



Henderson Global Investors

Jay Martha and Susan Motowidlak sat down with **Ryan Mattox**, managing director – North America, at Institutional Real Estate, Inc. to talk about Henderson's CASA fund series. The following is an excerpt of that conversation.

Henderson's series of CASA funds has been around for quite some time. When was the first fund launched and what is their investment strategy?

Motowidlak: The first CASA fund was launched in 1993 to invest in core and value-added apartments. Today, we are on CASA V. We have the same property focus that we did in 1993, when Jay and I worked on the first fund — U.S. apartments located in primary and select secondary markets with strong demographic and economic trends — but we have three investment strategies within each fund. First of all, we invest in conventional core apartments. Secondly, we invest in typical value-added apartments that need to be repositioned. Finally, we invest in tax-exempt bond financed apartments. We can choose to invest directly or via a joint venture depending on the asset.

How are apartments fitting into today's environment?

Motowidlak: Apartments are probably the best-positioned of the four primary sectors to perform very well over the next five-year period. There has been a repricing in the market, and it is a good time in general to invest in real estate because the lack of development portends a dearth of supply, which will help the occupancy side and rental rate. Unlike the period of the late '80s and '90s, multifamily is not overbuilt. From the demand side, we believe that professionally managed apartments will be the product of choice for former and would-be homeowners who are not looking to own at the moment. In addition, the echo boomers are hitting their stride in household formations. They are graduating from college, starting their

first jobs and setting up households, which likely will require apartment living. So we should have almost a perfect storm on both the demand and the supply side for the next five years or so.

I'm sure you know that you are not the only investment firm interested in apartments. How do you avoid getting caught up in competitive bidding and overpaying?

CORPORATE OVERVIEW



James Martha, managing director property, North America, joined Henderson in 1992 and is responsible for the overall management of the North American property business including the strategic planning and management of various client portfolios. He chairs the North American Property Investment Committee and Portfolio Performance Committee and is a member of the North American Management Committee. Martha is also a member of Henderson's Global Property Management Team. Martha has 28 years of property investment experience managing both debt and equity for institutional and HNW investors.



Susan Motowidlak, director and portfolio manager is responsible for the strategic planning and portfolio management of two multifamily commingled funds, as well as the ongoing management of operations, value enhancement and dispositions of various other North American fund and separate account assets. She is a member of the North American Property Investment Committee and Portfolio Performance Committee. She has 34 years of real estate experience, beginning her career with Aetna Realty Advisors as a Real Estate Analyst.

The Henderson CASA Fund Series has ...

- ❑ Approximately 20,520 apartment homes under management
- ❑ 61 total apartment properties in 25 markets
- ❑ \$1.7 billion of apartment assets in bond-financed and core/value-added strategies
- ❑ \$1.5 billion in bond-financed apartments
- ❑ Acquired 73 apartment properties for \$2 billion; sold 42 for \$900 million since 1999, for an average realized IRR of 14.4% before fees (13.2% after fees)
- ❑ Dedicated CASA portfolio management team working together for 17 years; supported by platform of 20+ professionals in asset management, research, transactions, finance, reporting and client relations

CORPORATE CONTACT

Henderson Global Investors

Daniel McDonough Jr.

Director of Institutional Marketing, Business Development

One Financial Plaza, 19th Floor • Hartford, CT 06103

Tel: 860-723-8610 • Fax: 860-723-8601

daniel_mcdonough@hendersonna.com

www.henderson.com

Martha: Our three-tiered strategy serves us well in sidestepping some of the general overheated auctioning. For example, we have our Manager of Partners Program in which we joint venture with local operators that have proprietary access to supply. More importantly, our focus on tax-exempt bond financed apartments results in us being part of a very select group of buyers with the expertise and experience to acquire these assets. Because of our experience and long track record with these types of assets, we are almost always on a seller's prospect list when they are looking for a buyer. In addition, because the seller can count on us to close, we have been selected many times to buy a property when we weren't the top bidder.

Why is it important to sellers that the first buyer is able to close?

Motowidlak: Tax-exempt bond financed apartments take nearly twice as long to close as conventionally financed apartments. For example, a conventionally financed apartment will typically take three months to close; a tax-exempt bond financed property can take up to six months

to close. Because of that duration and the complexities associated with the closing of the tax-exempt bond financing, sellers of tax-exempt bond financed properties are very particular in selecting their potential buyers because they lose so much time if they have to go back to the market.

Why would you use tax-exempt financing instead of conventional financing?

