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CAPS
CERTIFIED APARTMENT PORTFOLIO SUPERVISOR®

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INVESTMENT MANAGEMENT

Participant Guide

October 2018

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The National Apartment Association Education Institute acknowledges the contributions of countless volunteers who made this program possible. We extend our thanks to all and pledge to maintain the CAPS credential as the premier standard apartment industry training program for all apartment portfolio supervisors.

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Message to Apartment Portfolio Supervisors

Understanding the financial part of managing multifamily housing communities is critical to the CAPS' success. Ultimately, it is the CAPS' job to help property owners make money. In order to do that, they need to become fluent in the financials of the business.

Once a CAPS has mastered this essential knowledge and can apply it back on the job, they will be well on their way to maximizing the financial health and performance of a property owner's investment.

The Certified Apartment Portfolio Supervisor (CAPS) training program is designed to provide the CAPS with the necessary knowledge and skills to take on the responsibility of managing a portfolio of such valuable investments.

Investment Management is one module in the CAPS credential program.

The complete set of CAPS modules is:

1. **Client Services and Stakeholder Relations**
2. **Investment Management**
3. **Improving Asset Performance**
4. **Asset Evaluation and Preservation**
5. **Talent Development**
6. **Contemporary Issues in Multifamily Housing**

For more information about this program or any of NAAEI's education programs, ask your instructor, contact your local apartment association, or contact **NAAEI** at **(703) 518-6141** or **education@naahq.org**.

Module Structure and Timing

This module will run for approximately four to five hours. Each module will include a mix of activities, discussions, watching videos, and slides. Your instructor will lead the discussions and walk you through the course.

The time structure of the course will be:

Section	Time
Section 1 - Investing in Multifamily Housing Communities	15 minutes
Section 2: Multifamily Ownership Structures	10 minutes
Section 3: Mortgage Financing	60 minutes
Section 4: Budgeting	45 minutes
Section 5: Getting to the Bottom Line	60 minutes
Section 6: Property Valuation	25 minutes
Activity: In the Owner's Shoes	50 minutes

Introductions

Welcome to the **Investment Management** module, part of the National Apartment Association Education Institute's Certified Apartment Portfolio Supervisor (CAPS) credential program!

Your instructor will ask you to participate in the following activity:

Introduce yourself to the group and answer the following questions:

- **How do you think a property owner's perspective on property management might differ from a CAPS' perspective? Do they have different priorities? Should they?**
- **In your experience, what are some of the most challenging parts of preparing an annual budget?**

[if the class is large, then participants may do this activity in smaller groups]

Learning Goals

At the end of this module, you will be able to:

- **View the properties in your portfolio from the perspective of an owner with a valuable investment to protect.**
- **Identify the types and sources of mortgage financing, and how they might affect the management company's financial and reporting responsibilities.**
- **Coach site teams through the budgeting process.**
- **Work with your community managers to identify budget variances and trends, and craft thorough reports to the property owner.**
- **Be familiar with the fundamentals of property accounting, and interpret the financial documents that measure property performance.**
- **Understand how property values are determined, and recognize the direct impact that CAPS and their site teams can have on those property values.**

Section 1 - Investing in Multifamily Housing Communities

There are several significant advantages to investing in multifamily housing. As a CAPS, it will be important to have some familiarity with these advantages because they represent the true bottom line for the owner. Everything you do has the potential to affect the performance of this investment, and therefore, the benefit the owner accrues from the investment. In addition to providing tax benefits and opportunities for investment diversification, multifamily housing has long provided competitive returns compared to office, retail, and industrial properties. The National Council of Real Estate Investment Fiduciaries reports that multifamily housing properties have produced a higher total return, with less variance, than the average of all property types in the portfolios of pension funds and other large investors. During the 20- year period from 1984-2004, for example, multifamily properties earned an average 9.3% total annual return compared to 7.6% for all property types combined.

This section will cover some of the unique advantages of investing in multifamily housing communities.

Topics Covered:

- Why Invest in Multifamily Housing Communities?
- Income Taxes and Multifamily Housing Community Investments.

WHY INVEST IN MULTIFAMILY HOUSING COMMUNITIES?

People own or invest in property to make money, and historically, multifamily properties have proven to be to a sound choice. The National Multifamily Housing Council reports that demand for apartments will continue to grow significantly, based on current demographic trends. Multifamily housing provides, in the views of many investors, better yields compared to competing fixed-income and equity investments. Still, investors weigh the pros and cons of putting money into multifamily properties, just as they would do for any investment.

Advantages of multifamily housing investments may include reduced income taxes; regular disbursements of cash; diversification of investments; and the opportunity to sell the asset at a greater value in the future.There are a few disadvantages, as well. Real estate can't be liquidated easily or quickly, and properties are subject to potential losses from events like natural disasters and fires, as well as the market

fluctuations that affect other investments. In addition, a multifamily housing investment requires work to manage the investment on a daily basis.

Once an owner has made an investment in a multifamily housing property, he or she will be looking to the CAPS to protect it by doing everything possible to increase Net Operating Income (NOI). To that end, you should make a point of keeping up with financial news so that you can make necessary adjustments to your financial strategy as economic conditions warrant.

INCOME TAXES AND MULTIFAMILY HOUSING COMMUNITY INVESTMENTS

In the normal course of the job, you will likely never see an owner's tax return. Because the owner's tax preparation falls outside the purview of the CAPS' role, it's easy to forget just how much impact you can have on that bottom line. Everything you do ultimately affects the owner's taxable income, and some of the primary benefits of investing in multifamily housing communities relate to investors' income taxes.

Depreciation or Cost Recovery

Under the premise that a property loses its value with age and use, tax laws allow owners a deduction for cost recovery, also known as depreciation. Owners deduct depreciation—that is, the "cost" of wear and tear, age, or obsolescence that reduces the value of an asset—in determining their net taxable income.

