

CAP RATE EXAMPLES – APARTMENT BUILDINGS

The cap rate (CAP) is essentially the amount of net operating income that you receive for your purchase dollar expressed as a percentage.

$$\text{CAP} = \frac{\text{NOI}}{\text{P}} \quad \text{Net Operating Income divided by the purchase Price.}$$

Net Operating Income is income after all expenses except the mortgage have been paid.

Expenses must include an allowance for maintenance and especially management, even if the owner does both by him/herself. Commercial lenders (for all 5+ unit buildings) require that all typical expenses be included when evaluating a loan since they do not intend to go into the property management business in the event of foreclosure.

It is important to note the difference between cap rate and cash flow since these are sometimes confused. Cap rate is the profit percent that you earn on a building if it was bought for cash (no mortgage). Cash flow is how much money is left over after all expenses and the mortgage have been paid. Any building can have great cash flow by putting a lot down on a low interest rate loan.

Therefore, the cap rate is the best and most concise “snapshot” of a building’s financial performance to use when comparing competing properties since it looks at the building itself and not the effect of the mortgage that will finance it.

Sellers want to sell at the lowest cap rate possible; buyers want the highest. One of the benefits of considering the cap rate is its focus on profitability – the key essential in investing. One of its disadvantages is that the investor is initially dependent upon accurate numbers from the seller and your estimate of future year’s income and expense. Of course, once the seller has accepted your offer you will have the opportunity to verify the income and expense numbers by examining the property’s books and records (tenant leases, tax and insurance bills, repairs and maintenance projects completed, utility invoices etc.).

Oftentimes when reviewing listing information, it is apparent that agents have not included all of the expenses or even plugged in a vacancy rate. In this case it may make more sense to just use an arbitrary 60-70% (depending on age and condition of building) of gross income to come up with a Net Operating Income for different properties in order to compare them on some kind of level playing field.

WHAT EXPENSES MUST BE INCLUDED

In general, expenses will run at 35-45% of rents (depending on utility expense bill backs to the tenants, age and condition of the property and whether the property is self managed among other things) or \$3,300-3,600+ per unit per year on a simple post war (electric heat) owner managed ten unit building and \$4,300 or more per unit for a large garden complex with pool. Expenses will vary by county and whether we are looking at in-city, suburban or rural properties.

Real Estate Taxes run about \$800+ annually per unit on average in Seattle although this can vary greatly depending on size, view, condition and location. This tax expense can easily be verified by a review of the tax records.

Insurance has gone up substantially in recent years. Figure \$250-300 per unit; more on smaller buildings (or perhaps less if you are adding a new property to an existing portfolio).

Water/Sewer/Garbage has also gone up rapidly in recent years. This number varies by community and whether we are looking at studio apartments or three bedroom units with dishwashers and washing machines in the units. Figure around \$650-775 annually per unit on average. Note that the trend is towards sub-metering the water (which accounts for around \$390 of the average \$650 annual water/sewer/garbage bill) to have the tenants pay this bill directly based on their consumption which is now the case in over half of all Seattle apartment buildings surveyed recently. Note that the tenant leases must specifically state this though and these leases should be consistent throughout the entire apartment complex.

Common Area Electric and Heat (owner paid). Figure at least \$100 per month for hall lights and coin op laundry rooms.

Maintenance will obviously depend on the age and condition of the building as well as how often the apartments are turned over (new paint, carpet, cleaning etc.) but figure around \$575-775 annually per unit. Tenant longevity is the key to keeping costs down and making money in the rental apartment business. Keep your tenants happy by providing a clean, aesthetically pleasing apartment with a good degree of privacy and your tenants should stay for many years which will enhance your bottom line and ensure profitability for your investment. Note that more than half of Seattle residents rent instead of own (which is a high percentage for an American city) so it is not unusual to have very long term tenants which can be beneficial to both landlord and tenant.

Property Management. Lenders will use 5% of gross income and you can also use this percentage when doing your pro-forma analysis when evaluating a property. On small buildings (under 8 units where a new owner will almost surely self-manage) you can sometimes get away with a few hundred dollars per month for a tenant who acts as a resident manager) but commercial lenders will always plug in a management fee for all buildings of five units or more. But, be aware that actual costs for professional property

management will probably be more than 5% on smaller buildings. Management companies charge 5% minimum and often up to 8% when they show units as well (typically with the management company charging half a months rent as a leasing fee if the owner pays for the advertising or a full months rent as a leasing fee if the management company covers the advertising expense).

Replacement Reserves should be at least \$250-350 annually per unit (or substantially more for an older building) depending on the lender. This reserve is to cover major expenses down the road like replacing the roof, repainting the building etc.)

Miscellaneous Expenses. Figure at least \$500 per year on smaller buildings and probably somewhat more as unexpected events do occur. The stability of having long term tenants will keep this number down.

