The Place at 2120 Investment Opportunity

Trenton Dianovich

RED 498

Table of Contents

Executive Summary

The Place at 2120 is a 202-unit garden apartment property built in 1987 located in Tucson, Arizona. One-, two-, and three-bedroom floorplans are offered. Renovations of nearly all units have recently been completed, and the property appears to be in good physical condition. Property amenities include a clubhouse, a laundry facility, a fitness center, 228 uncovered parking spaces, a pool with hot tub/spa, a playground, a dog park, and grilling and pet cleanup stations.

The city of Tucson boasts strong employers along with a favorable climate, strong tourism, and other factors that create a ripe environment for the economic and population growth that can help an apartment investment thrive. Additionally, the current local apartment market has held strong amid widespread headwinds and exudes a positive long-term outlook.

It is recommended that this property be acquired for $22,957,287 at a 6.50% cap rate with a loan. The loan terms received were a 35-year term at a 6% interest rate. A 72% LTV can be achieved at those terms while satisfying all relevant loan metrics resulting in an IRR of 16.23%. Cash-on-cash returns start off modest in year 1 at just 4.7% but increase to a respectable 12.6% by year 10.

With strong market fundamentals and sizeable expected returns, it is advised that this opportunity be seriously considered.

Introduction

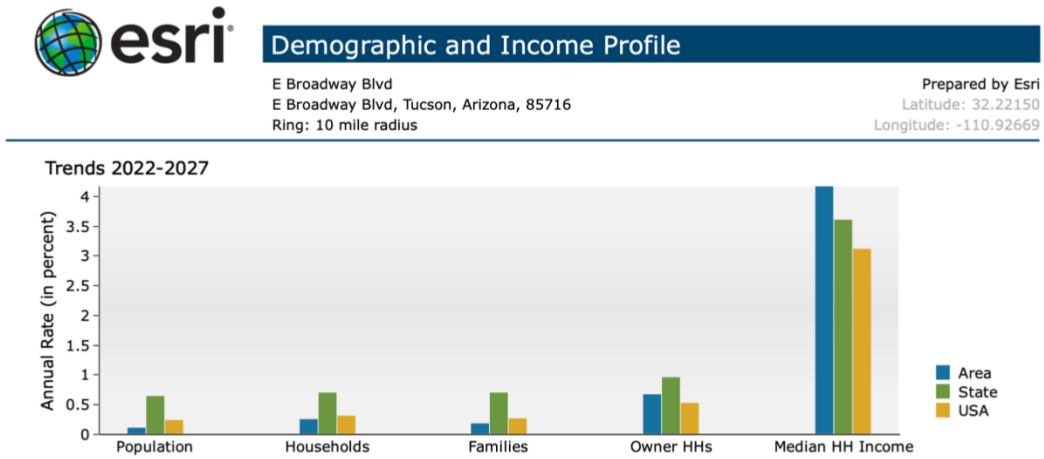
This report presents The Place at 2020, a 202-unit apartment property located in Tucson, Arizona and investigates its viability as an investment opportunity.

