

**Ask Dr. Ca\$h Flow**  
**by Nick Sidoti, R.A.M.**

Q: Dear Nick, When you are thinking about buying a property and are doing the financial analysis, how much do you allow for the reserves, and for the vacancy factor?  
Tom L., Buffalo, NY

A: Dear Tom, This is an area where many investors run into trouble. They forget to set aside money for problems and losses that are part of property ownership. Let's look at each of these factors.

One thing that you don't want to confuse is the amount set aside for reserves, and the amount set aside for routine repairs and maintenance.

**Reserves**

Reserves are money that you set aside in your budget for unexpected problems, or replacement of major items like the furnace or roof. Plan to set aside anywhere from 5%-10% for reserves, but you need to look to the property for guidance. The big question that you need to address is the age and condition of the building and its components. Don't forget to include something for the unexpected and unplanned breakdowns.

Example: If you know that the roof of the building will need to be replaced in about three years, and you expect that it will cost about \$1,800, you may want to put aside \$50 per month, plus the 5%, as explained below.

One thing that you don't want to confuse is the amount set aside for reserves, and the amount set aside for routine repairs and maintenance. You should plan to spend money on repairs and maintenance on a routine basis. The age and condition of the building will be a determining factor in deciding how much to include in the budget.

**Comment:** This is unclear. 5% of what, the purchase price of the building? The annual gross income?

**Vacancy Factor**

Vacancy factors vary from area to area. They really are dependent on supply and demand. When your property is located in a very desirable area where there are more "customers" (tenants) than "product" (apartments), the vacancy rate will be lower. The reverse is obviously true too. When there are more apartments than tenants, you should allow for more vacancies in your budget. Vacancy rates also depend on the condition of your property and your rent levels. Over-priced products don't sell. Even in the most competitive markets you should still allow for some vacancy losses. There will be times that apartments are vacant due to turnover, unexpected moves, cleaning or repairs, or deadbeats.

One way to find out what your market is doing is to find out what the financial institutions are using for a vacancy factor.

With the above information in mind, here are some numbers that you may be able to use as a base.

Vacancy factor – 5% of gross income.

Reserves – 5% of gross operating income.

Repairs – 5% of gross operating income.

Maintenance and Supplies – 5% of gross operating income.

I believe that when you are estimating these figures you are always better off estimating on the high side. As I've told my students in my talks around the country, if you are going to err, err on the side of caution.

P.S. Your question about vacancy factors gives me the opportunity to predict the future. With all the discussions of welfare reform – reducing the amount of money going to welfare recipients, removing people from the welfare roles, and cutbacks on all sorts of government programs, the vacancy rate will be increasing nationally.

Every time the government decides to tighten its belt, it is a double-edged sword. Even though you may not be renting to those on welfare or government programs, taking these people out of the rental market will increase vacancies and increase competition. Q

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