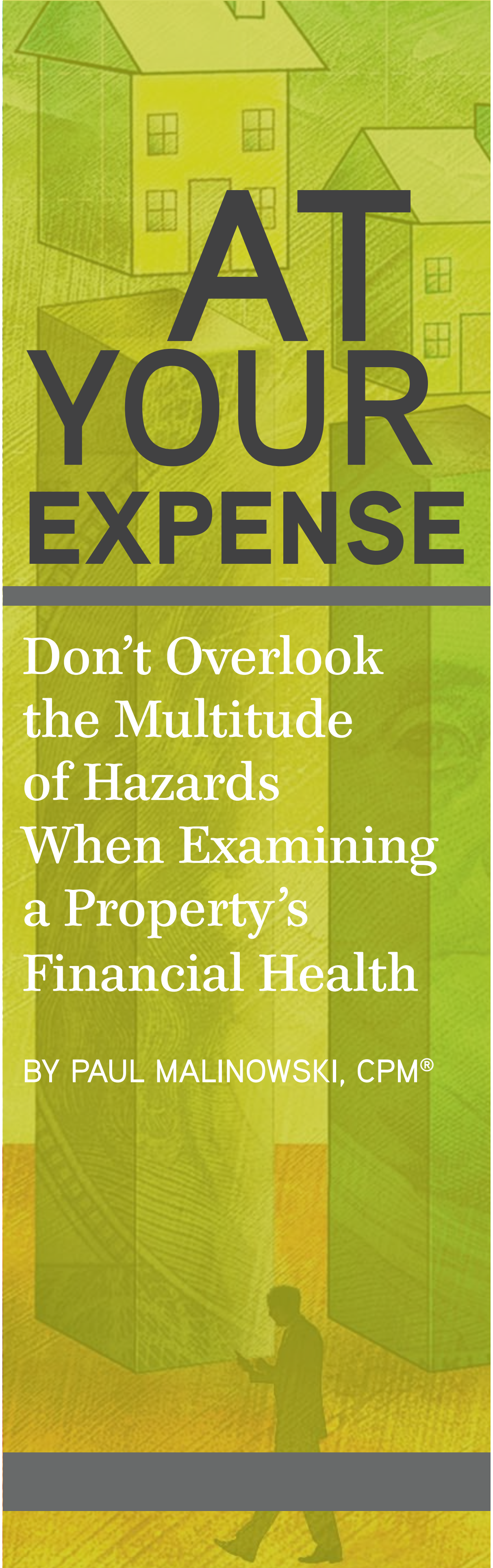

AT YOUR EXPENSE

Don't Overlook the Multitude of Hazards When Examining a Property's Financial Health

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Years ago, one of my clients was involved in a potential property transaction in which he had to decide to either buy out the remaining partners in the ownership entity or attempt to have the partners buy him out. In trying to assess whether the management company was maximizing the property's net operating income, he brought in a consultant to examine the property's expenses.

After one look at the property's most recent profit and loss statement, the consultant confidently declared the per unit per annum (PUPA) expense level to be "too high." PUPA is a way of comparing expenses between residential properties in which the annual expenses are divided by the number of living units.

My client seemed pleased with the consultant's analysis and the leverage it might give him when used as a negotiating tool. He was disappointed, however, when I told him, "It depends."

PUPA expenses are not the only way of breaking expenses down to their base level. In fact, they are not even applicable to commercial properties. The preferred method of expressing commercial properties' expenses is the dollars per square foot of rentable space method, although this method is also used in residential analyses. A third method for measuring expenses—percentage of gross potential income—is also used for both residential and commercial properties.

Regardless of method, making generalizations about a property's expenses or financial health based on any one of the methods alone, is dangerous. I still marvel at how many asset managers and property owners fixate on these figures as if an absolute, total expense industry standard figure exists that we should all use for every property.

Without a doubt, the annual IREM Income/Expense Analysis, which includes items like PUPA expenses and offer "base" figures from which we can make adjustments, is a valuable analytical tool. The analysis allows us to compare the expenses of a 30-unit property to those of a 120-unit property. But again, it offers just base figures.

Solely taking into account these figures would be a disservice to those who own and manage the property. Every property is unique, with at least one variable—if not a half dozen variables—that distinguishes its value or profitability from the building next door. A multitude of common expense hazards should be taken into account to develop realistic expectations for a property and its performance for both the owners and management team.

LOCATION MATTERS

Running a property can be cost prohibitive in one area and relatively affordable in another area, based on:

Wage Rates: Our company manages a property in Aspen, Colo.—a well-known mountain resort community—and one in Lamar, Colo.—a much lesser-known rural community on the Eastern plains. Wage rates differ dramatically between the two communities, thus impacting any line items with payroll or even contracted services.

Jurisdiction-Driven Expenses: Common expenses, like taxes or insurance rates, vary depending on the jurisdiction or geographic area where a property is located.

SIZE MATTERS

Size of rooms, size of a property and size of a lot play a big part in determining a property's expenses.

Bedroom Size Distribution: Would the expenses for a 36-unit, all-studio, 0-bedroom property be comparable to a 36-unit property with half its units housing three and four bedrooms? Not in my experience. Typically the 0-bedroom unit has one occupant, while the 4-bedroom unit can have up to seven or eight occupants. The impact on the water line item alone is dramatic.