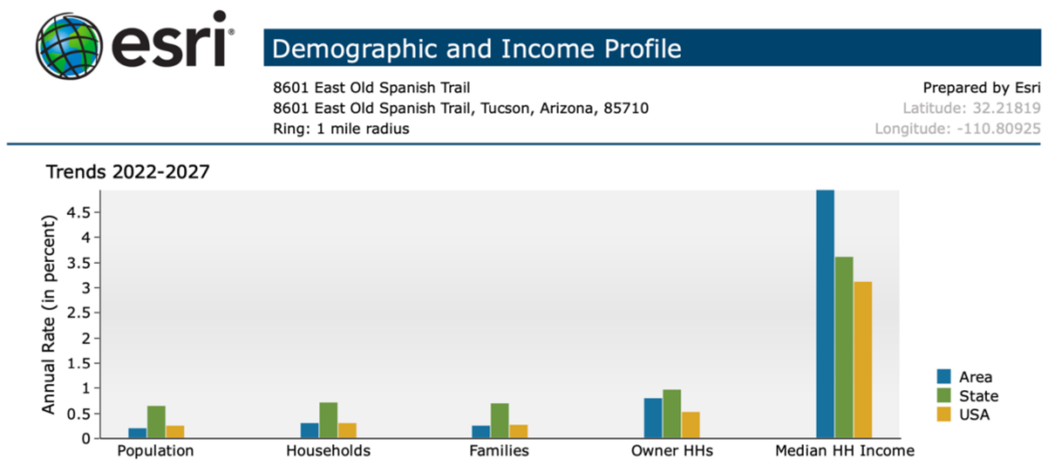
About Tucson

Tucson is located in the southwestern region of the United States in the eastern portion of Pima County, Arizona known as one of the most diverse valleys found in the Sonoran Desert. As the second largest city in Arizona, centered around the smaller towns of Oro Valley, Marana, Catalina, South Tucson, Sahuarita, Vail, and Green Valley, Tucson is one of the oldest continually inhabited areas of North America.

The Tucson MSA boasts a population size just over one million and is expected to continue growing at an average yearly growth rate of 0.7% into 2026 resulting in the addition of over 30,000 residents. Over the same period, total nonfarm employment is expected to reach 417,000 based on a modest 1.475% average yearly growth rate. Personal income is expected to grow at an average yearly growth rate of 5.75% eclipsing $70 billion in 2026. Lastly, retail sales, after growing by 9.5% in 2022, are expected to stabilize around an average annual growth rate of 4% nearing $25 billion by 2026.

Demographic and income trends expected from 2022 to 2027 of the larger Tucson area and the specific Old Spanish Trail submarket are shown below. They follow almost identical trends with increases in all areas shown. However, the rates of increase are below those of the state and entire country in most areas. The one area that the larger Tucson area and Old Spanish Trail submarket show rates of increase higher than the state and country is in median HH income with the rate of increase in the Old Spanish Trail submarket being more than a full percentage point higher than in the state and country. With substantial annual rates of increase in median HH income and moderate increases in other areas expected for the next five years, it is highly likely that there will be an increase in housing demand in this market over this period.





These population and economic growth trends are driven by various factors. First and foremost, Tucson sees an average of 350 sunny days a year in addition to warm dry air making it ideal for outdoor recreation. The protected natural areas that border Tucson on all sides and easy access to seven of the world's nine life zones help to make it widely considered one of the world's best destinations for outdoor activities. Additionally, it is the first UNESCO Creative City of Gastronomy in the United States. As a place that has become known for outstanding outdoor adventures, rich cultural traditions, a vibrant arts scene, world-class golf, and great dining, Tucson hosts nearly 7 million visitors annually, and it is becoming a hot spot for remote workers and investors alike thanks to rents that sit below the national average. It is also home to the University of Arizona, the first university established in Arizona, which attracts over 50,000 students and staff from around the world. Other top employers include Raytheon Missile Systems and Davis-Monthan Air Force Base. These strong employers along with the favorable climate, strong tourism, and other factors mentioned create a ripe environment for the economic and population growth in Tucson that can help a multifamily investment thrive.

Current Local Apartment Market Conditions

The Tucson apartment market has held strong. Its vacancy rates currently sit at 8.16%, according to Cushman & Wakefield's 2023 Q4 market beat. This is up by 0.70% from Q4 of 2022 and significantly higher than the record low of 4.5% seen in mid-2021, but it is returning to historic average levels and over 1,000 units have been recently added to fulfill the strong demand. Over-construction has for the most part been limited though with the current pipeline of 1,600 units representing just 1.9% of the existing stock, according to CoStar. Compare this to other markets in the Sun Belt that are seeing more than 8% of inventory under construction (CoStar). With a more controlled pipeline, Tucson will have an easier time navigating supply-side pressures.

Rents have increased YOY by nearly 1.0%, currently sitting at an average of $1,182. Although historically rent growth hovers around 2.9% (CoStar), the fact that many other markets are experiencing negative rent growth highlights this market's resiliency. The U.S. Bureau of Labor Statistics indicated that "remote worker migration contributed to 60% of the increase in home purchase and rental prices" (Arizona Daily Star). According to CoStar, these rents are still well below national averages and roughly 40% lower than those seen in nearby Phoenix, so Tucson's affordable cost of living will continue to be a driver of growth. However, the affordable housing index in Tucson has fallen below the national average of 40.1% to 38.2% for the first time in 15 years (Arizona Daily Star), so demand for rental units will remain high at least until the housing supply stabilizes.