Depreciation is the principal source of tax shelter. It is a "paper" expense for owners that can significantly reduce taxable income, even though the property itself continues to produce positive cash flow.

Depreciation, however, only temporarily defers tax obligations. Amounts deducted in prior years must ultimately be recognized when the property is sold.

The Capital Gains Tax Rate

Multifamily housing properties are treated as "capital" assets for income tax purposes, and owners also pay capital gains tax on the appreciated value of the property when they sell it. Capital assets can qualify for special reduced tax rates when they're sold.

The capital gains tax rate influences investor interest in buying and selling multifamily properties. Buyer and seller motivations are affected in different ways, depending on the legislative process and Congressional views on whether the rate is too high or too low.

What's a 1031 Exchange?

Thanks to IRC Section 1031, a properly structured 1031 Exchange allows an investor to sell a property, reinvest the proceeds in a new property, and then defer all capital gain taxes. The time requirements in a 1031 exchange are very specific. From the time of closing on the sale of the relinquished (sale) property, a taxpayer must do both of the following:

- Properly identify potential replacement properties within 45 calendar days (the "Identification Period")
- Close on the replacement properties within 180 calendar days of the relinquished property sale – OR – the due date (including extensions) for the taxpayer's tax return for the taxable year in which the relinquished property was transferred, whichever is earlier (the "Exchange Period").

The Concept of Basis

A property's basis is the amount that it is worth for tax purposes. The basis increases with capital improvements and decreases with deductions taken for depreciation.

- **Original basis** – cost of new construction or property acquisition. Determines book value for tax purposes. Original basis must allocate between land and improvements.
- **Recoverable basis** – cost of capital improvements only, not the cost of the land.
- **Adjusted basis** – adjusts the original basis up or down over the time period the property is owned to reflect the capital improvements added or depreciation claimed. The adjusted basis is the source for the capital gains rate. A taxable gain or loss is determined by the difference between the net sale price and the adjusted basis.

Section 2 - Multifamily Ownership Structures

OWNERSHIP TYPES

Legal ownership structures vary primarily based on taxation and liability. There are six common ownership structures: Sole proprietorships, Limited Liability Companies (LLCs), S Corporations, limited partnerships, real estate investment trusts (REITs), Tenant in Common (TIC) structures, and standard, or "C," corporations.

Individual or Sole Proprietorship

Sole proprietorships are the simplest business form under which one can operate a business. The sole proprietorship is not a legal entity of its own; it simply refers to a person who owns the business and is personally responsible for its debts.

Sole proprietorships are easy and inexpensive to start or dissolve, and the owner retains all of the profits. However, sole proprietorships are risky since the owner is personally liable for any expenses, and it can be difficult to borrow money as a sole proprietor.

Limited Liability Company (LLC)

A Limited Liability Company (LLC) is a legal form of business that combines aspects of corporations (protection from personal liability for business debts) and partnership or individual owners (a passthrough tax structure, in which taxes "pass through" to the owner's taxes, which is generally advantageous to the owner). Most LLCs consist of two or more members, but many states allow single-member LLCs.

LLCs are usually fairly easy to create, and provide a separate legal entity from its members. Usually only the LLC is responsible for company's debts. However, it can be difficult to borrow money as an LLC, and the LLC members/owners are responsible for all losses.

S Corporation

An S corporation is a special form of corporation that meets certain IRS requirements, primarily having a maximum of 100 shareholders. It's named after subchapter S of the tax code. S corporations are taxed like a partnership, rather than being double-taxed like a standard "C" corporation. All taxes "pass through" to the owners' tax returns, as with LLCs.

The advantages and disadvantages of S corporations are similar to those of LLCs, though S corporations tend to be a bit more difficult to set up and maintain, but transitions better to a public stock offering.

Limited Liability Partnership (LLP)

In an LLP, partners contribute capital but don't actively manage the business. This passive role is what distinguishes an LLP. LLPs do limit partners' liability, and otherwise the laws regarding LLPs vary by state.

Joint Venture

A joint venture is a partnership formed to achieve a specific goal or to operate for a specific period of time. Once the goal is reached, the partnership is dissolved. This structure can work well if the partners are aligned in terms of goals and exit strategy.

Real Estate Investment Trust (REIT)

REITs allow small investors to pool investments in real estate while diversifying their risks, maintaining their liquidity, and getting professional management services for the property. REITS are governed by IRS regulations. They come with tax advantages, but investors have little control, since the professional manager makes buying, selling, and management decisions.

Tenants in Common (TIC)

This entity occurs when two or more people own an asset in equal or unequal shares. Owners receive a proportional share of all revenues generated by the property and ownership can be inherited. This structure comes with tax advantages: people can defer capital gains tax that would be owed on a property that's sold as long as proceeds are reinvested in a similar type of property (1031 tax-deferred exchange), provides a way for average person to own part of a large property with a small investment, and allows investors to not have to worry about the day-to-day operation of property (low risk). On the downside, it may be difficult to sell an interest in the property except to one or more of the co-tenants. Also, the TIC sponsor, who locates appropriate properties and provides turnkey real estate investment services, controls the management of the investment, so the investors don't have a lot of say in things.

Corporation

Sometimes known as a "C" corporation to distinguish it from S corporations, these are standard corporations, and are not often used for real estate investments. They do offer limited liability to all owners, but come with two tax-related downsides: Double taxation, in which the corporation has to pay taxes on its profits, which are taxed again when shareholders receive distributions of these profits and have to report them as income; plus capital gains taxes (incurred when selling) are higher than for passthrough entities such as S-corps and LLCs.