Martha: Tax-exempt financing came into being in the early '80s when the federal government allowed states and municipalities to issue bonds that would be exempt from federal taxes in an effort to encourage the development of moderate income housing. Moving the authority over where moderate-income housing was developed away from the federal government and into the hands of the local housing authority was an excellent decision. For the investor and developer, tax-exempt bonds result in significantly lower cost to finance the property, which motivates the investment. The trade off is that the property is required to set aside a certain portion of its units, typically 20 percent, for residents that make 80

percent or less of the MSA's median income, which motivates the housing authority. Although, in many cases, the set-aside units have the same rents as market-rate units, the restrictions do protect those residents from rent spikes that might eliminate their ability to afford housing in the market, so we see it as a win-win.

Motowidlak: The tax-exempt bond financed apartments we typically buy are existing stable properties, which, due to the lower cost of the financing, have a very strong income component. This is one of the differentiators between our CASA series and a typical value-add program. Typical value-add programs tend to have a higher appreciation return, while ours tends to have a slightly higher income return.

So this financing can be used for existing apartments as well as new construction?

Martha: Although the financing was developed to encourage new construction for moderate-income housing, we typically buy properties with existing bonds in place. The bond program that we tend to target are bonds that were issued for developments in the 1980s and early 1990s, also known as pre-1986 tax reform act (TRA) bonds, so the age of the properties is typically in the 20- to 25-year range. The pre-1986 TRA bonds tend to have more attractive restrictions versus post-1986 bonds. In addition, we have the ability to extend the term of the bond in most cases. A typical bond issue was 30 years. We typically come in and extend those bonds for another 25 years or so in order to obtain long-term financing through the tax-exempt plan.

Why do you focus on 20- to -25-year-old apartments?

Motowidlak: In addition to the less restrictive set-aside requirements associated with the bonds, there is often a value-added component associated with the age of the property. The general property type in our CASA Funds is down the middle, B-quality property in an infill location. We invest capital into the property to make sure that it is consistent with the local market demands. The result is a value-added rehab program of physical assets plus a leveraged return because of the low-cost financing.

Apartments are a favored sector U.S. Apartment Characteristics

- Represent a sizable investment for institutional investors
- Next to office, 2nd largest share of institutional ownership
- Most attractive risk-adjusted returns of the major sectors
- Sector has proven to be most buoyant in recessionary periods
- Characterized by high, stable occupancy rates
- Lowest capital expenditure ratio
- Apartment dividend payout ratio is estimated to be 83%
- Other property types' dividend payout ratios range from 64% to 74%
- Favorable financing terms compared to commercial assets
- Fannie Mae and Freddie Mac executions available below 6%
- Bond financing currently below 3%
- Current and expected fundamentals favor apartments



Reading Commons, Boston

What is the difference in financing cost between a tax-exempt bond and typical financing?

Martha: In most instances, we use floating rate debt when a property is financed with tax-exempt bonds. The tax-exempt rate stack uses the SIFMA rate as the pricing index. Today, SIFMA is trading at around 25 basis points. Then we pay an enhancement fee — essentially the purchase of a guarantee from a government agency or bank that the bond will be paid — and in some cases a rating agency fee, so the all-in cost of debt in today’s market ends up at about 225 basis points for AAA-rated tax-exempt bonds. Conventional financing is generally 5+ percent today. The +/- 300 basis point spread falls to the bottom line, enhancing both our cash flow and total return.

What type of experience do you need to successfully acquire tax-exempt bond financed assets?

Motowidlak: The requirements to execute these bonds are very detailed and precise. Most managers do not have the infrastructure or experience to meet the reporting requirements of government-issued bonds. To aggregate all the information, you need to have close working relationships with experienced property management companies that also have experience in managing these types of properties. So on an operational basis, you need a much higher level of expertise to maintain the properties and meet the requirements of the housing department.

How does Henderson’s expertise compare to others when you do find yourself competing with others with capability in this area.

Martha: The typical bond-financed property will look and operate almost identical to conventionally financed property in the same market, so there is really little difference from the resident’s perspective. However, the seller of a property with a bond in place is cognizant that a firm with our experience, knowledge and track record is just a better buyer; we’re a proven closer. Any buyer of tax-exempt bond financed property needs to be approved by the bond issuer. The background check of a bond financed property buyer always includes the history and any

Tax-Exempt Bond Financing

Housing Revenue Bonds are tax-exempt municipal bonds providing tax relief benefits at the federal level and sometimes state level to taxable investors.

