

## **Start the New Year Right with Property Management Budgeting Basics** by Craig McConachie

Preparing a budget for an apartment complex is one of the most important functions in property management. Forecasting with accuracy, setting realistic goals and attaining those goals can be very rewarding. Rather than viewing the budget process as laborious number crunching, the property manager can look upon it as challenging and satisfying. An accurate budget becomes the essential planning device for setting rent rates, scheduling major repairs and capital improvements. The property owner can understand, at a glance, what the cash flow will be on a month-to-month basis, whether to expect a profit or be prepared to make an owner's deposit.

This article discusses how to prepare a one-year operating budget for an apartment complex.

There are many types of budgets: one year, five year, capital expense, rent-up, construction, renovation, etc. This article discusses how to prepare a one-year operating budget for an apartment complex. This type of budget has five basic components: 1) income 2) operating expenses 3) capital expenses 4) debt service and 5) cash flow.

The first step in preparing the budget is to gather all the pertinent data. If historical income and expense figures are available, they can be extremely helpful. An attempt should be made to examine all figures on a "zero-based" budget concept. This assumes that you have no historical information available and each number must be thoroughly researched and arrived at separately.

Rent rates should be examined in detail. Unit type, size, location and condition should be reviewed. One commonly used approach is to establish a price for the best unit of each type and then deduct for any deficiencies in the other units to arrive at fair and accurate scheduled rents. Market surveys using comparable apartments in the area should be completed. Comparisons should consider price per square foot, amenities (in the units and at the complex), and any move-in fees, deposits or incentives. Changing demographics, population trends and employment need to be analyzed to determine what will affect the demand for rental housing.

Timing of rent raises should be reviewed and decided upon before finalizing the scheduled rent for the upcoming year.

Once the projected rent schedule has been determined, other income sources need to be examined. These might include: application fees, security deposits, late fees, coin-op income, credit check fees, pet fees, carports, garages, storage, cable TV, etc. Each income category must be separately analyzed and projected income scheduled for the month in which it will be received. It is a good idea to make notes on the assumptions that are being used for each category as you go along. These will later be used to formally accompany the final budget.

Vacancy and credit loss should be calculated next. Historical data can sometimes help to determine the amount of turnover per month. Average loss of rent per day / per unit type needs to be established, as well as the amount of time it takes the on-site staff to prepare the unit for re-rent and the amount of time to market and rent the unit. Credit loss is directly related to tenant screening procedures, tenant profile and collection policies. Strict adherence to established policies and procedures will help control this.

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Supply and demand of rental properties, new units under construction and projected absorption play a critical role in determining vacancy factors. Once a vacancy and credit loss percentage has been established for each month, it can be applied to the total scheduled income (rent income plus other income) to arrive at the Effective Income.

There are basically two types of expenses that are incurred: Fixed (uncontrollable) and variable (controllable). Although some operating expenses are sometimes called

“uncontrollable”, a good property manager knows that all expenses can be controlled to some extent. These types of expenses might include utilities, property insurance, property taxes, payroll taxes and management fees. Variable or controllable expenses include maintenance and repairs, payroll, legal and accounting, landscaping, advertising, painting, cleaning, etc.

Some managers prefer to have one person prepare the income projection and another prepare the expense projection. This prevents the temptation to increase or decrease certain categories to arrive at the desired bottom line. Accuracy must be the definitive goal in budgeting.

Vendors, utility companies, insurance agents, city and county municipalities must all be contacted to ascertain projected expenses relating to the property. Property taxes and valuation must be examined carefully to arrive at an accurate figure.

The maintenance expense category should begin with a complete physical inspection of the property. Any deferred maintenance should be noted and associated costs budgeted. The owner's goals must be known in order to prioritize the expenses. Cash flow of the property will dictate the level of maintenance that can be sustained. If the project suffers from a substantial amount of deferred maintenance, the owner may not be able to contribute enough funds to correct it all in one year.

The capital expense portion of the budget is prepared next. Here again, the physical inspection of the property plays a key role. The age and condition of all major components at the property needs to be determined. Roofs, carpets, appliances, pool equipment, furniture, etc., can all be considered capital improvements if they are replaced. Try to determine what month these expenses will most likely be paid. For instance, if you know that you have a majority of the leases expiring in September, you may want to budget for carpet replacement costs in October.

In some instances, capital expenses might be prompted by a change in market conditions rather than deterioration (e.g. replacing green shag carpet and avocado appliances with more contemporary colors), or to improve energy efficiency and performance (e.g. changing to five gallon toilets or regular fluorescent lamps to T-8 electronic ballast fixtures). Some capital expenses may be made to increase the income stream (e.g. carports, storage unit or garages).

Whatever the reason, capital expenses play a critical role in the budget process. Their impact on value, refinancing and disposition is substantial. Ownership goals and directions need to be thoroughly understood by both the manager and the owner(s) before coming to any conclusions.

The last portion of the budget is to establish the debt service. This is very often beyond the property manager's control. It is on the bottom of the budget, but on top of the priority list for payables. You should know the amount of principal and interest due on all debt paid by the property (First, Second, Third mortgages, promissory notes, letters of credit, etc.) for each month. Make sure to research any balloon payments, adjustable rate mortgages (ARM's), refinancing fees, etc. After compiling the data for income, operating expenses, capital expenses and debt service, you will know be able to arrive at the “bottom line” or Cash Flow.

Once this preliminary budget has been prepared, you may wish to analyze your numbers in several different ways. The most common are: per unit, per rentable square foot and percentage of income. Doing this will allow you to more easily compare your property to others. If the budget does not meet with the owner's goals or presents a negative cash flow, you may wish to adjust it at this point.

The final budget should be approved by the owner and include a complete, narrative summary of all the notes and assumptions that were used for each line item.

Monitoring the budget and providing a comparison to the budget report at the end of each month is essential. Do not wait until the middle or end of the year to review the budget. It provides one of the property manager's most important tools to measure his effectiveness and the property's performance.

Remember that a budget is a projection and will not be perfect. No one can predict every contingency that may arise over the course of a year. Round off your figures. You do not need to account for every penny. Make sure you include a miscellaneous category to catch some of the unplanned expenses.

Now that your budget is complete, you have met the challenge and there are no contingencies, for which you have not budgeted, sit back and relax. The property can now run itself, and best of all, you do not have to prepare a budget again for another twelve months!

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