Ownership Form	Taxation Status	Investor Liability
Sole Proprietorship	Single	Unlimited
Limited Liability Company	Single	Limited
S Corporation	Single	Limited
Limited Partnership	Single	Unlimited
REIT	Modified Single	Limited
Tenant in Common (TIC)	Single	Limited
Corporation	Single	Limited

Section 3 - Mortgage Financing

Most multifamily community investments are financed with mortgage loans. Investors rely on mortgages for many reasons. While some take out loans because they need the additional financing to cover the cost of the property, others do so to give them the financial freedom to diversify their investments. Mortgages also give investors the ability to take advantage of the financial leverage of low interest rates and high yields. All of these benefits, combined with some very significant tax benefits, make mortgage loans an attractive option for investors.

Depending on the mortgage lender and the type of loan, there may be specific benchmarks, reporting, and debt service requirements the property has to meet, so it's important for the CAPS to be familiar with lender and loan types. Every property in your portfolio will have its own unique financing situation, and it will be your responsibility to know the requirements of each of them.

In this part of the training, you'll increase your financial literacy by learning the general outlines of mortgage financing, why owner's might choose particular types of lenders and loans, and the critical role mortgage financing plays in apartment investments.

Topics Covered:

- Mortgages and Investors.
- Mortgage Notes.
- Receivership.
- Types of Mortgage Loans.
- Sources of Mortgage Financing.
- Mortgage Financing Risks.
- Loan Analysis.
- The Debt Coverage Ratio.

MORTGAGES AND INVESTORS

A mortgage is one of the most common sources of financing real estate investments. It is a lien (or legal claim) on a property that secures a loan. It also includes a promise (the promissory note) that the borrower will repay the money according to the terms of the loan.

The Survey of Residential Finance reports that 86% of all properties of 50 or more units had mortgages, and almost two-thirds of those had level payment, fixed-rate loans.

Why Investors Choose Mortgages

There are many reasons why investors choose to make use of debt when buying or developing an apartment property. For example, investors may:

- Need additional funds to purchase or develop an apartment community.
- Have enough money to buy a property, but take out a loan in order to use the money to diversify their investments.
- Want to take advantage of the tax benefits that allow them to deduct mortgage interest and depreciate their assets.

Investors also borrow to benefit from financial "leverage"—that is, using borrowed funds to increase their overall purchasing power. Practically speaking, this means an owner borrows money at a lower interest rate than what the property itself is expected to yield.

More on Financial Leverage

Leverage can be positive or negative. When the property produces a higher return than the loan's interest rate, you have positive leverage, and the owner's profit and purchasing power increase. Conversely, when the property produces a lower rate of return than the loan's interest rate, negative leverage occurs, and both the owner's profit and cash flow decrease. There are occasions when short-term negative leverage is desirable, such as when the property is undergoing significant renovations that will increase its long-term value.

This principle of financial leverage makes real estate different than other types of investments. Indeed, the investor can borrow a large part of the purchase price or development cost, which is a benefit not found in investments such as stocks and bonds.

MORTGAGE AND PROMISSORY NOTES

Throughout the United States, two basic instruments are used in real estate financing. When an investor makes arrangements for a loan, the mortgage is the legal instrument used to provide the security. A typical mortgage loan has two parts: the mortgage and the promissory note.

The mortgage is the legal document that pledges the real estate as collateral for a loan. Collateral is any property pledged for payment of a loan and is said to secure a loan. (Unsecured loans are riskier for lenders and have higher interest rates.)

The promissory note is the legal document that a borrower executes promising to pay back the lender. The promissory note lays out in detail the loan amount, terms, and other conditions of the loan.

Key Provisions of the Promissory Note

- Amount borrowed.
- Rate of interest.
- Payment due dates.
- Loan maturity date (that is, the date when all remaining amounts are due.)
- Reference to the real estate providing security for the loan.
- Specific terms relating to defaults, grace periods, and early payments (also known as pre- payments.)
- Details on how payments will be applied, usually in this order: (1) to late payments, fees, and penalties; (2) to interest; and (3) to principal.
- Additional key clauses to protect the lender and the borrower.

Clauses to Protect the Lender

- Borrower must pay monthly amounts for property insurance, real estate taxes, and if required, mortgage insurance premiums. This clause exists because unpaid taxes, for example, have a priority lien over the mortgage, which means the property could be sold at a tax sale to satisfy the tax lien.
- Borrower must pay all other taxes, assessments, charges, and claims that have priority over the mortgage. The reason, of course, is to prevent the lender's security interest from being compromised.
- Borrower must have hazard insurance coverage against fire, flood, hail, smoke, and liability insurance.
- The property must be kept in good condition so as not to diminish the property's value.
- The lender's approval is required for any new owner. In most cases, such transfers are not permitted unless the entire loan balance, plus accrued interest, is paid immediately.
- Mortgage loans also often include an assignment clause, which allows the lender the right to sell the note.
- Mortgage loans may require replacement reserve funding on a regular basis to meet capital improvement needs in the future. Amounts may vary and be a fixed dollar amount, a percentage of loan value, or other agreed upon criteria.

Clauses to Protect the Borrower

- Some mortgages may include a non-recourse clause, in which the lender agrees not to hold the borrower personally liable in the event of default. Without such a clause, the debt would be considered recourse debt, which means the lender may be entitled to pursue the borrower's other assets as repayment of the loan. Unsurprisingly, all investors would like to have a non-recourse clause as part of their loan agreements, but if market credit conditions are tight, it may be difficult to obtain.
- Prepayment rights and loan assumption conditions can also be potentially favorable to the borrower if there are no prepayment or assumption penalties.

Prepayment Penalties

Unlike residential mortgage loans, investment loans might contain penalties for paying off the loan before its maturity date. In some instances, commercial lenders will allow loans to be paid off early without penalty under certain circumstances. For example, if an owner has a property with a 4% loan and a lender could reinvest the money into at 6% or 7%, a loan prepayment might be allowed even if the loan documents specify that the loan must be carried to its full term. Other loans permit prepayment with a built-in penalty. The penalties are outlined in the Yield Maintenance clause of the loan documents. Usually, the prepayment penalty is specified as a percentage of the remaining balance.