Number of Units: Typically, having a larger building or more units means having more tenants or residents, and more sources of income with the same amount of expenses. This concept of more for less (or about the same) is known as "economies of scale." A roof repair amortized over 30 units will be four times greater than if it were amortized over 120 units, assuming a similar "footprint" of the roof. However, larger properties with more buildings could adversely affect expenses. Let's say Property A has 100 units in one building and Property B has 100 units over two buildings. Property B has double the exposure for its building systems to go wrong—two leaky roofs, two boiler failures, etc. When you have multiple buildings in different locations, the economies of scale shrink even more because you have to pay for additional maintenance, landscaping and other services, even though you have many units.

Lot Size: Larger lot sizes may mean lower density which might enhance the marketing of a property, but it can be a killer to maintain if the landscaping is not low-maintenance. A seven-acre site of which half of the lot is grass will necessitate grounds upkeep, not to mention increased water costs for summer lawn sprinkling. Mowing, trimming, edging and watering almost seven acres of primarily grass can cause operating expenses to skyrocket.

OWNERS MATTER

Owner goals and policies can have a huge impact on expenses, depending on their interests, how long they intend on holding a property and whether they capitalize expenses.

Owner Goals: An investor once blocked our approval as a management agent because some expense line items in our financial statements for another property we managed were "excessively high." The investor cited our "grounds contract" line item as the main culprit. Actually, it was unusually high—per the direction of our client, who was well connected to the city council of the town where the property was located, and he understandably wanted the property to be pristine 24/7. Unfortunately, there is a high expense in retaining someone around the clock to pick up every wayward, wind-blown gum wrapper.

Holding Period: Property owners who intend on a long-term hold are less concerned about the Net Operating Income (NOI) affecting value, as opposed to owners looking for short-term holds. The latter will look to maximize sale price under the income approach, to say nothing of enhancing the property's financial attractiveness to a potential buyer.

Capitalization Policy: Whether an owner prefers to capitalize expenditures so they become an asset and never appear as an expenditure, or merely make repairs for the tax write-off (which does show up as an expense), expensing choices can have a big impact. For-profit entities tend to prefer more liberal use of the "instant gratification" that expensing brings, while some of our non-profit clients have wanted partial carpet replacements capitalized. Don't overlook asset expenditures. Just because they don't show up as expenses, doesn't mean they aren't there.

BUILDING CHARACTERISTICS MATTER

A building's class, age, type and whether it's been rehabbed—or at least updated—are interconnected and have a huge impact on expenses.

Building Class: A newer, Class A building should obviously have lower operating expenses than a comparable Class C building, but it may have more expense items overall since it's likely to have more amenities, making any kind of comparison of overall expenses difficult. Class A operating expenses may include a swimming pool and clubhouse, while the Class C building won't even have those line items on its income statement.

Building Age: It might seem obvious, but the impact a building's age can have on expenses might be more substantial than you think. Using some examples from the 2009 IREM Income/Expense Survey, expenses for elevator buildings built prior to 1946 nationally run 6 percent higher per square foot than the same type of building built from 1978 to present; expenses for low-rise buildings with 12-24 units differ 17 percent for the same time periods; and expenses for low-rise buildings with more than 24 units differed by 27 percent for the same time periods.

Rehabs: A building that was constructed 35 years ago will have higher operating expenses, from utilities to maintenance, than a similar property that has been modernized. An apartment previously rehabbed will likely cost less to turn after a move-out. We manage a 35-year-old building and we "rehab" it with every turn, upgrading counter tops, floor coverings, cabinets, etc. This is a good way to phase the cost of a property's modernization, but a bad way to make your PUPA's look good. A more typical rehab, done at one time, is generally capitalized and would not be expensed.

Energy Efficiencies: A property can be older and never rehabbed but still have some energy improvements. If a 1975 building at least had low-flow toilets, newer insulated windows or energy-efficient furnaces, its water or heating costs should be less than a similar building with no upgrades.

Type of Building: IREM breaks out its Income/Expense Analysis by types of building: apartments, office buildings, shopping centers, federally assisted apartments, and condominiums/cooperatives. Obviously, those buildings' expenses should never be compared from one type of building to another. I do not recommend comparing conventional apartment expenses to federally assisted apartment expenses, as how these properties are structured and operated differently. Lastly, within the IREM Conventional Apartments Income/Expense Analysis, generally four further breakouts exist: high-rise buildings, low-rise building of 12-24 units, low-rise building over 24 units, and garden-style buildings. Comparing within each building type is best if your market area has data for all four building types, as they vary consistently.

Audit-Worthy Properties: Does the property have some sort of government funding or financing that requires a financial audit? When we review affordable housing developers' pre-development proforma operating budgets, inevitably everyone forgets to include this. Even the smallest property will add about $5,000 in annual operating expense for an audit, and larger properties can easily spend $10,000-$15,000.

UTILITIES MATTER

Cost of Utilities: Every water district has increased its usage rates to discourage watering. We previously managed a property whose owner wanted to conserve water. We cut back on sprinkling, which naturally resulted in lower water costs but browner grass. When the representative for the property's equity investor did his annual inspection in the summer, he took one look at the drought-stricken brown "carpet," and immediately chided us for lack of curb appeal. I did my best to explain a drought's impact on the cost of water. He wouldn't hear of it so we opened the spigots, so to speak, and therefore the expense.

Master Metering Vs. Individual Meters: Who pays what utilities? Don't assume. Of course, a property that pays all utility expenses will run substantially higher than when the tenant pays utilities or when a charge-back system is in place.

Now that you know these variances exist, attempt to quantify them as much as possible. Try to determine a "market adjustment" just as you would for a rental survey—when you shop properties to compare rent. You may have to guess what the "median" is for your market area and adjust up or down based on the variables listed above. You'll be doing your clients a service by digging deeper and finding the true reasons for industry standard deviations. ▪

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