Five Factors for Evaluating An Apartment Building
by Larry Rubenstein, Ph.D.

The apartment investment market in Southern California is as hot as it's been in my 35 years in the business of owning buildings and advising client-owners. I know many people are wondering whether they should jump in and purchase their first building. Apartment building ownership can be profitable, but the decision shouldn't be taken lightly and requires a lot of research.

Consider these five factors used by many sophisticated buyers.

1. The *gross rent multiplier* represents the purchase price compared to the total possible rent collection.
For example, if the asking price were $1 million and the scheduled gross income if fully collected were $100,000, the gross rent multiplier would be 10. This is a useful shortcut number as long as building age, condition, area, rent control, who pays utilities, and potential upside on rent are taken into account.

2. The *capitalization rate* is the rate received on an investment if it were paid for completely in cash, without a mortgage.
Determining this number requires knowing or estimating total building expenses and loss of rent collections, such as vacancies, skip-outs, evictions, move-in discounts. To calculate the capitalization rate, subtract the rent collection loss and total expenses from the scheduled gross income, and divide that number by the purchase price. Using the example above, $100,000 scheduled gross income less, say, 5 percent collection loss and less, say, 35 percent expenses, leaves $60,000 net operating income. Dividing $60,000 by $1 million asking price yields a 6 percent capitalization rate or a 6 percent return on the investment if paying all cash. This, of course, excludes potential appreciation or depreciation.

3. The *cost per unit* is also a useful number in determining value compared to other buildings. To compute it, divide the purchase price by the number of apartment units.
In the example above, if this were a 10-unit building, the cost per unit would be $100,000. By itself, this has little meaning, and, as in the factors above, this number is primarily rent driven. The building's condition, unit size and, of course, location are factors driving this number, but all of these drive rent as well.

4. The *cost per square foot* is also related to cost per unit, as is rent per square foot.
An interesting relational rule of thumb is to divide the cost per unit by 100. An average monthly rent per unit that is equal to or higher than this number would be a very positive sign for purchase in the present marketplace.

5. Determining *cash flow* depends on rent collection, expense, and mortgage rate, both present and future.
A mortgage interest rate that is less than the capitalization rate results in a higher cash flow. If rents are below-market, they can be raised to meet the market (barring rent control) to increase cash flow. Reducing expenses also increases cash flow.

Cash flow divided by investment – down payment, capital improvements and closing costs- yields the return on investment, excluding appreciation. In evaluating a purchase, look at the factors discussed above under present circumstances -current rent and current expenses. Also run these numbers at market rent and perhaps lower expenses.

Learning the language will help greatly when considering a first time purchase.

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