Assumable Mortgages

In some cases the property investor may be able to take over, or assume, responsibility for the existing mortgage rather than taking on a new loan on the property. This can be advantageous if the existing mortgage has a lower interest rate than the buyer could get on a new loan, but assumable mortgages are generally limited to government-insured loans (i.e., HUD- or VA-insured.)

TYPES OF MORTGAGE LOANS

It is imperative for the CAPS to know which type of mortgage loan applies to each property in their portfolio, because that loan type governs the amount and variability of the monthly debt service. It also may dictate that certain benchmarks be met before the loan can be paid off. There are several types of mortgage loans available to apartment investors. The four most common types are fixed rate loans, variable rate loans, balloon loans, and bullet loans.

Fixed Rate Loans

Fixed rate mortgage loans usually have a term of 10-20 years, and have an interest rate that stays the same over the life of the loan. Borrowers make level payments—that is, the same amount each month—for the entire term of the loan. Payments are

amortized, or applied to interest and principle (in that order) until the loan is paid in full. This is the most popular type of mortgage loan, and the easiest to budget for because of the fixed monthly payments.

Amortization is the process of paying off the principal as part of loan payments over the life of the loan.

Variable Rate Loans

Variable rate mortgage loans—also called an Adjustable Rate Mortgage, or an ARM—have a market interest rate that adjusts over time. The interest rate is based on a financial index, such as interest rates on one-, three-, and five-year treasury securities, six-month Treasury bills, or the prime lending rate. Typical intervals for rate adjustments are monthly, quarterly, or annually.

The loan will have a cap, or limit, that defines the maximum increases in payments or interest rates allowed. It will also have a floor that specifies the minimum interest rate.

Owners may choose variable rate loans because they can get lower interest rates initially. This can be useful when the owner is unsure of how a property will perform (e.g., new construction). The CAPS will need to be familiar with the variable rate terms—frequency of adjustments, caps—and will need to budget accordingly.

Balloon Loans

Balloon loans are common in new construction or property repositioning. They typically behave like a fixed-rate mortgage with a constant monthly payment for a set number of years, and then must be paid off in a single "balloon" payment that repays the outstanding principal balance that was not amortized over the loan term. This final payment usually comes from the property's permanent financing. For example, when a new construction project that was financed with a balloon loan gets close to stabilized, the owner of the property would acquire permanent financing and use that to pay off the balloon. Keep in mind that some balloon loans require certain benchmarks be met by the time you get to the final payment.

Bullet Loans

Bullet mortgage loans are structured so that the loan principal is paid off in one lump sum at a specified time. Many of these loans, however, may require monthly payments to pay interest costs.

Typically, borrowers use these loans for interim financing, such as a construction loan to build a new apartment community or to rehabilitate an existing one. In both of these situations, the property may not produce income for a significant period of time, so borrowers must take that into account.

Bullet loans are typically short-term loans of three to seven years without a provision for extension. As with balloon loans, the lump sum payment often comes from the

property's permanent financing, and there may be benchmarks that have to be met before it can be paid off.

Other Types of Loans

- Rollover loans—a fixed rate loan for a certain number of years when it then must "rollover" to prevailing interest or paid-off.
- Takeout loans—permanent financing that "takes out" a bullet loan or construction loan at completion.
- Gap loans—short term, higher interest loans to cover financing gaps.
- Wrap loans—junior mortgage(s) that provide additional financing. These loans are sometimes also called "mezzanine" loans. They are always considered subordinate to first (a.k.a. "senior") mortgages, which take payment priority over wrap loans. As a result, junior loans typically carry a higher interest rate because the lender is taking on more risk.

THE COST OF BORROWING MONEY

Application Fees	Loan (Discount) Points	Legal Expenses	Title Reviews
Title Insurance	Credit Report	Survey Costs	Property Inspections
Environmental Audits	Engineering Reports	Mortgage Broker Fees	Appraisal Report
Closing Costs	One basis point = 0.01% (1/100th of a %) or 0.0001		

100 basis points = 1%

SOURCES OF MORTGAGE FINANCING

There are several common sources of mortgage financing for properties. Those include:

Commercial banks: These are the largest financial institutions in the country, and provide both short-term and long-term financing for developing, constructing and acquiring apartment communities.

Life Insurance Companies specialize in providing large amounts of long-term debt for office buildings, shopping centers, industrial properties and apartment communities.

Pension Funds lend money using the tax-exempt contributions collected from corporations, labor unions, and government employee benefit accounts. The funds want to make money from the loans, and also want to protect the contributions that have been accumulated and have enough liquidity to pay member retirement benefits.

Investment Banks underwrite and sell Initial Public Stock Offerings (IPOs) and act as dealmakers for private debt placement and corporate mergers and acquisitions.

Mortgage Brokers, both individuals and companies, are another source. They act as intermediaries between the borrower and potential lenders.

Private Sources such as individual investors and limited partnerships are sometimes sources for mortgage loans.

Syndications package real estate investments that make it possible for numerous small investors to own property and obtain tax and investment benefits.

GOVERNMENT FINANCING RESOURCES

There are several government financing resources as well. Those include:

Government-Sponsored Enterprises (GSEs), such as Fannie Mae: Federal National Mortgage Association (FMFNA); Freddie Mac: Federal Home Loan Mortgage Corporation (FHLMC), and secondary funding sources. GSE's hold mortgages on about 30% of all properties with 50+ units.

The **Federal Housing Administration (FHA)** offers loans to borrowers who meet certain requirements relating to items such as cost and profit distribution limits, and also insures mortgage loans made by lenders.

