

Risky Business – Tips for Entering the Apartment Market

By David Zlotolow

The last several years have produced great returns for apartments in the Southern California Area. Higher rents and occupancy rates combined with lower interest rates have generated tremendous returns for apartment owners. Apartments are now commonly selling for prices exceeding \$100,000 a door all over Southern California. But what does the future hold?

There are several factors to consider when entering the apartment market or when considering a new purchase. Here are some tips that I think may be helpful. I will break them down into three sections; Rate Risk, Rent Risk and Maintenance Risk.

Rate Risk

Believe it or not, interest rates are starting to trend down again. This is great for the apartment market. However, the low rates are a potential pit fall. Lower floating rate loans with attractive start rates may seem enticing but could prove to be expensive down the road if rates return to the long run level of around 8%. This is very important to those who are in the purchase market. Make sure if you are taking a floating rate loan to look at the historical performance, for example Libor (London InterBank Offer Rate) is lower than the WSJ Prime Rate and the 11th District Cost of Funds Rate, but Libor is traditionally one of the most volatile rates. Libor is very low now, but it will probably be the first index to jump up when global demand turns around. So, it might be cheaper today and very costly tomorrow, but you can protect yourself against rate risk with a fixed rate loan program.

Rent Risk

Rent Risk, one of the main catch phrases used in the marketing on apartments for sale is “under market rents, major upside potential”, this implies that rents can be raised after purchase. When buying, be sure to look into what the local rent control code says. In Los Angeles, for example any apartment building built before 1978 is under the rent control code and rent raises are limited to 3% per year. Also rents have been trending higher over the last several years, but past performance is no guarantee of future performance. Be careful when calculating your rent projections not to be too optimistic. There was quite a long spell of vacancies and lower rents that few people seem willing to remember.

Maintenance Risk

Many older buildings have differed, undiscovered problems that appear to be simple to fix but could become very costly. For example, leaky pipes can generate mold, cooking oil can clog up pipes, a roof can be replaced over rotten rafters.... In addition, some apartment programs such as Section 8 require that apartments are maintained to strict standards while rents are held constant. So... be careful and make sure you have any new building inspected by someone competent and trustworthy. Also, remember that in buildings with rent control and master metering, you are responsible if electric and gas prices go up!

In closing, even though apartments have soared in price over the last several years does not necessarily mean that prices will continue to go up. But, Los Angeles must look wonderful to a large percentage of the population digging out of the snow right now and with the average price of a home in Southern California, many are left with apartments as the only solution. If you are going to buy, make sure to protect yourself. The last place you want to put yourself in is a building with a rising interest payment, stagnant rents and rising maintenance costs. Be careful, and remember prudence can be the better part of valor.

David Zlotolow has over 10 years in the real estate business, he is a graduate of U.S.C. Dept. of Economics and has an MBA from Pepperdine University. He derives first hand experience as

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