investors focus on the broader benefits of investing in multifamily.

Martin: We find that to be the case on smaller individual's properties more so than with a larger owner who has more properties, where they can shift the cost of insurance among the better-performing properties. You get one owner who only has one or two properties, and he doesn't have the benefit of being able to move those costs around to the better-performing properties. What ends up happening is at the end of the day, you close, and they're saying, "Oh my gosh, nobody told me about insurance! I budgeted $350 a door, and it's $650 a door. What happened? Nobody told me about that!" Insurance is always the last thing people think about when they close — whether it's a house or a commercial building.

Raines: One of the positive things about the reappraisal is that you'll have certainty again. Once you have the new assessment, you know what the taxes are going to be for the next four years. If that uncertainty isn't scaring people away now, then the certainty is only going to help the cap rate a little bit.

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MODERATOR

SARAH BUTTS

Sarah Butts is the Sales Manager at Memphis Business Journal where she has been for over 11 years. She oversees the multi-media advertising and audience department who are responsible for creating targeted marketing plans for local and national clients.

PANELISTS

LEA HEILIG

Lea Heilig specializes in multifamily investment sales at Woodyard Realty Corp. serving private and institutional clients. Her experience spans urban and suburban apartment properties, involving community revitalization, new development, and multifamily land sales. Lea has earned the coveted CCIM designation and is a repeat recipient of the Pinnacle and CoStar Power Broker industry awards.

JERRY MARTIN

Jerry specializes in developing risk solutions and insurance programs for the multifamily real estate sector. This is executed by assisting property managers, developers and owners stabilize their profit margins by placing their risks inside an exclusive multifamily risk management program that is minimally affected by the changes of the general insurance marketplace. Prior to his position with McGriff, Jerry served as President of two local insurance brokerages in the Memphis area.

DREW RAINES

Drew Raines is exclusively dedicated to the representation of taxpayers through the property tax appeal process. He has successfully negotiated settlement agreements with assessors, argued cases before county boards of equalization, the Tennessee State Board of Equalization, and the Assessment Appeals Commission, and guided taxpayers through the exemption, greenbelt, and payment in lieu of taxes (PILOT) application processes.

SPENCER EARNEST

Owner of Ace Central Property Inspection. He is a native Memphian, husband and proud father of four children. He started his company as a one-man inspector and Ace Central is quickly becoming one of the fastest growing inspection companies in Tennessee. Our early success can be attributed to system and processes and insatiable appetite for learning and growth.

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Heilig: We've been going through decades of reassessments, and there have always been the concerned voices when the four-year reassessment cycle was coming up. Ultimately, investor appetite has not faltered. Here's a practical example: 15 years ago when I started in the industry, the price per unit (PPU) in Midtown averaged $30,000-$35,000 a unit. Then we began seeing $50,000 a unit. Once the market supported $70,000/unit, we thought investors had reached their ceiling.

Earlier this year, however, we closed a property in Midtown for a record $96,000 per door. It was a class A renovation of a historic 1920's building. We believe this growth in sale prices is because of the ongoing strength of property fundamentals in the multifamily space. An investor — whether they're a real estate investment manager for a large institutional group or a private individual — wants to make allocations where they can gain reliable, predictable income streams that can be achieved through solid cash flows. So, they opt for the multifamily sector. I think that has quite a bit to do with why we are seeing these numbers.

Butts: If someone invests in multifamily housing, what should they be prepared for with repairs or problems? What should they be looking for?

Earnest: It depends on whether it's new construction or preexisting. With new construction, you should be okay. They shouldn't have any issues. Obviously, we still have to do our due diligence and inspect the new constructions and make sure that the builders are doing their part and following what the SOPs require.

With preexisting construction, what I'm seeing is deferred maintenance issues. What people don't realize is that if the deferred maintenance isn't handled properly, it will cause other issues. We always say that water can bankrupt you. Those little minor leaks here and there could have cost $100–$200 to resolve, but they go unattended and end up costing thousands of dollars' worth of damage.

What I do, especially with first-time homebuyers, is give them maintenance books. We're going to tell you what the condition is today, and we want you to be able to keep it in that condition. So, when a realtor comes back to do upgrades, it'll be a smooth process. We tell them what they can do in the fall and what else they can do in the winter — little things that would keep their property going in the right direction.

Butts: What draws investors to the Memphis multifamily market?

Heilig: The first qualification is economic viability. Generally, when investors are identifying a target market, they're looking for strong economic fundamentals. In our case, stability is a hallmark characteristic of our market, because we have a very diverse and, therefore, stable economy.

We have the logistics industry, and investors see a $20 billion economic impact annually generated by the second largest cargo airport in the world and surrounding distribution centers. We have FedEx right now with a $1.5 billion modernization of its hub, which is future-proofing the anchor industry for our whole Metro area. Beyond logistics, investors see the eighth largest medical district in the United States. We have eight anchor institutions and prominent hospitals: St. Jude, Le Bonheur, Southern School of Optometry, etc., and colleges that combined provide 20,000 jobs and serve well over 13,000 students. The medical device industry alone has an annual economic impact of $2.6 billion, generated by 47 local medical device companies that manufacture products for global distribution. Investors look for this diversity of industries.

The tourism industry is hardly ever addressed. Memphis Tourism's most recent annual report highlights that 12 million tourists came through Memphis in 2018 — that's one million monthly visitors on average. The impact on the local economy is $3.5 billion annually, supporting some 50,000 jobs across 2,000 companies. And beyond our diverse economic base, we have advocacy groups that are looking to sustain these numbers and improve them in the future — the Downtown Memphis Commission, Midtown Memphis District Collaborative, Memphis Bioworks Foundation, the Memphis Airport Authority — all of these amazing institutions are looking to move us forward.