The Low Income Housing Tax Credit (LIHTC), or Section 42, is the main financing source for developing affordable housing. It's regulated by the Internal Revenue Service and rrovides tax credits to eligible developers in return for creating affordable housing for individuals and families with low to moderate incomes. Approximately 100,000 affordable units per year have been provided by this program since its inception. The Department of Agriculture provides financing for development of affordable housing in rural areas.

MORTGAGE FINANCING RISKS

In the world of mortgage financing, both lenders and borrowers need to understand how economic conditions, inflation, and risk have an impact on the availability and cost of mortgage funds.

Economic Conditions

The market-rate interest on mortgage loans is determined by what lenders will accept for the use of their money for a period of time and what borrowers will pay to use those funds.

Investors need to earn enough of an interest rate so they have the incentive to divert resources (their money) from present to future consumption.

The demand for mortgage loans is a function of the demand for apartments, which is driven by economic conditions such as household formation, job growth, household income, alternative housing opportunities, and the cost of mortgage credit.

Inflation

It's also necessary to determine how inflation will affect investment returns. The rate of inflation is of particular importance for those making or purchasing loans made at fixed interest rates over long time spans. Interest rates need to be high enough to offset the expected loss of purchasing power due to inflation.

Other Mortgage Loan Risks

- Default risk refers to the possibility that borrowers will default on their obligation to pay back the loan. This risk will vary with the type of the loan, the creditworthiness of the borrower, and the potential for the property's value to decline.

- Interest rate risk is influenced by the rate of household savings, the demand for housing, and the level of future inflation. It is unanticipated inflation that concerns lenders, because the interest rate on loans they have made could end up being too low.
- Legislative or regulatory risk refers to the changed status of the lending environment caused by new or amended laws at the federal, state, or local level. These laws include: tax law changes relating to investment property, laws affecting interest rates and disclosures, rent controls, affordable housing, and building or zoning regulations that could adversely affect the development or renovation of apartment properties. This category of risk is especially relevant to the CAPS because it has the greatest chance of affecting day-to-day operations.

All of these regulations have a direct impact on how a CAPS does his or her job.

LOAN ANALYSIS

When deciding whether to make a loan, lenders not only assess the creditworthiness of the borrower, but also use certain financial calculations to evaluate the overall safety of the loan.

Lenders primarily use two calculations—the loan to value ratio (LTV) and the debt coverage ratio (DCR)—to determine the risk associated with a loan.

The Loan to Value Ratio (LTV)

The loan to value ratio measures risk to the lender by comparing the amount of the loan to the market value of the property. In short, the lender is trying to determine if the property is worth more than the loan balance.

The loan to value ratio is expressed as a percentage, and the lower the LTV, the lower the risk to the lender. The formula is: Loan amount / property value = LTV.

Most lenders typically like to see LTV percentages in the range of 60 to 75%, though this may vary by market.

Because loan principal payments reduce the outstanding loan balance, the LTV may decline over the term of the loan. That means the lender's risk goes down, assuming the property value holds or increases because of NOI performance. From the lender's perspective, the lower LTV is a better risk, because the borrower has more equity in the property. From the borrower's perspective, however, the higher LTV may be preferable, because more of the property's value has been borrowed, which frees up funding to use elsewhere.

LTV Examples:

If a property has a value of $2,470,300 with a mortgage loan of $2,000,000, its LTV is:

$2,000,000 / $2,470,300 = 0.81 = 81%.

But if that same property could grow NOI to a capitalized value of $2,785,000 and the mortgage remained at $2,000,000, the LTV ratio drops to 72%:

$2,000,000/$2785 = 0.72 = 72%

From the lender's perspective, the lower LTV is a better risk, because the borrower has more equity in the property. From the borrower's perspective, however, the higher LTV may be preferable, because more of the property's value has been borrowed, which frees up funding to use elsewhere.

THE DEBT COVERAGE RATIO (DCR)

Even though it is not directly based on property value, the Debt Coverage Ratio (DCR) is another way lenders evaluate a loan. The DCR measures the property's capacity to repay the loan from its Net Operating Income. The formula is: NOI / Annual Debt Service (ADS) = DCR.

The DCR is expressed as a decimal greater or lesser than 1.0, such as 1.14:1, which means there is $1.14 of NOI for every $1 of debt. The higher the DCR, the less risk to the lender; the closer the DCR is to 1.0, the riskier the loan. Many lenders will look for a DCR of as much as 1.25 or 1.35 if it's a risker loan.

DCR Examples:

If a property has an annual NOI of $708,900 with an annual debt service of $675,000, the DCR is:

$ 708,900 / $ 675,000 = $1.05 = A ratio of $1.05:1, or $1.05 of income for every dollar of debt.

But if through active financial leadership and operating excellence, the CAPS could grow the NOI to $817,500. Applying the same debt service commitment changes the debt coverage ratio to $1.21: $1.00.

$817,500 / $675,000 = 1.21 = A ratio of 1.21:1, or $1.21 of income for every dollar of debt.

The lender would prefer the second operating position since there is now $.21 remaining for every dollar of debt service paid, indicating a safer, lower risk position for the lender.

RECEIVERSHIP

What Happens When the Borrower Doesn't Pay?

When an investor defaults on a mortgage loan, he or she risks having the property go into receivership, and eventually, foreclosure. When a property reaches the point of foreclosure, it can be forcibly sold in order to pay off the loan.

Receivership is a court order whereby all the property subject to dispute in a legal action is placed under the dominion and control of an independent person known as a receiver. Receivership is an extraordinary remedy, the purpose of which is to preserve the property during the time needed to prosecute a lawsuit if a danger is present that such property will be dissipated or removed from the jurisdiction of the court if a receiver is not appointed. Receivership takes place through a court order whereby a trustee is appointed to administer the property.

The Receivership Process

1. The lender's Asset Manager will make an honest attempt to work something out with the borrower if they have that option, and if the borrower is able or willing to get back on course.