TWO BUILDINGS LISTED FOR SALE

Below are two comparable buildings listed for sale on the Commercial Brokers Association with the income and expense numbers as provided by the listing agent:

	Building "A" 2117 Waverly Pl. N. 8 Units (8-1/1) 5,332 total sf 1956 construction PRICE: \$1,175,000	Building "B" 2832 14 th Ave W 8 Units (2-Stud, 2-1/1, 4-2/1) 5,508 total sf 1963 construction PRICE: \$1,295,000
GSI (Gross Schedule Inc.)	\$79,360	\$84,200
Vacancy	(1,338)	(2,405)
Other Income	<u>0</u>	<u>1,680</u>
Gross Operating Income	\$78,022	\$83,475
Taxes	\$ 8,000	6,088
Insurance	2,000	2,400
WSG (water/sewer/garbage)	6,183	5,342
Owner paid electric	0	585
Maintenance	4,800	2,400
Management	3,968	0
Other	0	0
Reserves	<u>1,450</u>	<u>0</u>
	\$26,401	\$16,815

NOI (Net Operating Income)	\$51,621	\$66,660
Stated Cap Rate	4.4	5.1
Actual Cap Rate	4.4	4.3

Before making any assumptions on these properties, it is important that the numbers be converted for a fair comparison.. Building B is self managed so a management fee should be imputed (a 5% management fee would be \$4,174). Also the maintenance amount given for building B seems unrealistically low since a couple of tenant move outs requiring new paint and carpet would exceed this amount so we should increase this to maybe 6% of gross income (\$5,009) which is close to what Building A is quoting. Reserves are always understated by owners but we should put at least \$1,450 into Building's B expenses for comparison purposes.

Adding this additional \$10,633 to the Building B expense column would lower the Net Operating Income to \$55,027 which would, in turn, drop the cap rate to 4.3.

Therefore, as previously stated, it is easier to use a standard percentage of gross income (maybe 35% in this case) for vacancy and expenses to determine the NOI and the cap rate when comparing properties. By this quick back-of-the-envelope method:

Gross Scheduled Income	\$79,360	\$84,200
Less Vacancy & Expenses	<u>(27,776)</u>	<u>(29,470)</u>
Net Operating Income	\$51,584	\$54,730
Estimated Cap Rate	4.4	4.2

Note that this method works best when both buildings are of a similar era. Much older buildings (unless extensively updated) would require that a higher vacancy / maintenance percentage (maybe 40-45%) be used.

It is important to remember that location is paramount. Buildings on busy arterials or near airport runways or railways are less desirable and will have a higher tenant turnover (with the resulting greater expense) than those buildings that can offer the tenants a certain "homey" feel with a safe, quiet atmosphere and a degree of privacy.

Another very important determining criteria in evaluating multi-family buildings is the degree of renovation and upgrading that the units have received. With much of the in-city building stock in the close-in neighborhoods being fifty or more years old, there may not have been any upgrades in decades (or sometimes worse are those mid-70's renovations with the dropped ceilings, poor quality cabinets and oddly colored formica laminate surfaces). Even though we are now entering into a landlord's market (with steadily rising rents) buildings are still in direct competition. Tenants are fairly astute

when comparing price versus value. The cozy, comfortable, well maintained and better located building always has the edge in retaining tenants in any market.

So even though the initial price (and perhaps higher cap rate) of a building may make it initially appealing, major renovations of the individual apartments would be a major out of pocket expense of ownership (as well as the down time and loss of income while work is being done on vacant units). Having to replace major building infrastructure such as old galvanized plumbing could be a costly project which will not directly increase the rental potential of the apartment units. So cap rates are only an initial indication of how well a property is priced. Further information on the particular neighborhood's rental market and the true condition of the building itself along with the level of individual apartment upgrades is needed to make a wise investment decision.

An astute investor must also consider the future potential of a property. As previously mentioned, sub-metering water to the tenants is a significant boost to Net Operating Income (and the resulting cap rate). Oftentimes buildings that have been in the same owner's hands for many years will have below market rents which have not been reflected in the asking price – which can be a golden opportunity to the savvy investor. Also, some properties have larger one or two bedroom units which have the potential to easily add individual stacked washer/dryer units which are a major marketing advantage and will pay for themselves in a very short time. And, though the market has now changed away from condo conversions, this could be another card to play when the cyclical real estate market turns yet again to favor this option.

The bottom line is that there are many aspects of a building to consider before submitting an offer and in most cases the buyer does not get the opportunity to view the interior of a property (unless a vacant unit is available) or to examine the books and records until the seller has accepted the buyer's offer.

For a city the size of Seattle, there always seems to be a lack of supply of fairly priced, nicely maintained and well located multi-family properties. Therefore, in these competitive times, when an appealing property does hit the market, it is usually wise to come in strong when making the initial offer to beat out the competition. Then, once the offer is accepted, do a thorough review of the books and records, check the building records and permits at the Department of Planning and Development and do a thorough professional inspection. The buyer can confirm that the advertised upgrades and renovations are acceptable during the inspection and once the written inspection report is in hand, the seller can be approached to re-negotiate the sales price based on any significant repairs that the report calls out.