

## Mitochondria Learns to Invest #16

By Klarise Yahya, Apartment Loan Broker

*Continued from last month ...*

“What do you have, eight listings? Three from Saradama Hill, three from the University district, and two from the College area? What happened to that other hilly area?” Mrs. Langerhorn asked.

“Oh, I saw it but realized that it’s too far from my work. The commute would be just too long!” I replied.

Mrs. Langerhorn accepted my explanation. “Ok”, she said, “pick one area and put your data here in the middle of the table where we can both read it.”

Overall, I was most attracted to Saradama Hill. I guess I just felt comfortable there. I asked, “Would you rather have my notes or the MLS datasheet? One of the agents offered to fax the MLS data to me, and I thought that was a good idea so I asked all the agents to do so”.

“The MLS datasheet would be a splendid start, but you’ll have to put your telephone notes regarding the rental income on the table, too, because sometimes agents don’t put the rents in the MLS. They’re selling rental property, but you have to call them to get the income! Can you imagine that?”

I pulled the three MLS datasheets from Saradama Hill and matched them with my notes. “Regardless of what agents tell you, *the only value to income property*” Mrs. Langerhorn said, *“is the income*. So the first thing we must do is to forecast the income we expect to receive.

*“We don’t automatically use the income stated by the owner.* He could have filled the building with family members who haven’t had their rent increased since Clinton’s second term, but will eagerly swear to whatever figure the owner proposes.

“Alternatively, the reported rents could actually be above-market, but only because the seller accepts low quality tenants who stopped paying their rent after the second month. It was easy for tenants to agree to pay above-market, because they had no real intention of doing so on a continuing basis.

“Also, and I know it’s counter-intuitive, you need to realize that after owning a building for a while many owners no longer aggressively push the rents. Eventually the building will be making an acceptable cash flow and he will have agreeable tenants. Rather than rock the boat, the owner no longer strives to keep his rents at full market levels. He sacrifices income for amiability.

“Clearly, we need to independently estimate the gross income we are likely to receive if the units were vacated and re-leased to new tenants. The technical name for this – and you really should begin calling thing by their proper terms – is Gross Scheduled Income (GSI). Gross Scheduled Income is the total rent the units could be expected to achieve if (a) in rentable condition and (b) properly exposed to the market (c) for a reasonable length of time.

“We have one bedroom units and two bedroom units, right? So let’s make a chart like this:”

	Rent 1-BR Unit	Rent per SqFt	Rent 2-BR Unit	Rent per SqFt
Saradama 01				
Saradama 02				
Saradama 03				
<b>Average</b>				

I interrupted. I really didn't have anything to contribute, but she'd been talking a long time and I just felt like it was my turn to say something so I asked the obvious: "How do I know what to put in the boxes?"

"Well, the first column contains the addresses of the properties you're going to analyze. 'Rent per Bedroom' is what the data indicates the rent to be for *that* unit in *that* building. For example, Saradama 01 has only one 1-bedroom unit, and it rents for \$750. Obviously, the data shows that we can get \$750 for the one-bedroom unit.

"But it has three two-bedroom units renting, your notes say, for \$900, \$925, and \$950. If the units are similar, then the data tells us that you should be able to equalize the rents at \$925 if you bought the building. So go ahead and fill in those parts of the chart."

	Rent 1-BR Unit	Rent per SqFt	Rent 2-BR Unit	Rent per SqFt
Saradama 01	\$750		\$925	
Saradama 02				
Saradama 03				
<b>Average</b>				

"Continuing with Saradama 01, the one-bedroom unit contains about 812 square feet", Mrs. Langerhorn said.

"How do you know that?" I asked. Sometimes it seemed like she could make the most outrageous statements about a property she'd never seen.

"Well, the MLS datasheet states that the entire building is composed of three 02-bedroom units and one 01-bedroom unit and contains 3,698 sqft. What we want to do is to subtract out all the second bedrooms to arrive at one-bedroom equivalency.

“I have found that the bedrooms of most – not all, but most – rental units in our area contain about 150 sqft (including closets). If we have three ‘extra’ bedrooms, at an estimated 150 sqft each, we need to minus out 450 sqft to get ‘1-bedroom’ equivalency. So we subtract 450 sqft from the published square footage and get 3,248 sqft. Then we divide by the four units, and find that our one-bedroom unit probably contains about 812 sqft. To get the two-bedroom sizes, we just add 150 sqft and find that they are most likely 962 sqft. After awhile, you get so you can do it in your head.

“Just to double check, if we add one 01-bedroom unit at 812 sqft and three 02 bedroom units at 962 sqft, we’re back to the reported building size of 3,698 sqft.”

After she explained it, all the magic disappeared. It now seemed so logical.

“Could you just go ahead and fill in the Rent per Square Foot for Saradama 01”, she asked.

Early in our relationship she’d suggested I buy a financial calculator. I bought an HP10B11 because it did what I needed and was affordable. I took it out of my purse and put it on the table close to me. “Ok”, I said, “the one-bedroom units rents for \$750 and has 812 sqft.” I punched in 750 and divided by 812. “That means it rents for \$0.92 per square foot.”

I continued, “The market rent for the two-bedroom units is \$925 and they have 962 sqft each. So, \$925 divided by 962 equals \$0.96 per square foot”.

I put the rent-per-square-foot figures in the appropriate boxes.