2. If there is no chance of working something out, the Asset manager will request that the lender's attorney petition the court to appoint a Receiver and/or start the foreclosure process.

3. The Receiver answers to the court, and is charged with preserving the asset on behalf of the borrower and the lender.

The Necessity of Receivership

Receivership prevents the borrower from using any income from the property for any purpose other than repayment of the loan. It also prevents the borrower from lowering the value of the asset in any way (e.g., through neglect.) Lenders pursue receivership prior to foreclosure because they have an interest in preserving a cash-generating property. In addition, it can take a very long time to move from the initial default to foreclosure, so the lender needs to ensure the property is well-managed in the interim.

The CAPS Role

When a property you're supervising goes into receivership, you'll have an extra set of challenges to navigate. You may need to deal with hiring freezes and spending freezes (or at least a much more difficult expense approval process). If vendors haven't been paid, you'll need to deal with those contracts. In the case of a high-profile property or owner, there may be public relations fallout.

Residents will also be an area of significant concern. When residents are aware that the property is in financial trouble, they can become frightened and angry. They may feel as if their home is in jeopardy, and they might take their fears and anger out on you or your site team. Turnover and occupancy problems may crop up if residents preemptively move out before you're ready for them to go.

During this difficult time, it is the CAPS' job to help ensure that the site team stays functional, and that the property stays operational in the most cost-efficient way possible.

Section 4 - Budgeting

A budget is the most important part of a business or operating plan. It provides the roadmap for achieving the property portfolio's performance and investment goals. Over time, it charts the portfolio's direction. In this part of your training, you'll learn how to lead and coach your team of community managers through this critical financial process.

Topics Covered:

- The CAPS Role.
- Overseeing Budget Timing Across the Portfolio.
- Knowing Which Type of Budget You Need
- Communicating the Property Owner's Goals.
- Communicating Expectations.
- Providing the Necessary Resources and Data.
- Coaching Community Managers Through the Process.
- Reviewing and Submitting the Budgets.
- Two "How-To" Techniques: Extrapolation and Annualization.
- Budget Re-forecasting.

RECEIVERSHIP - THE CAPS ROLE

CAPS and owners use budgets to plan and monitor financial activities and track the performance of a property. As you work with each site team to create a budget for each property in your assigned portfolio, you'll need to be a good leader. That means you should communicate clear expectations about budget goals, make sure the team has the data and resources they need to prepare realistic and detailed budgets, challenge the numbers when necessary, and recognize progress and hard work.

While your community managers will do most of the heavy lifting of preparing the budget details, you will play a critical role in setting up and overseeing that process.

You will need to:

- Oversee the timing of budget production across the portfolio.
- Know which type of budget each property must produce.
- Communicate the property owner's goals to each team.
- Communicate clear expectations to each team.
- Make sure each team has the data and resources they need.
- Coach your community managers through the process.
- Review and submit the final budget.

Each of these tasks will be described in more detail below.

OVERSEEING BUDGET TIMING ACROSS THE PORTFOLIO

The CAPS is tasked with overseeing the creation of multiple budgets across an entire portfolio, and there are time management and people management challenges to overcome in order to get the job done effectively. Your management agreement will provide detail on the due date for transmitting the budget to the owner.

You will need to know each property owner's timing goals for budget review. Budgets are generally produced once a year, but you may have different budget due dates for different properties, so you'll have to prioritize your time commitments based on when each budget is due.

At the same time, budgeting is rigorous process, and you'll be working with multiple site teams at a time, so you'll have to make sure they all start early enough to get everything done on time. Teams should be prepared to start the process months before the start of the fiscal year.

They should also be prepared for the possibility that the owner may want budget estimates for more than one year, perhaps for three to five years in the future. These projections can help an owner decide whether to sell or refinance, and when to do so.

To ensure that you are prepared to oversee the annual budget process, keep an ongoing budget file for each property for yourself. You can use this file to keep notes and documentation in during the year in preparation for budgeting. Consider encouraging your community managers to do the same.

KNOWING WHICH TYPE OF BUDGET YOU NEED

There are several types of budgets that you may task your site teams with preparing, each serving a different objective, and each measuring different things:

Budget Type	Use	Features
Lease-up Budget	New properties (until property reaches stable occupancy)	Good for planning non-recurring expenses (e.g., start-up phase marketing efforts). Will change as buildings are delivered for lease.
Renovation (a.k.a. Modernization) Budget	Properties undergoing renovations for enhancement or restoration	Good for determining cost versus value. May reflect rent premiums, large capital expenditures, savings due to upgrades, etc. May change if value proposition changes as work progresses. This does not necessarily have to be a stand-alone document. It is often incorporated into the operating budget.
Operating Budget	Stable properties, fully leased, operating normally	Easiest to prepare, because you have access to historic data.

In this course, we'll focus on the operating budget.

COMMUNICATING THE PROPERTY OWNERS' GOALS

Before your site teams begin to prepare their annual operating budgets, you'll need to ensure that they understand the owners' operational and financial goals for those properties. For example, does the owner want to:

- Receive a specific rate of return?
- Generate cash flow?
- Renovate or upgrade a property?
- Sell a property?

Often, owners will give you a head start by articulating specific budget goals for revenue and expenses. For example, you may be given budget goals of 93% occupancy, a 36% lease renewal rate, and an expense increase of 2%.

But in some cases, you may need to talk with the owner to determine his or her budget targets. The most realistic budget goals are based on economic conditions in the marketplace, and you and your site teams may need to help the owner understand these conditions and how they relate to the proposed goals. This will be made easier, of course, if you've been including market data in the owners' reports all along.

COMMUNICATING EXPECTATIONS

When you're getting your community managers and site teams ready for the budgeting process, make sure you communicate clear expectations for what you want them to produce..

