

HOW TO

CALCULATE YOUR INVESTMENT PROPERTY'S VALUE

IN TODAY'S MARKET



BY JOHN STILES

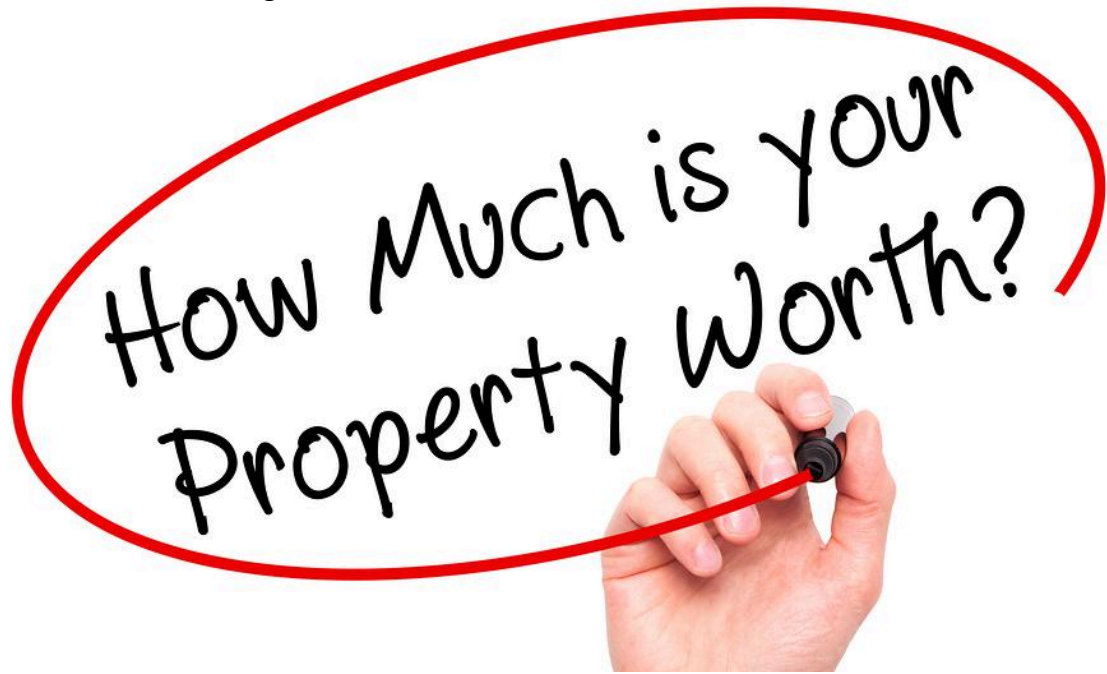
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What is the Value of Your Property?

There are many reasons to determine your apartment building's value in today's market. Maybe you recently received your annual property tax evaluation, and you're considering contesting it. Maybe you are assessing your net worth and want to update how your property fits into the picture. Maybe your loan term is getting close to the end, and you're wondering if you should refinance with another bank. Or, maybe you've been hearing all the news reports about the hot real estate market, and you're wondering if it's time to 1031 exchange into a bigger and better property.

Whatever your reasons, understanding your property's current value is important for being a successful property owner. We're often asked the question, "How do you determine your property's value?" This book is designed to answer that question for you.

The 3 Main Value Approaches

Historically, Real Estate Appraisers have set the standard for determining a property's value. Banks almost always require an updated appraisal of the property when a loan is originated, so it's important to understand how an appraisal works.

There are three main value approaches included in a typical appraisal:

1. Cost / Replacement Approach
2. Sales Comparison Approach
3. Income Approach

Cost / Replacement Approach

The Cost / Replacement Approach is what it would cost in today's dollars to build a similar property in the same location. This is interesting information, but it typically is not a very good indicator of what the current property is worth in an open market. Construction costs have been increasing substantially in recent years due to higher labor and material prices. Updated building codes and inclusionary zoning laws have also added costs to new construction projects. Depending on the specific situation, the cost / replacement approach usually results in a higher price than the existing property would realize on the open market.

Sales Comparison Approach

The sales comparison approach is familiar to most of the general public because it is the primary way that residential real estate is valued. The appraiser will use similar properties that have recently sold and that are in close proximity to the subject property. This approach is typically closer to the building's actual value because it takes into account recent market activity. However, this approach is challenging for apartments and commercial property in general because there is insufficient concentration of similar properties in any given neighborhood.

In order to find comparable properties that are similar in size, style and age, the appraiser may need to extend the geographical search to a several-mile radius. Naturally, the tenant base and potential rental income will change as you go further from the subject property. Additionally, each building can be operated very differently which will result in varying income and expense numbers. As you will see in the following section, the resulting net operating income will drastically affect the property's value. Similar to the Cost / Replacement Approach, the Sales Comparison Approach provides interesting information, but it may not be an accurate representation of your building's true value.