	Rent 1-BR Unit	Rent per SqFt	Rent 2-BR Unit	Rent per SqFt
Saradama 01	\$750	\$0.92	\$925	\$0.96
Saradama 02				
Saradama 03				
<b>Average</b>				

Mrs. Langerhorn looked at my notes and said, “Saradama 02 has three 1-bedroom units renting at \$725, \$740, and \$775. Unless we have information that the units really are different, we have to presume that they are comparable in size and amenities. Because one of the units is already being rented for \$775, we conclude that the market rent for 1-bedroom units in Saradama 02 is, indeed, \$775.

“And Saradama 02’s sole 2-bedroom unit rents for a reported \$950. Could you just fill in the boxes and then work out the rent per square foot?”

	Rent 1-BR Unit	Rent per SqFt	Rent 2-BR Unit	Rent per SqFt
Saradama 01	\$750	\$0.92	\$925	\$0.96
Saradama 02	\$775		\$950	
<b>Average</b>				

I tried to use her approach to estimate unit sizes. Saradama 02 had three 01-bedroom units and one 02-bedroom unit in 3,150 sqft. I subtracted the “extra” bedroom (at 150 sqft) from the reported building size and got 3,000 sqft. I divided that number by the four total units and found that the 01-bedroom units were probably about 750 sqft and the two-bedroom unit was most likely 900 sqft. I talked out loud as I was doing this so she could correct me if I went off course.

Then I put the 01-bedroom market rent in my calculator and divided by the unit size, giving me \$1.03 as Rent per Square Foot for the 01-bedroom units.

Following the same procedure for the 02-bedroom unit, I divided \$950 by 900 sqft and came to \$1.06 per square foot.

I put the figures in the boxes where they belonged. I looked up and saw Mrs. Langerhorn smiling softly at me. It made me feel like I was doing the right thing. Us women can communicate so much with just our expressions!

	Rent 1-BR Unit	Rent per SqFt	Rent 2-BR Unit	Rent per SqFt
Saradama 01	\$750	\$0.92	\$925	\$0.92
Saradama 02	\$775	\$1.03	\$950	\$1.06
Saradama 03				
<b>Average</b>				

“Ok”, she said, “now do Saradama 03 while I sip my tea.” Saradama 03 had two 01-bedroom units and two 02-bedroom units. The MLS datasheet said it contained 3,300 sqft. Both the 01-bedrooms rented for \$760. The 02-bedrooms rented for \$925. I did the math and put the figures in the correct boxes.

	Rent 1-BR Unit	Rent per SqFt	Rent 2-BR Unit	Rent per SqFt
Saradama 01	\$750	\$0.92	\$925	\$0.96
Saradama 02	\$775	\$1.03	\$950	\$1.06
Saradama 03	\$760	\$1.02	\$925	\$1.03
<b>Average</b>				

“Average each column,” she said.

I did as she requested and turned the paper around so she could read the grid better.

	Rent 1-BR Unit	Rent per SqFt	Rent 2-BR Unit	Rent per SqFt
Saradama 01	\$750	\$0.92	\$925	\$0.96
Saradama 02	\$775	\$1.03	\$950	\$1.06
Saradama 03	\$760	\$1.02	\$925	\$1.03
<b>Average</b>	<b>\$762</b>	<b>\$0.99</b>	<b>\$933</b>	<b>\$1.02</b>

“I really don’t know how this can be useful,” I said. “Remember what you said? “We really don’t know whether those are the real rents or if it’s all just made up!”

“I was referring to the units in any particular building. Theoretically, of course, I suppose it might be possible that all the rents in the entire area are represented fraudulently”, Mrs. Langerhorn answered. “But as a practical matter it doesn’t seem very likely that all the sellers would be making up the same figures, does it? You see, what we need to be aware of is a rental figure that is not supportable. If, for example, one of the datasheets indicated they were getting \$1,100 a month for the same sort of 01-bedroom apartment that was renting for \$750 down the street, we would be very suspicious of the outlier. But when all the rental figures cluster pretty tightly around a central median, we tend to have a degree of confidence in the data.”

Mrs. Langerhorn took off her glasses and rubbed the side of her nose as she began speaking in that dreadful lecturing tone she sometimes used. “This grid tells us three things. Notice that there is only a \$25 range between the market rents of the one bedroom units. The cheapest 01-bedroom unit is \$750, and the most expensive is \$775. Similarly, there is only a \$25 range among the two bedroom units. You tend to find narrow rental ranges mostly when rents are increasing. So the first thing this grid tells us is that we’re looking at a competitive marketplace where rents are trending up.

“Next: we have established that the market rent for units in this area is about \$1 per square foot. It is 99 cents for the one-bedrooms and \$1.02 for the two-bedrooms, but for our purposes we can round them both off to \$1.00 psf. The second benefit of this grid is that, when we analyze a property we can pretty quickly determine if rents are at market or if there is room to increase them.

“Thirdly, if we know the market rents we can estimate pretty closely how much we can afford to pay for a small building”. *Continued next month ...*

*Klarise Yahya is a Commercial Loan Broker. If you are thinking of refinancing or purchasing five units or more anywhere in the U.S.A., **Klarise Yahya** can help. **Find out how much you can borrow!** For a complimentary mortgage analysis, please call her at (818) 500-9966.*