

## How to Evaluate Your Apartment Building Purchase

by Larry Rubenstein

Many readers told me that my article [CREJ, March 15, 2004] covering the evaluation of an apartment building purchase was useful. We looked at the parameters used in expressing apartment values, such as cost per unit, gross rent multiplier, capitalization rate and cost per square foot. However, some readers are unsure how to apply the information to their potential purchases or to buildings that they own.

Another question concerns how the numbers fit into the bigger picture. For example, are the numbers for the building being evaluated par for the course or an outlier? This article aims to review those parameters and how to calculate them.

LRA Management Inc. compiled data on many of the apartment buildings it managed in 2004, which will provide an idea of what percentage expenses and collections to expect on a purchase and thus help compute key indicators.

The capitalization rate generally is the most precise way to evaluate a purchase. It requires information on the property's realistic expenses, vacancies, skip-outs, evictions, move-in discounts and upside in rent potential.

Recall that the definition of capitalization rate is the return that buyers would receive on their investment if they paid completely in cash.

In other words, talking the annual rent collections, subtracting all the expenses and having no mortgage payment, this "net operating income" is the annual cash return. Dividing the annual return by the all-cash purchase price results in the capitalization rate.

In this market, capitalization rates run as low as the 4 percent range and perhaps as high as the upper 6 percent range.

For example, \$100,000 in scheduled gross income less 5 percent collection loss, less 35 percent expenses, leaves \$60,000 net operating income; Divide \$60,000 by a \$1 million asking price results in a 6 percent capitalization rate or a 6 percent return on the investment if a buyer pays all cash. Of course, this excludes potential appreciation or depreciation.

Another helpful use of the capitalization rate is its relationship to mortgage rate. If the capitalization rate equals the mortgage rate, the mortgage payments are covered by the property, and you get the capitalization rate return on your down payment. And the other relationships work for or against you, accordingly.

One obvious note of caution is about percentages. The percentages discussed here are related to scheduled gross income, the total rent a landlord would collect if the building were full and everyone paid in full. Clearly, for 10 units paying \$5,000 each or 100 units paying \$500 each, the scheduled gross income of \$50,000 would be the same, but the expenses would be much higher in the 100-unit building.

Similarly, a building with master-metered utilities would have much higher utility expenses than one that metered individually. Also, expect an old building to have more maintenance expenses than a new one, but large buildings have some economies of scale.

Taking all this into consideration, LRA Management found remarkably similar percentages among buildings of different size, age and owners. Using these numbers can provide a very rough guideline in evaluating capitalization rates and purchase prices.

Our results underline the favorable prices for owning apartment buildings, particularly in Southern California. Ten years ago, these numbers would have been far less promising. As for the future, please consult your own crystal ball. LRA Management's 2004 results follow.

Total collections as a percentage of scheduled gross income averaged 98 percent for buildings constructed after 1978 and 97 percent for those built before or in 1978. The numbers are a bit surprising in that most of the pre-1979 buildings are rent-controlled so one would expect lower turnover. Those numbers contrast with the numbers we experienced in the mid-1990s, which were 85 percent to 90 percent. Imagine making 10 percent more of your scheduled gross income as a return on investment. That's the equivalent of getting free building maintenance. And one wonders why apartment prices are so much higher today.

The expense categories were utilities, operations, administration, maintenance and major capital upgrades.

- **Utilities**, as a percentage of scheduled gross income, were similar between old and new buildings, as well as for building size – five to 200 units. Pre-1979 buildings averaged 7 percent; post-1978 buildings averaged 6.2 percent. So some utility savings may be gained by owning a new building. However, average rents are a bit lower in the old buildings, so the lower-rent denominator explains some of this difference.
- **Operations** includes a range of expenses: property taxes, insurance, business taxes and fees, pest control, pool and legal fees. These percentages definitely were higher for old buildings, averaging 18 percent, while new buildings averaged 14 percent.
- **Administration** includes professional management, resident managers and payroll expenses. Again, the old buildings ran a bit higher in expenses than newer: 8.25 percent versus 7.75 percent, respectively. This difference may be simply the mathematics of the smaller denominator of lower average rent in the old buildings.
- **Maintenance** includes all the rest, including plumbing, painting, cleaning, routine carpet changes and repairs. Remarkably old and new buildings had similar maintenance percentage of scheduled gross income, 10.7 percent. This includes normal turnover rent-ready work, as well.
- **Major capital improvements** include such things as rehabbing units with marble tile and installing fancy carpet, molding, new cabinets and fixtures. They also include putting on a new roof and upgrading common areas. These generally are discretionary expenses, which depend on an owner's plans for the building.

LRA Management has been averaging 2 percent of scheduled gross income on the buildings it manages; of course, the property owner ultimately directs the amount spent.

Adding up expenses and subtracting the collection losses, the net operating income for these properties averaged 53 percent for the old buildings and 58 percent for the new buildings.

So how can an investor apply this information to a potential purchase?

Multiply a building's annual scheduled gross income by 53 percent or 58 percent, depending on building age. Dividing that number by the purchase price provides the capitalization rate. Keep in mind that these percentages are based on average rents of \$930 per month for the older buildings and \$1,100 for the newer ones. Adjusting the scheduled gross income for under market rents will give a better idea of a building's potential value.

So, assuming a scheduled gross income of \$100,000 per year and a purchase price of 10 times scheduled gross income, or \$1 million, an old building's net operating income of 53 percent generates \$53,000 on a \$1 million investment, or a 5.3 percent cash return. Use your building's numbers to calculate your capitalization rate.

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