- Provide a list of the specific supporting documents that must accompany budgets submitted to you for approval.
- Have them develop every budget category independently, and avoid flat percentage changes.
- Require details on the assumptions and data used in the projections. Software programs can take assumptions and use them to project results. This will help illuminate the expenses and revenue expected for the next year.

Bringing all of your community managers together at the beginning of the main budget season for a budget "camp" could be one useful way to coach them and make sure they're headed in the right direction. Take advantage of the opportunity to talk to them about the owners' goals, the budget templates and software they'll be using, and the budgeting process in general.

They may find it useful to do some of the preliminary work on their budgets there, as well, since the environment is likely to be less distracting than their onsite office environment. Using current year-to-date actuals and budget performance, the group focuses on projections for major income and expense categories, known adjustments needed for the coming year, and other budget assumptions provided by human resources, risk management, and asset management personnel in the management company for items such as payroll and benefits, insurance costs, and capital improvement plans.

PROVIDING THE NECESSARY RESOURCES AND DATA

Make sure your teams have the data and resources they need to prepare realistic and detailed budgets:

- Distribute copies of previous operating statements and prior years' budget performance compared to actual results.
- Review and analyze existing service contracts for potential cost increases.
- Provide a summary of personnel costs (particularly the pay and benefit increases to be budgeted.)
- Make sure they have the necessary templates. Many management companies use the budget template provided by their property management software. Others use a spreadsheet and may pre-load estimates for areas over which on-site operations have little control, i.e. taxes, insurance, employee benefit loads.

COACHING COMMUNITY MANAGERS THROUGH THE PROCESS

Community managers almost always do the initial budget preparation because they:

- Know their properties.
- Have last year's budget figures and notes.
- Can contact vendors and suppliers to get the best information on pricing.
- Know the market trends.
- Are more closely involved with the property than the CAPS.

Occasionally the CAPS may do the initial budget construction themselves with the help of informed input from their community managers, but this is not typical.

It's important for you to work closely with your community managers on the budget. Although the community managers supply much of the detail, the budget is simply too important to manage from a distance. Consider checking in with your community managers regularly throughout the process rather than waiting until close to the deadline. Make sure your community managers are including the service managers or maintenance supervisors in the budget development process, too. These are the people who know more about the day-to-day physical operation of the property than anyone else, and their input is indispensable.

Coach the Fundamentals

As a CAPS, you'll probably be familiar with the preparation of annual budgets already, but you'll need to make sure your community managers fully understand the budget basics, as well.

Ensure that they understand the importance of the budget. By regularly comparing actual income and expenses to the budget, you and the community manager will be able to monitor a property's performance, identify income shortfalls and expense overruns, and take corrective measures. Budgets may also be used to evaluate the performance of personnel.

You should emphasize that the budget acts as a road map for the immediate future of the property, but that, ultimately, they are educated guesses about the future. The community managers who are preparing the budget may find they need to account for variances between the budget estimates and the property's actual income and expenses. The budget forecasts income and expenses for an entire year, which usually matches the calendar year. The community manager may need to extrapolate or annualize income and expense numbers to come up with reasonable estimates (extrapolation and annualization are explained in more detail later in this module).

All projections must be based on sound and reasonable assumptions that the community manager can clearly explain—in fact, most owners will require you to provide these explanations in writing when you submit the budget for approval.

Step 1: Forecast Income

Coaching community managers through income forecasting can be especially challenging for a new CAPS. You may feel torn between your instincts as a recent community manager to keep forecasts realistic and conservative, and your instincts as a proxy for the property owner to be aggressive in growing income. You will have to find an appropriate balance between these two concerns while you coach your community managers through the process.

Your community managers should begin by using last year's income as a starting point. They should evaluate rental income performance relative to budget and year-over-year growth. Can they project the same, more, or less? They should be prepared to say why. Factor in seasonal changes, renewal schedules, and occupancy shifts, such as summer move-outs for student properties.

In addition, they should consider the impact of any special or one-time events, as well as ongoing variables, such as:

- The economy.
- Local market conditions.
- Competitive environment.
- Expectations for growth

The major source of income, of course, is rental income. The key concept to remember here is that rental income is a function of rental rates, occupancy levels, and collection percentages. Therefore, to determine anticipated income, the team needs to consider occupancy trends and pricing strategies. They don't just add a percentage increase "across the board"—they need to justify every income number factoring in things like seasonality and economic trends. for their new roles, but that's not always the case.

Step 2: Project anticipated expenses

These include the normal operating expenses: payroll, marketing and advertising, maintenance and repair, utilities, insurance, property taxes, and so on.

To come up with a solid projection for the year's expenses, your community managers should:

- Review the operating history of the property, the prior year's budget, and the actual results year-to-date, but consider current economic trends and the

age of the property, as well. Look for anomalies, trends, and places where the property has been consistently over-budget.

- Make good use of historical operating data going back several years.
- Look for expenses that may not be needed in the current budget year because they were completed in a prior year or were one-time costs. This would also include expenses for uninsured losses associated with an insurance settlement.
- Anticipate future expenses that haven't been part of a previous budget.
- Factor in occupancy projections when budgeting utility costs. When units are occupied, residents, and not the property, may be paying the charges.

Allow budgeting software or a spreadsheet program to help simplify the process by using "locked in" numbers provided by management, and recurring expenses. (Be sure the community managers include a narrative about their assumptions, including why and when, so they can support the projections.)

Check to see what budget numbers the management company may provide. Often, these include tax estimates, insurance costs, and management and accounting fees.

Step 3: "What if...?" scenarios.

Have your community manager take advantage of the full capabilities of property management software. Many of these software packages allow you to try out different budget assumptions and answer "What if...?" questions before the budget is put to rest. For example, they could try out a "what if" scenario with rent increases budgeted at $20 per unit, rather than $10. Doing these "what if" scenarios is also called a sensitivity analysis.

"Zero-Based" Budgeting Method

Some properties may present a special "what if" problem: What if the property is new and lacks historical data?

