



Financials of Apartment Buildings

By James Kilpatrick, Managing Broker of Kilpatrick & Company

I wrote recently about the changing nature of investment real estate transactions. One aspect that stays the same is the need to thoroughly analyze a prospective purchase or sale. The “numbers” of a real estate transaction seem to perplex and awe many owners as well as many real estate agents and is the source of numerous questions coming into our office. I will go over some of the basic concepts here.

The four main measures when comparing different real estate transactions are price per unit, price per foot, Gross Rent Multiplier, and Capitalization Rate (Cap Rate). Obviously there are many other factors that need to be considered, but all else being equal, these four numbers give good insight as to the attraction of any given investment compared with other opportunities.

There is a tradeoff between objectivity of the measures and usefulness. Price per unit is the most objective; if a building is \$200,000 per unit then there’s no disputing that. This measure is much less useful for example if comparing a building full of studios to a building that is all 3 bedrooms. Generally a non-conforming (illegal or built without city approval) unit will be considered in the price per unit, but a bank or a buyer may discount the value of that unit (and may require proof that it is up to most codes)

Price per foot is a very objective measure of how much one is paying for actual building area. If your price per foot is very high for the location and surroundings, the rents may be above market. For buildings with big common areas price per foot needs to be taken with a grain of salt. The price paid per foot of rentable apartment may be much more than the price per foot listed (which might include big hallways, entry areas, etc.) Typically with buildings that have exterior walkway entrances, the square footage will not include those walkways. The tax records, Multiple Listing Service, and even sometimes appraisals can be wrong, so why not string a tape measure to make sure you’re getting roughly the square footage you think you’re getting?

Gross Rent Multiplier (or GRM) is probably the most looked at measure of apartment buildings. It is the Price divided by the annual scheduled rents. This number is usually between 8 and 15. It does not take into account vacancy, expenses (which vary greatly from building to building), lost rent, deadbeat tenants, etc. Along with GRM comes “market GRM”. This is typically the measure of what the GRM would be if the Buyer could snap her fingers and have all rents be at market. Market GRM is more useful in a non-rent controlled

city, but is still very useful in rent controlled markets. It's good to know the potential even if it's hard to gauge whether it will take 6 months or 10 years to get there.

The Capitalization Rate or "Cap" rate is a much better indication of what actual return will be, but because it is calculated using expenses and other projections it is more subject to debate and uncertainty. The Cap rate is the Net Operating Income divided by the Price. Net operating income is the Income less all vacancies, expenses, etc. but NOT including loan payments. So if you purchase a property all cash the money you get from the property before taxes is the net operating income. That number divided by price is the Cap Rate. They typically range between 4% and 11%.

A final measure on the purchase side of the equation is Cash on cash or cash on cash return (expressed as a percentage), also known as cash flow (expressed as a dollar amount). This is the measure that takes loan into consideration and thus on a typical transaction is completely different from Cap Rate—despite much confusion. Cash on cash measures the actual dollar cash flow divided by the actual down payment. For example, on a \$1 Million transaction with a \$400,000 down payment and \$20,000 cash flow my cash on cash return is $20k/400k = 5\%$

For those who would like to delve deeper, most bookstores will have instructional material on Internal Rate of Return, Net Present Value and other more complicated valuation techniques that institutions frequently use on large investments where more specific projections and calculations are required.

Please keep in mind that my area of expertise is Real Estate Brokerage. The tax consequences, exchange validity, accounting rules and legality of various strategies are best discussed with the appropriate professional. I have several that I will be happy to recommend. If you missed last month's installment, you may contact me for a copy of the last issue.

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