Beyond the makeup of our economic base, investors see our revitalized downtown, which is our response to urban shifts in population, gravitating toward a high renter demographic. Urbanization is extremely important to help us compete with other metropolitan areas that are peer cities and are vying for the future employment base. That is the young urban professional who desires to live in an urban "Live. Work. Play." ecosystem. Locally, our urban renewal was pioneered by forward-thinking developers who, over the past several decades, have revitalized downtown properties, bringing in housing, office, etc., with impressive results that today go beyond downtown to include the Medical District, Midtown and beyond.

The New Urbanism movement started in the early 1990s, but essentially, it's this idea of a walkable, densely populated community with close proximity to employment centers, activities, dining, entertainment, and even recreational opportunities. Investors see that as a market, we are positioning ourselves to draw in the younger generation that wants to live here. In turn, the young employment base causes companies to want to relocate, to bring branches or headquarters into these markets, where they have a future generation of their employees guaranteed. We've seen it downtown with ServiceMaster's headquarters and its 1,200 jobs. The Indigo Ag headquarters from Boston is bringing 700 jobs. FedEx is adding 690 jobs by repurposing the Gibson Guitar Factory. And, FedEx is in lease negotiations to bring additional divisions downtown, which, according to some sources, could add another 1,000 jobs to the downtown core.

So positioning the city to be competitive through smart city planning that attracts the future generation of employees draws in further business investment and future-proofs our city in the eyes of investors.

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Raines: You've got to look at Memphis in the context of the national market, and these primary markets have overheated to the point where you can't get a return on these properties. In Memphis, you do have that sustainability. You have that income stream from which you actually can make money on a property at a reasonable cap rate.

Martin: We're seeing foreign investors come in with money to purchase property in the multifamily space. We have a number of foreign clients purchasing property here. Many of the people we're seeing are from Israel. Lots of Israeli money.

Heilig: Primary markets are overheating. In search for higher yields, investors are pivoting toward secondary markets. So, we have a coming together of two drivers for Memphis' resurgence: favorable market timing and that we have positioned ourselves well as a city to get on the radar of investors.

Earnest: I recently had a meeting with investors from Israel and other different countries who are coming here. They want to get a team together with eyes on the ground here. I've been seeing that, and I'm very excited about that.

Butts: How do Memphis property taxes compare to Nashville?

Raines: In the Nashville 2017 reappraisal, the assessor was a lot more aggressive at valuing property across the board. The tax rate in 2017 dropped 30%, which is huge. You could have a massive value increase and still be paying well below what you were paying the prior year. That's a good thing because it's more equitable to everybody. That resulted in Nashville having half the tax rate that Memphis has.

When everybody is valued fairly, and not just the properties that have sold, then it distributes the tax burden more evenly and the rates fall. We're hoping that's what they'll do here in Shelby County in 2021.

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>
> **DREW RAINES**

Butts: Looking ahead, what new trends are prompting the multifamily industry to innovate for the future?

Heilig: We believe the future of the multifamily industry is bright. We now have smart city planning with expanded residential PILOT (Payment in Lieu of Taxes) boundaries. Previously, the mechanics to build 21-century housing and accommodate the urban renter-by-choice population were limited to the downtown central business improvement district. Now, with those boundaries expanded, we're seeing new Class A product go up in Midtown and beyond.

I believe Memphis is positioning itself to become what Mayor Strickland likes to call the "It City." Our brand identity is changing. We have wonderful accolades as the birthplace of The Blues and Rock-and-Roll, and the barbecue capital of the world. But we are building on that legacy and the world is now beginning to see us as a diverse, innovative, thriving and authentic city.

We were ranked #7 of the Top 10 cities in the United States to Start a Business; the Top 4 market for millennials to move to; #10 Top market growth of tech jobs; 15th of the revitalized downtowns in the nation. We're building on the heritage but also positioning ourselves for the future. According to Frommer's Travel Guide in 2019, Memphis is one of the Best Places to Travel and visit right now.

Earnest: We follow the real estate industry closely. We like transactions — we're seeing lots of them and we think they'll continue.

Martin: When we're talking to people about insurance, the newer trends in the conventional space are the mixed-use, apartment complexes in communities, similar to Highland Row Apartments and Union Row in Memphis. We also see a lot of historic rehab — people are going into older buildings and repurposing them for multifamily use. You can do mixed-use in a historic rehab as well. There's a lot of that here in Memphis. Henry Turley has done a ton of that downtown, and Billy Orgel has done a lot of that and continues to do a lot of that as well. So, the historic rehab area is very popular.

One of the larger growing areas that we're seeing developers using is low-income housing tax credits in the affordable housing space to do historic rehabs or mixed-use. The affordable housing space is booming, not only in Memphis but throughout the country — as is and construction of affordable housing.

You can't be a novice to acquire those credits, you typically have to have a sponsor or a consultant. But it's a growing area — bigtime. We're seeing a lot of suburban growth but also rural growth throughout the country. Don't sleep on affordable housing.

Raines: Those tax credits often work hand in hand with payment in lieu of tax programs. So, you get two major benefits at the same time. If you're applying for the tax credits, you should be applying for the PILOT program as well.

Martin: People typically view affordable housing as properties in high-crime areas in disrepair. While this is sometimes accurate, there are many complexes that are as nice and well-built as any conventional project you will see. Just because it's labeled "affordable housing," doesn't mean it is in a bad area or in disrepair.