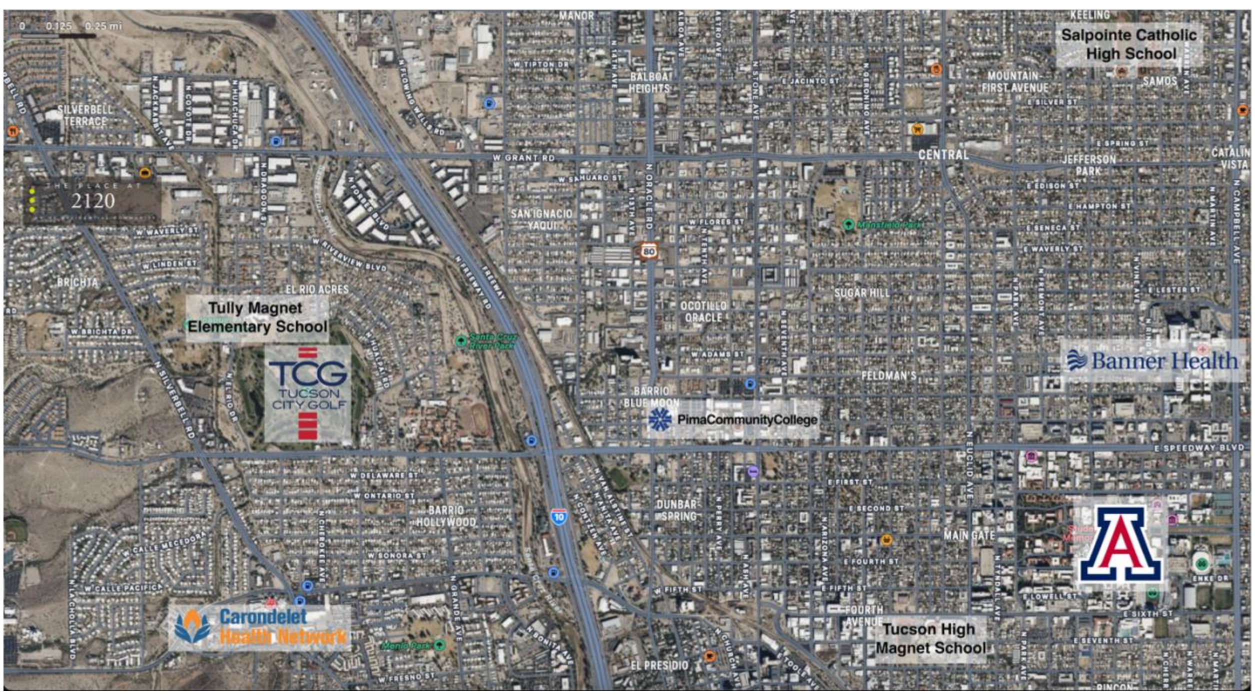
Market sales have slowed, as have national sales, due to the wide gap between buyers' and sellers' pricing expectations in light of expensive financing and a looming economic recession. The 12-month total of transactions currently sits at 59 while it sat at 111 a year ago, according to CoStar, a nearly 50% decline in sales volume. These sales traded at cap rates ranging from 4.3% to 8.9% with at 6.5% average (CoStar). Although sales volume has taken a hit, these decreases are being seen nationwide and cap rates are stabilizing near pre-pandemic levels, so it should not be a distraction from Tucson's long term positive outlook.