Income Approach

While an appraisal will likely include all three approaches, the Income Approach is considered the most reliable determination of value. This is because rental properties are actually considered a business. Without the income, the building's value would drop dramatically. The income is what causes the property to have value to any typical owner. Unlike the reasons behind a single-family home or an owner-occupied commercial building, most apartment owners don't have any use for an apartment building besides providing housing to tenants who are willing to pay a fair rental amount. It is this function of the building that causes it to have value beyond the underlying asset.

The Income Approach references the Net Operating Income (NOI) and uses a multiple of that amount to determine the value. The multiple is called the capitalization rate (or cap rate) and is equivalent to a cash-on-cash return formula if the property was purchased with cash. Because most investment real estate is purchased using debt leverage, and the amount of leverage varies, it is difficult to use a simple cash-on-cash formula to compare all real estate opportunities. Therefore, the capitalization rate is utilized to even the playing field and provide a better comparison tool.

To determine a property's value using the capitalization rate formula, you divide the net operating income by the local market's capitalization rate.

$$\frac{\text{Net Operating Income}}{\text{Capitalization Rate}} = \text{Value}$$

For example, a building that has a net operating income of \$60,000 per year in a market that demands a 6% capitalization rate would be worth about \$1,000,000.

$$\frac{\$60,000}{.06 \text{ (or 6\%)}} = \$1,000,000$$

If you know the net operating income and already have a purchase price you can calculate the capitalization rate.

$$\frac{\text{Net Operating Income}}{\text{Value}} = \text{Cap Rate}$$

For example:

$$\frac{\$60,000}{\$1,000,000} = .06 \text{ (or 6\%)}$$

Lastly, if you know the value and apply the market cap rate, you can calculate what the Net Operating Income should be.

$$\text{Value} \times \text{Capitalization Rate} = \text{Net Operating Income}$$

For example:

$$\$1,000,000 \times .06 = \$60,000$$

The capitalization rate formula is well known, although it is sometimes misunderstood by property investors. First of all, the formula is most accurately applied to a stabilized asset. If your property has high vacancy or under-market rents, then the resulting capitalization rate may vary greatly from what it should be.

Secondly, it is important to be consistent with what income and expense line items to include when calculating the net operating income. We will explore this in more detail in the next section.

Calculating your NOI

Net operating income (NOI) is the result of subtracting a building's operating expenses from its gross income. In its basic form, it is a very simple formula. However, before you dismiss the topic, be sure you consider the following.

Gross Income

Rental income is the most common aspect of the gross income. Nevertheless, there are numerous other income opportunities that should be included when possible. This list might highlight a possible income source that you are missing at your property.

- Gross Potential Rental Income (the highest rent that the property could realistically attain in today's market)
- Garage Rental Income
- Parking Space Rental Income
- Storage Unit Rental Income
- Laundry Income
- Vending
- Late Fees
- Pet Rent
- Utility Billing Recapture
- Other

Before we move on to expenses, there are a few line items that are subtracted from the income.

- Loss to Lease (the amount of potential rent that is not being collected due to current lease agreements at lesser rent rates)
- Physical Vacancy (rental units that are vacant due to turnover renovations, lack of demand or other reasons)
- Economic Vacancy / Bad Debt (scheduled rent that is not being collected)

These deductions from the gross rental income don't typically show up in your profit and loss statement because they don't represent actual dollars moving from your tenant's bank account to yours. However, these line items are important for analyzing the performance of a property and identifying places where a building's income can be improved.

The total of all these items is referred to as the Effective Gross Income.

Expenses

As with the rental income, many of the expense line items will be obvious such as:

- Property Taxes
- Property Insurance
- Repairs
- Utilities

However, we see that many property owners, especially those that are self-managing, don't include expenses that another business owner would expect to have. These include:

- Property Management
- Leasing Fees
- Payroll for On-Site Staff (leasing, maintenance, concierge, etc.)
- Advertising
- Legal & Tax Services
- Unit Turnovers
- Capital Improvements / Reserves (A prudent business owner will plan for expected upgrades such as a roof replacement, window replacement or other major expenses.)

One thing that is not included in the net operating income is your mortgage payment. The specific loan terms can vary based on the borrower, lender, loan amount and the loan origination date. Since this isn't consistent across property owners, this is the one item that is excluded when calculating the NOI.

When all the potential and actual income and expenses are accounted for, you can accurately calculate your net operating income. After that, you can determine the property's potential market value.

Bonus Evaluation

While the capitalization rate formula is considered the most popular method to determine a property's value, there is another option that can also be helpful: the Gross Rent Multiplier. The Gross Rent Multiplier (or GRM) is a calculation used by many real estate investors when analyzing smaller apartment buildings such as those that have between 5– 50 units. These smaller buildings may not have the same economies of scale as larger buildings do (such as having on-site staff) and may not be effectively analyzed using the market capitalization rate discussed earlier. Using a GRM is also a helpful way to compare properties when the actual expenses and NOI are not yet known.

