

## **Buying Apartments Out of State – Part 3**

### **By Tim Elliott**

My first article discussed some reasons to look outside of California for your next apartment building. Some of the reasons were better near term growth, better cash flow, higher depreciation, better leverage and more landlord friendly states. The second article discussed demographics and job growth and suggested some parts of the country to consider.

You may be already searching for apartments listed on the internet. If you search a site like LoopNet you may find many properties with capitalization rates of 8% or more that look like they could generate good cash flow. And they are so easy to find! You just search by the list price or number of units and then sort by capitalization rate. In fact there are so many listings that you may be overwhelmed with choices and have trouble deciding which ones are worth investigating. You can spend many hours looking at properties and walk away confused and frustrated. So how do you know which ones are good investments and which ones are a nightmare money pit?

Here are some features I look for to initially qualify a property. This will help you sift through the listings more quickly and find the more attractive deals.

**Construction** - Brick or stucco will last longer and require less maintenance than any painted surface. Avoid any exterior siding material that requires extensive painting. Look for pitched roofs for better drainage and longer roof life.

**Location** - Look for properties that are located on a major street with good visibility and good signage. This will reduce your advertising costs and help keep your vacancy down.

**Financing** - Look for properties that allow new financing to take advantage of the current low interest rates. If a property has a loan that must be assumed and it is more than 6.5% or requires more than 25% down to match the loan then move on.

**Separate Meters** - Tenants should pay their own utilities. With increasing energy costs, units that are separately metered for gas and electric are much more desirable. You don't want to be paying for gas heat on a property with a central boiler and have gas prices go up by 10-20%. Yes, you can implement a RUBS program but that is more time and more work.

**Capital Improvements** - Always look for properties where the owner has made major improvements like new roofs, paint, repaved parking lots, upgraded kitchens, new appliances, etc. These are large expenses and will save you a lot of money in the future. Any property that is 20 years old or more that has not had at least some of these improvements will be a money pit. You may be selling a 60 year old building and an apartment complex built in the 1980's might seem new by comparison. But after 20 years, things start to wear out and if someone else has not replaced them you will.

**Management** - Finding a good management company can be difficult. If the current management company is doing a good job of keeping occupancy high and expenses low and they can continue managing for you, that property looks very attractive.

**Demographics** - I prefer cities with a population of at least 100,000. The local economy will be

diverse enough to weather economic downturns. Also, there will be enough management companies to choose from to look after your property. Check the census data for population change from 2000-2006. The US average was 6% or about 1% growth per year. If the city you choose is not growing at an average rate be careful. If growth is negative keep looking. Also check census data for per capita income and average household income. If per capita income in the local area is \$15,000/year the property is in a poor area. Per capita income should be at least \$25,000 and household income should be at least \$40,000.

**Capitalization Rates** - The Capitalization (Cap) rate is the Net Operating Income (income - expenses) divided by the purchase price. It is a relative measure of the rate of return a property will produce. It does not include the loan payments. In effect, it is the rate of return you would get if you bought the property for all cash. They differ from the than the Gross Rent Multiplier (GRM) which is simply Gross Scheduled Rent divided by purchase price.

One problem is that the cap rates advertised by brokers are usually proforma (hypothetical) rather than the actual current cap rate. They show what the potential returns could be, not what they are today. Yes, believe it or not, sometimes brokers try to make properties look a little better than they really are. Have you heard the expression "put some lipstick on this pig"? So you could realize the proforma returns if you raised the rents, collect more late fees, reduce the vacancy, start charging for water usage, reduce management fees and maintenance costs and find a cheaper insurance policy. Well, good luck with all that. So, the first thing you need to do is look at the current income and expenses and calculate the current cap rate so you know how much has to change to get to the proforma cap.

The other problem with cap rates is that even current actual numbers (especially expenses) may not be reasonable. Frequently owners show unrealistically low maintenance costs because they do the work themselves or have a friend that does the work very cheap. Also many owners stop making improvements if they know they are going to sell soon. Another common problem is not allowing for management fees in the expenses which usually occur when the owner manages. If you are looking at a property that is 20-30 years old you will need to budget for replacements of appliances, cabinets, flooring, roofs, etc. These capital expenses are typically not included in a cap rate calculation but they are real expenses nonetheless. A typical amount is \$250 per unit per year.

So don't be fooled by a high proforma cap rate. But conversely, don't be fooled by a low cap rate. Some brokers do present actual numbers and even though they may not look great there may be good potential returns. Sometimes owners are charging far less than market rents and you could raise rents to generate more income. Sometimes the owners are paying too much for management, maintenance or insurance and if you can reduce these expenses to average amounts you may have found a good property.

The bottom line is you need to analyze the operating statements to know whether any property is an opportunity to make money or to lose money. You need to review all the numbers and be able to recognize whether they are high, low or about average for the location and condition of the subject property.

*Tim Elliott is an investor in Long Beach and may be reached at 562-305-4293.*