Detailed Property Description

The Place at 2120 is a 202-unit garden apartment property with four unique floorplan offerings built in 1987. It has two varieties of one-bedroom, one-bathroom floorplans at 412 and 500 square feet respectively. Additionally, it offers both two-bedroom, two-bathroom and three-bedroom, two-bathroom floor plans at 728 and 969 square feet respectively. Each unit features central heating/air, carpet/vinyl plank flooring, all electric black kitchen appliances, a garbage disposal, and a private storage closet located directly outside the unit. Almost all units have been recently renovated sometime between 2021 and 2023 with roughly only 20 units remaining unrenovated. The units are spread throughout 11 buildings on the property taking up 115,230 square feet. The buildings are two stories with units on both the ground and upper levels. The upper-level units offer carpeted flooring for sound deadening and vaulted ceilings. There is a 12th building that houses the leasing office, clubhouse, laundry, and fitness center. Other property amenities include 228 uncovered parking spaces, a pool with hot tub/spa, a playground, a dog park, and grilling and pet cleanup stations.

It is located just west of the Interstate 10 in Tucson. Just about anything a resident would need is within close proximity. There is a Safeway, Ace Hardware, Anytime Fitness, Big O Tires, several drug/convenience stores, a couple banks, and various fast-food options minutes away. The St. Mary's Hospital is easily accessible heading south on Silverbell Road and the Banner University Medical Center is a short drive away. Various options for schooling exist throughout Tucson, and there are two Tucson City Golf courses nearby. This can all be seen in the maps below.

Location and Aerial Maps



Photos of Property

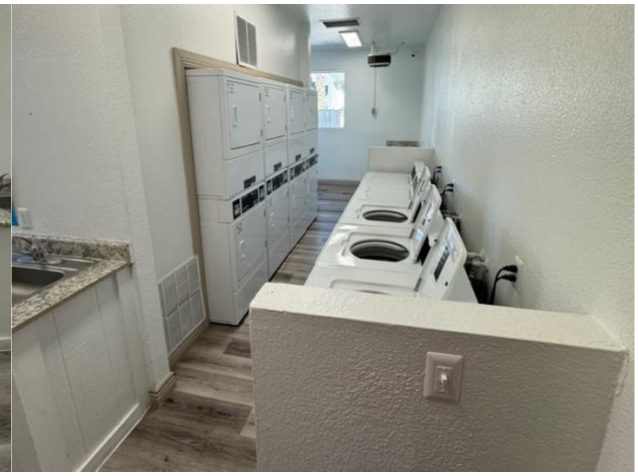
Exterior

Amenities

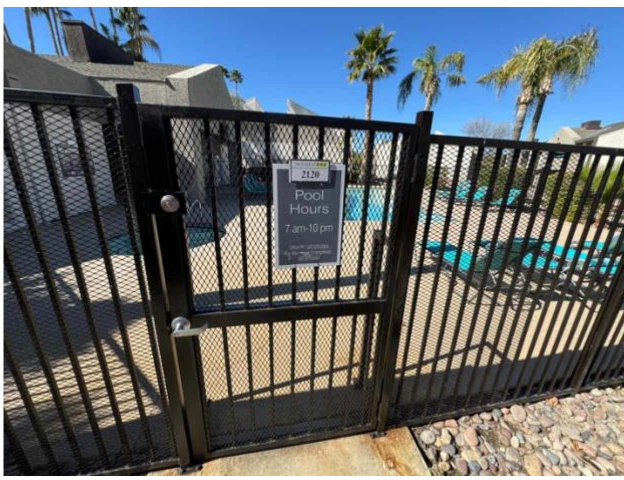
Clubhouse with Kitchen

Mail

Laundry



Pool with Hot Tub/Spa



Fitness Center

Playground

Dog Park

Grilling and Pet Cleanup Stations

Units

Upper-Level Updated Unit

Ground-Level Non-Updated Unit




Storage closet

Floorplans

Summary of Current Physical Condition of Property

The property currently appears to be in good physical condition. There were no obvious defects identified during the tour, and management provided that there has been no significant fire or water intrusion or other property damage in the past 12 months. Additionally, management reported that there were no capital expenditures in progress or planned for the next 12 months, and no significant rehab or construction is currently taking place. Therefore, prior to inspections, it appears the property is in good shape.

Recommended Due Diligence/Inspections to be Performed

While the property appears to be in good physical condition with strong financial standing, it is still recommended to perform several phases of due diligence and inspections. It is recommended that roof, HVAC, and overall structural inspections are performed. Additionally, it is recommended that due diligence be performed on the current books and rent roll to confirm financial performance.