- ❑ Bonds are issued for the development or renovation of market rate housing with pre-determined set asides for residents with moderate to low income levels (typically 20/80 or 20/50).
- ❑ Utilizing tax-exempt housing revenue bonds is a leverage strategy that gives investors access to core-like apartment opportunities with below-market financing.
- ❑ Bond financing has typically averaged 200 to 400 bps below conventional multifamily financing.
- ❑ Experience working with issuers, credit facilities, private placement vehicles, rating agencies, bond counsel and remarketing agents is essential to successfully execute tax-exempt bond financing.
- ❑ Henderson’s established track record is a competitive advantage as sellers and various participants are reassured of the certainty of execution.
- ❑ The skills necessary for the ongoing complex day-to-day management and reporting requirements associated with bond financed assets are critical, thus, it is essential to maintain property management relationships with operators experienced in bond financed assets.

Los Prados, Plantation, FL



track record with this type of product and financing. Henderson has been a buyer of tax-exempt bond financed properties for the past 17 years and has maintained a very impressive track record over that period.

Motowidlak: The property typically requires enhancement as well, and we have relationships with federal agencies as well as mortgage banks that allow us to secure those enhancements at very attractive rates, which again, helps our bottom line.

Does being a preferred buyer on a bond ever translate into a better price for the asset?

Martha: It not only often translates into a better price for the asset — we often end up with the asset despite being outbid — but it translates into a lower cost for the enhancement. It is crucial to the issuer of the enhancement that the bond sponsor be credit worthy. The experience of the sponsor has a significant impact on that cost of enhancement. We have a very good track record and history that helps keep that cost of debt low.

How do tax-exempt investors benefit from tax-exempt bonds?

Martha: Actually, the buyer of the bonds themselves is not our client. Typically, the buyer of the bonds is a taxable entity, such as a corporate institution, that is looking for tax-exempt income. Our clients are institutions interested in investing in our apartment funds seeking to benefit from the operating cash flow and appreciation. The cash flow is boosted by the low cost of debt, and the longer term appreciation is generated by owning stabilized apartments over a period of years.

Have you used this strategy since the beginning of the CASA series?

Martha: We’ve always invested in value-added tax-exempt bond financed properties, but how that financing fits into our performance has evolved. In the late ’80s and early ’90s, debt was a bad word for the institutional investor. Although we acquired properties that had tax-exempt bonds in place, the financing was considered a liability and there-

fore we ended up defeasing those bonds so that we could present an unlevered fund to our clients. In 1995, we pursued the same value-add apartment strategy by targeting properties that had tax-exempt bonds. By this time, however, investors were beginning to accept the fact that the low-cost debt associated with the bonds was a return enhancer rather than a liability, and so our second CASA fund saw us bringing bond-financed properties into the portfolio and retaining the debt. By the third fund, we were primarily focused on tax-exempt bond financed properties. In fact, we ended up refinancing the first fund by purchasing a highly leveraged tax-exempted bond portfolio and spreading that leverage across the initial portfolio we had originally defeased. We brought back in the bond financing strategy in 1999 that we originally defeased back in 1993.

How is the current economy affecting your bond strategy?

Motowidlak: There will almost always be a spread between tax-exempt bonds and market-rate bonds. So although today all interest rates are low, we still receive a performance boost by using the tax-exempt bond

strategy. These bonds are also considered quite safe due to their enhancement, which improves their desirability in uncertain economic times .

Besides the already-in-place financing, what are some of the advantages of acquiring these assets?

Motowidlak: These apartments are often a vital part of a community's stability. They provide housing for moderate-income, renters-by-necessity families, typically in areas near where they work and play. When we purchase a property, we tend to upgrade the physical plant and bring it up to standard with the market-rate complexes in the area. From the outside, no one can tell the difference between our subsidized complexes and the market rate building across the street. Because of the bond financing, we can provide affordable housing in infill locations in some of the higher-cost metro markets in the country. This is a good thing for the renter as well as for the community. The buyer of a tax-exempt bond financed property can normally choose to pay off the bonds and convert the property to conventional market rate financing, and avoid the set-aside requirement. But we believe that keeping the tax-

exempt financing in place is good for everyone — the tenant, the community and our investors.

Martha: Although the bond financing is just one component of our value-add CASA apartment series, it is a primary component of the financing strategy. The financing is important to the enhancement of both our income and total returns. It is also important to note that our typical property is also a conventional market rate property, so that even though there are set-aside requirements associated with the bond, there isn't really any difference in most cases between our property and the property across the street that is conventionally financed. Sometimes that message gets lost. People have an image of a low-income housing project, and that is not the type of property that we are investing in. We are invested in standard, core apartments. We tend to end up with an investment that carries a slightly lower risk than a full rehab, but with the same level of return. Lowering risk while maintaining value level returns is very attractive at this point in the cycle. Actually, it's very attractive at most points in the cycle. ♦

Investment Strategy

