Sample Problem #1 – Tranquil Manor

Please use any edition of our Real Estate Investment Analysis software for this problem.

Tranquil Manor is a 33,000 square foot apartment complex located at 1000 Raucous Causeway, South Haven, CT 06999. The location is fully built-up and well established with multi-family housing. The prevailing capitalization rate in this area for properties such as this is 11%. You are contemplating the purchase of this property on January 1, 2006.

The building is brick, about 50 years old and has been well-maintained. There is no evidence of deferred maintenance or of the need to replace the roof or mechanicals at any time in the near future. 75% of the value of the property lies in the building and 25% in the land.

The building has 48 apartments. Every apartment is occupied and all leases expire within a year or less. The owner has presented us with the following rent roll information:

10 studio apartments @ $700 each
30 1-bedroom apartments @ $950 each
8 2-bedroom apartments @ $1,150 each

(A note on data entry: Don’t enter 48 individual apartments into the rent roll; it’s an unnecessary exercise. Make only three entries, one for each type of apartment, and aggregate the rent for each. For example, as the first “tenant” enter a name such as “10 studio apartments @ $700” and the first year’s rent as 7000.)

Your research shows that these rents are realistic in this market and also that rents have been increasing at about 2% per year. Although there are no vacancies now, you will estimate a 2% loss of revenue as a credit allowance (i.e., uncollectable rent).

You combine the owner’s representations with your knowledge of similar buildings and come up the following estimate of first-year operating expenses:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting</td>
<td>2,500</td>
</tr>
<tr>
<td>Insurance (fire and liab.)</td>
<td>29,300</td>
</tr>
<tr>
<td>Lawn/Snow</td>
<td>7,400</td>
</tr>
<tr>
<td>Legal</td>
<td>6,200</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>3,200</td>
</tr>
<tr>
<td>Property Management</td>
<td>38,400</td>
</tr>
<tr>
<td>Repairs and Maintenance</td>
<td>29,300</td>
</tr>
<tr>
<td>Supplies</td>
<td>7,400</td>
</tr>
<tr>
<td>Real Estate Taxes</td>
<td>42,600</td>
</tr>
<tr>
<td>Trash Removal</td>
<td>18,600</td>
</tr>
<tr>
<td>Electricity</td>
<td>12,200</td>
</tr>
<tr>
<td>Sewer and Water</td>
<td>29,500</td>
</tr>
<tr>
<td>Telephone</td>
<td>800</td>
</tr>
</tbody>
</table>
You believe that each of these expenses will increase at 3% per year except insurance (5%) and real estate taxes (4%).

The seller’s asking price is $3 million. You believe you can obtain financing for 70% of the purchase price. The terms are 7% initial rate, 240-month term and 2 points. The rate will adjust annually and you project that it will increase 1% each year for the next two years.

The seller will also take back secondary financing in the amount of $300,000. The terms are 8.5% initial rate, 120-month term and no points. The note calls for an annual rate adjustment; again you project 1% increases in the second and third years.

You expect to spend $10,000 in legal and related costs to close the transaction. You also expect to pay 7% of the selling price as your cost of sale when you eventually dispose of the property.

Enter this data and then begin examining the reports. Start with the APOD. What is your projected NOI? Given the market’s prevailing cap rate, does the asking price seem realistic?

Note that your NOI is going up each year, but at a decelerating rate. Why?

Next look at the Cashflow and Resale Analysis. How much cash will you need to close this deal? What number(s) will your lender probably look at first when you present this report? Are they likely to be satisfactory?

Look at the Cash Flow Before Taxes. You should see it decline over the first three years, then slowly recover. Why?

Examine the projected selling price for each of the five years. How do these projections compare to your original purchase price?

Look at the projected Gain on Sale, Sale Proceeds before Taxes and Internal Rate of Return. Are you going to benefit from the sale of this property at any point during the first five years?

If you haven’t done so already, save this Excel file with a unique name so that you can keep a copy as is; then begin using the program’s “What if…?” abilities to re-structure this deal. We will refer to your work so far as “Original Problem 1.”

Start by reducing the purchase price $100,000 at a time; then reconsider the cash flow and resale questions above. (Note: If you entered 0.7 as the first mortgage amount, the program will maintain your 70% loan-to-value ratio.) Assuming that you leave all other assumption unchanged for now, at what price does the deal begin to look acceptable? At what price does it look so good, you start to tell stories about it to your golf partners?
Keep in mind that there are no precise answers to these questions. Think like an investor. What kinds of returns are acceptable to you?

Save one or more of these modified analyses (always with unique names) so you can now get more creative. What if you convince the seller to accept a lower interest rate and/or longer term on the secondary financing? What if you can negotiate a lower-cost property management contract, perhaps with no increase for the second year? What if interest rates don’t go up by a full point in years two and three? What if they go up more than one point, or if they go up every year? What if you find a lender willing to give you a 75% loan-to-value ratio? What if you are able to obtain an interest-only first mortgage at the same rate as the amortized loan. At 0.5% higher than the amortized loan?

Mix and match these changes along with variations in the purchase price to see how they impact the performance of this investment. Try some other changes as well to see if you can structure viable alternatives to the original proposition.

Now that you have done all this work, you belatedly ask the seller if you can examine the leases. Here you discover a serious discrepancy. The seller has given you not what the tenant’s are actually paying but rather what they would be paying if he, soft-hearted philanthrope that he is, were charging as much as the other greedy capitalist roaders in the neighborhood. In other words, he lied. Now you know why he has no vacancies.

The real rent roll for 2006 looks like this:

10 studio apartments @ $650 each
30 1-bedroom apartments @ $850 each
8 2-bedroom apartments @ $1,000 each

Go back to your file. Your new rent assumptions will be these:

   a) use the monthly rents shown directly above as the true rents for the first year (2006);
   b) take the monthly rents the seller gave you originally, increase those rents by 2% and use the resulting figures for year two (2007);
   c) finally, increase the year two rent amounts by 2% annually for years three, four and five.

To avoid getting too bogged down in the mechanics of making these entries, you can use these directions to re-model the income assumptions:

1) On the Rent Roll, uncheck the “Use Global Inflation Rate” check box.
2) Take the dollar amounts you see in 2006, rows 13 and below and re-type those dollar amounts into 2007 as part of a formula that increases them by 2%. For example, if you see 7000 in 2006, put =7000*1.02 in 2007. This is what is described in “b” above.
3) Take the new, lower rents that the seller has just given you and put them under year 2006. This is what is described in “a” above.

4) In year 2008, enter .02 for each of the three rows of data. This is what is described in “c” above.

If you’re unfamiliar with Excel and get tangled up in form over substance, remember that you can always just uncheck the “global” checkbox, calculate the monthly rents manually as described in a, b and c above and then type them in.

When the apartments were rented a below-market rates, the seller experienced no vacancy and you made no allowance (other than 2% for uncollectable rent). What will happen when you impose significant rent increases? (Hint: Some tenants will leave and replacements will no longer be lined up three-deep in the hall.) You should provide a greater vacancy allowance in year two, followed by a moderate level in subsequent years.

Now revisit the questions you considered with “Original Problem 1.” Some of your answers, of course will be different. Earlier I asked you to think like an investor and consider what kinds of returns might be acceptable. Do you feel that the same returns would be acceptable in this revised scenario as in the first? Why, or why not?


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