Summary of Current Lease Terms & Rent Roll

The current lease terms include a variety of flexible short- and long-term lease options, but most leases are signed on one-year terms.

The current monthly rent roll (1/18/2024) details the market and actual rents being charged across the four different unit types. The total estimated monthly market rent for the property is listed at $231,731 whereas the total monthly actual rent is listed at $182,816, so there is around a $50,000 discrepancy between the estimated market rent and what is actually being collected.

Breaking it down by unit, the current average market rent for A1 units is $927.94 while the current average actual rent being collected is $861.74, an approximately $65 discrepancy. The current average market rent for A2 units is $1,026.06 while the current average actual rent being collected is $929.68, an approximately $95 discrepancy. The current average market rent for B1 units is $1,154.51 while the current average actual rent being collected is $1,127.71, an approximately $30 discrepancy. Lastly, the current average market rent for C1 units is $1,535 while the current average actual rent being collected is $1,377.50, an approximately $155 discrepancy. The largest discrepancy between market and actual rents can be seen in the larger C1 units whereas the lowest discrepancy is seen in the midlevel B1 units.

The current rent roll shows 18 vacant units resulting in an 8.91% vacancy rate. There are also 15 scheduled move outs that could end up increasing vacancy if not backfilled before the move out dates. Finally, it appears that four units are withheld to be used as either model units or housing for property staff.

Competitive Properties

Puesta Del Sol Apartments and La Lomita Apartments have been identified as competitive properties to The Place at 2120. They are both located within minutes from the subject property. Both Puesta Del Sol Apartments and La Lomita Apartments have one- and two-bedroom units, but neither offers three-bedroom units. The subject property has three-bedroom units that, while only a small percentage of the unit mix, allow it to reach a larger tenant mix. Another differentiating factor that allows the subject property to stand apart from its competitors is that it allows pets with no breed or size restrictions whereas both competitors have restrictions on the breed and size of pets. The one thing that Puesta Del Sol Apartments offers that the subject property does not is covered parking. This could be seen as advantageous for them because it caters to tenants looking for that. Covered parking is not offered by La Lomita Apartments though, so it does not appear critical that the subject property have it. Even without covered parking, the availability of three-bedroom units and lack of restrictions on pets provide The Place at 2120 with a strong competitive advantage.

Value Added

While The Place at 2120 presents compelling financials as-is, several potential value-add opportunities have been identified that could further enhance the financials.

First, it was mentioned in the previous section that one of the competitors offer covered parking, so it would be reasonable to add covered parking to the subject property. It would not only make it more competitive with nearby properties, but it could also increase the value of the property by increasing income. Management mentioned that covered parking was offered to tenants at other properties anywhere from $15 to $25 a month. With 228 total parking spaces on the property, this addition could increase income by up to $68,400 resulting in over $600,000 in additional property value at a 6.50% cap rate.

Furthermore, a common practice that could provide additional value is integrating solar power with the covered parking. This would provide a multitude of benefits. First and foremost, it would provide sustainable energy to the property and tenants, reducing the property's impact on the environment. From a financial standpoint, over the long term, it would result in lower property operating costs and lower utility costs for tenants. Being able to advertise the environmental consciousness and lower utility costs of the property to tenants would provide a strong competitive advantage that would help attract tenants and potentially draw premium rents. Either of these resulting outcomes would make the property more valuable.

To continue, another service not offered by the subject property that is becoming popular in the industry is valet trash. Industry standard for valet trash service is between $25 and $35 per month. With 202 units, income could be increased by up to $85,000 by implementing a valet trash service. At a 6.5% cap rate, this would increase the value of the property by over $1.3 million. Management mentioned that a valet trash service at this property is not expected to be popular among tenants though, so this may not be the best option.

With a variety of potential value-add options, it is suggested that a survey be conducted among tenants to gauge interest in each of the options and determine which one ultimately would provide the greatest opportunity.