The GRM formula is: $\text{Annual Effective Gross Income} \times \text{Gross Rent Multiplier} = \text{Property Value}$

For example, if the property's Effective Gross income is \$100,000 and the Gross Rent Multiplier is 10 then the Property Value would be \$1,000,000

$$\$100,000 \times 10 = \$1,000,000$$

Or, if we know the property value and income and want to determine the Gross Rent Multiplier:

$$\frac{\text{Property Value}}{\text{Annual Effective Gross Income}} = \text{Gross Rent Multiplier}$$

Using the example previously discussed:

$$\frac{\$1,000,000}{\$100,000} = 10$$

And lastly, if we know the property value and the Gross Rent Multiplier, we can estimate where the income should be:

$$\frac{\text{Property Value}}{\text{Gross Rent Multiplier}} = \text{Annual Effective Gross Income}$$

Or:

$$\frac{\$1,000,000}{10} = \$100,000$$

In general, a higher Gross Rent Multiplier indicates that the building is a more desirable asset. The desirability of the building is affected by the location, condition and the building amenities. While this may be attractive, a higher GRM may also indicate lower cash flow.

With that in mind, the GRM formula is a helpful alternative but should not be the only calculation used to determine a property's value.

What Today's Buyers Want

What overrides every formula available is the power of the open market. Apartment investing has become very popular, and more and more people are looking to cash in on the craze. Some investors (including large insurance institutions and real estate investment trusts) are seeking the long-term predictability that multi-family housing provides to its investors. Housing is a human need that shows no sign of decreased demand in the foreseeable future. Record high property values in the single family real estate market are helping keep the demand for rental housing high. The perceived stability of the apartment market makes this a relatively safe investment.

When a property is evaluated, a pro-forma is often prepared and reviewed. The pro-forma is based on the property's past performance and projects the financials moving forward. Most potential buyers will want to see a pro-forma, but experienced investors will rely more on the actual history of the property.

Many property owners attempt to sell their property based on what the rent could be and what the expenses should be. Unfortunately, this is not effective. An experienced buyer will understand that it takes more than just snapping your fingers to increase the rent to current market rates. Likely, there is a good reason that rents aren't where they could be. Maybe the building has deferred maintenance, maybe there are amenities that other local buildings offer that are missing in yours. Maybe the units are outdated and in order to get the condition to a point that would attract higher paying tenants you would need to have months of lost rent while the units are being renovated.

These buildings will still sell, but often to a different type of investor. Value-add apartment buyers get excited when they come across this type of property because they see an opportunity to reposition the property through major renovations and improved property management. They plan to make higher returns in a short amount of time through forced appreciation. Since they plan to invest a large amount of capital into the building, a purchase price that will make sense to them will be much less than the property's potential value.

Maximizing Your Property Value

There are many things you can do to improve your property's value. It is not the purpose of this book to explore that topic in depth, but, in short, you need to find ways to increase your property's income and decrease your property's expenses. As explained earlier, the resulting net operating income will be used when evaluating your property's value. It's never too early to begin this process.

Where to Find the Information You Need

As you've seen, there is a lot of data and information that goes into your property's value. Some of this data you will have handy—like your property's income and expenses. However, other information may not be as easily attainable—like the current capitalization rate in your area, market rate rents and recent market sales activity.

You could hire an appraiser for hundreds or thousands of dollars to provide an official evaluation. However, as a professional real estate agent, I also have the data needed to place a value on your property. In addition, I can help you identify specific ways to improve your NOI and increase your value.

If you are interested in maximizing your property value, be sure to contact me today!

About the Author

John Stiles

I will always remember February 2007. I was a newlywed, and we were renting our own place for the first time in South Minneapolis, MN. What was supposed to be a wonderful experience turned bad when our heat went out during the coldest month of the year.

Numerous phone calls and messages to the property management company went unanswered and our lack of heat persisted. It took conversations with the city council, being featured on the evening news and nearly an entire week before it was no longer necessary to wear our winter coats indoors. What was more frustrating than the cold itself was that the property owner and property manager failed to keep us informed about any response or progress during that freezing week. There was no acknowledgement of our situation.

That experience left me thinking that surely I could do a better job. Life took a few different turns, but eventually I became a full-time leasing agent and property manager in the Twin Cities from 2010– 2016. Over the years, I have been able to acquire a few rental properties of my own. Being on the ownership and management side of the relationship has allowed me to learn so much about running a successful real estate company. I have come to believe that the most important key to that success is treating our tenants as valuable customers. Without tenants, there is no rental income. Without rental income, there is no rental business. Without a rental business, the rental property's value is negligible.

In 2016, I transitioned to the sales side of the business and currently work with investors as they buy and sell their properties. Today, I seek to improve the lives of those around me by helping:

1. provide safe and desirable housing options where tenants are valued, and communities are strengthened.
2. provide solid business operations and strategic advancement to improve the financial well-being of my investment partners.
3. provide VIP-level customer service for my clients that are buying, selling and investing.

John Stiles is a licensed Minnesota real estate broker with the Twin Cities Multifamily Team at Peritus Real Estate where he specializes in helping clients buy, sell and invest in multi-family investment properties.