New 10 Year Cash Flow Analysis

The New 10 Year Cash Flow Analysis for The Place on 2120 required various assumptions that will be detailed here. To start, rents on the rent roll were based on the average of current actual rents for each unit type. The current actual rents were used instead of the current market rents to take a more conservative approach, but if a more aggressive approach was desired current market rents could be used because, as mentioned earlier, they are substantially higher than current actual rents in some cases. Yearly rent growth estimates were based on the current slowing of rent growth with expectations for it to return to historical average levels by year 3. Vacancy rates were forecasted to mirror the current actual figure of 8.91% in year 1 and tick up slightly to 9% for the remainder of the hold in line with CoStar's forecasted average for the market. Credit loss percentage was estimated at a conservative 5% for the entirety of the hold. This is loosely based on data observed in the provided trailing 12 months statement and should provide some room for error. Expense growth was modeled at 2%, just slightly below the FED's 10-year expected inflation target, for the entire hold. The management fee percentage, based on values seen in the trailing 12 months statement, was set at 3%. Finally, expenses were estimated at the industry average, 40% of effective gross income, with capital expenditures determined using the help of expert opinions. Both were modeled to grow at the previously mentioned 2% expense growth rate.

Proposed Financing

The two sources of financing considered for this property investment were a Freddie Mac Fixed Rate loan and a HUD 223(f) loan.

The Freddie Mac Fixed Rate loan offers interest rates between 5.99% and 6.39%, allows loan amounts from $5M to $100M, accepts loan terms from 5 to 30 years, and provides up to 30 years of amortization (multifamily.loans).

The HUD 223(f) loan offers interest rates between 4.79% and 7.29%, allows loan amounts starting at $3M, accepts loan terms up to 35 years, and similarly provides amortization up to 35 years (multifamily.loans).

Both loans were modeled, and it was determined that the HUD 223(f) loan would be the better options for several reasons. First, it offers lower interest rates even when modeled conservatively at 6% in the middle of the provided interest rate range. Next, it allows for 35 years of amortization instead of just 30 years. These factors lower the annual debt service making it possible to remain within the 1.25 DSCR threshold, recommended by Robert Motz of Pima Federal Credit Union, at a higher LTV. The model allowed for an LTV of 75% while remaining above the 1.25 DSCR threshold under the terms of the HUD 223(f) loan. Achieving a higher LTV through lower interest rates and prolonged amortization allows for a greater return on cash equity or investor IRR, so choosing to go with the HUD 223(f) loan is advised.

Financial Metrics

With the proposed financing in place, the financial metrics can be examined. The cash-on-cash return is modest in year 1 at 4.7% and grows steadily year after year up to 12.6% in year 10. While the cash-on-cash return may not be exemplary at the start, it surely improves throughout the duration of the hold. Looking at the IRR, if this property was purchased without a loan and instead treated as an all-equity investment, the resulting IRR is estimated at just under 10%. This by itself is promising considering you would be earning nearly a 6 percentage point spread on the 10-Year Treasury that sits at 4.33% as of writing this. However, if a loan is used, as proposed above, it is estimated that an IRR of 16.23% can be achieved because of the positive leverage that ensues. This provides a nearly 12 percentage point spread on the 10-Year Treasury and an additional 6.28 percentage point return compared to the all-equity investment. If comfortable taking the additional risk of a loan, it is clear that, using the terms modeled, it would allow for much more favorable returns.

Offering Price Recommendation

Based on careful financial analysis, it is recommended that an offering price of $22,957,287 be used to acquire this property. This offering price is estimated to provide the strong financial metrics discussed in the previous section. It was determined using a cap rate of 6.5%. This cap rate was chosen based on past 12 months sales data provided by CoStar. This data showed cap rates ranging all the way from 8.9% down to 4.4% with an average of 6.5% across 57 transactions. The average was chosen as a conservative measure. Using this cap rate and the Year 1 NOI of $1,492,224, the recommended offering price of $22,957,287 was calculated.

Conclusion

The Place at 2120, a 202-unit apartment property located in Tucson, Arizona, is a promising investment opportunity. It is located in a city that has strong growth potential. Additionally, the apartment market conditions are healthy and appear to have withstood the headwinds. If acquired at the recommended purchase price of $22,957,287 with a loan at the terms specified herein, this property is estimated to generate returns above 15%. It is recommended that this opportunity be seriously considered.

Sources and Citations

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