In these cases, your community managers can prepare budgets using the less-preferred "zero-based" method, which makes little use of past actual results, but uses assumptions based on current market conditions instead.

To ensure that they are on solid ground with any assumptions they make, have them consult periodic national income and expense analyses put out by industry

professional organizations. The National Apartment Association's "Annual Income & Expenses Survey," and the Institute of Real Estate Management's "Income/Expense Analysis Reports" provide extensive data they can use to make informed budget decisions.

This zero-based budgeting method should be used only when historical information for the property is unavailable or less than accurate (such as when a previously poorly managed property is acquired)—or when the property is brand new.

REVIEWING AND SUBMITTING THE BUDGETS

After your community managers complete their budget preparation, you will need to review each one in detail with the community manager who prepared it. Check to see that all assumptions are clearly spelled out and that all supporting data and documents are present. Challenge the numbers where necessary.

Once your review is complete, you'll submit each budget to the management company individual charged with reviewing it before it goes to the property owner (usually an asset manager, sometimes the CFO). You should be very familiar with the budgets by that point, so you should be able to justify them if there are questions.

TWO "HOW-TO" TECHNIQUES: EXTRAPOLATION AND ANNUALIZATION

Extrapolation and annualization are two methods to help you come up with realistic budget numbers. You can then reality check them throughout the year by re-forecasting the numbers based on actual data.

Extrapolation

You'll often need to use extrapolation to forecast figures for your budget. This means you'll come up with a best-guess estimate based on trends you observe in the information you already know. For example, you might use data you've gathered for several months to extrapolate expenses for an entire year. However, before you use known data for extrapolation, check that the numbers aren't skewed too high or too low for some reason, and that you take seasonal changes into consideration.

Annualization

Annualizing a number is similar to extrapolating.

Example: The electricity bill has been $500 in the months of January, February, and March. To annualize the electricity expense for the year, just multiply $500 by 12 months. That gives you a total annual expense of $6,000.

Be careful, though. Annualization doesn't do a good job of picking up on cyclical trends or other oddities in the data pattern. For example, if the electricity includes the heat—the cost of which can vary tremendously over the course of the year—use the historical data for the prior year instead.

BUDGET RE-FORECASTING

Each month, you'll work with the team to re-forecast revenue and expenses. Re-forecasting means you'll use the actual year-to-date numbers and the most current information on market and property conditions to forecast future results. Even performance results from a prior year can help when re-forecasting.

Re-forecasting allows you to:

- Assess how the property is expected to perform for the balance of the year in relation to the original budget.
- Determine whether you need to make further changes in income and expenses in future forecasts.
- Understand your property and the impact of occupancy conditions on property performance.

Remember: you're not changing the annual budget. You're simply taking the actual year-to-date results, projecting the income and expenses for the remaining months in the budget year, and recommending ongoing adjustments as necessary. If you re-forecast every time you encounter a budget variance, you have, effectively, a rolling budget that allows you to track unforeseen changes, and be better prepared for the following year's annual budgeting process.

Re-forecasting is both an art and a science, but the essential point is to stay on top of things and anticipate the changes needed so the property meets or exceeds the budget at year-end, and you can prepare the owner for changes that require his or her involvement.

Section 5 - Getting to the Bottom Line

In order to be a good steward of the properties in your portfolio, you must fully understand certain financial fundamentals and be able to apply them to improve the financial position of the properties you supervise.

In this part of the training, you'll learn more about some of the concepts that form the basis of financial literacy in the multifamily housing industry.

Topics Covered:

- Accrual vs. Cash Basis Accounting.
- Operating Income.
- Operating Expenses.
- Calculations for Measuring Property Performance.
- Documents for Measuring Property Performance.
- The Operating Statement.
- The General Ledger.
- Budget Variances.
- Variance Trends.

ACCRUAL-BASIS VS. CASH-BASIS ACCOUNTING

There are three accounting methods for recording financial transactions:

- Accrual-basis accounting—This method records all income and expenses in the period they are earned or incurred, regardless of when they are actually received or paid. Accrual-based accounting provides better historical data than cash-based accounting, because it gives a more realistic and controlled picture of net operating income in the period. This is the most common type of accounting used in multifamily residential management.
- Cash-basis accounting—This method records all income and expenses when they are actually received or paid. This can give you a good snapshot of how much cash is available in the moment (which may occasionally be useful,

especially if you want to pay out cash at the end of the month), but causes widely fluctuating numbers. As a result, cash basis accounting may give a distorted picture of profitability at a given point in time. Consider which is more important: knowing when rent is incurred, or just noting the cash received when it was paid?

- Modified accrual-basis accounting—This method combines elements of accrual- and cash-basis accounting. Revenue is still recognized when earned. Expenditures are recognized when the liability is incurred. However, adjustments are made below NOI to accounts like escrows, replacement reserves, accounts payable, and accounts receivable to get to a true cash flow number. Modified accrual gives a realistic cash-on-hand picture while still providing good historical expense data.

The Management Agreement will usually specify the type of accounting method the owner requires.

OPERATING INCOME

Operating income (also known as operating revenue) is the money generated by a property. There are two types of operating income: effective gross income (EGI) and net operating income (NOI) (note: different companies may use different terminology for these concepts):

- Effective gross income (EGI) is all the money a property takes in, including rent and other income.
- Net operating income is effective gross income less operating expenses.

Each property needs to generate and collect as much income as possible. Rent is the largest source of property income, although additional income (also known as "other income," "miscellaneous income," or "ancillary income") may be collected through parking fees, application and administrative fees, lease term fees, pet fees, deposit forfeitures, and laundry, vending, cable, and amenity charges.

Service fees, upgrade charges, and concierge-type services add valuable income, but can fluctuate based on demand. These include revenue share opportunities with outside providers such as food delivery firms and pet health and grooming services.

Other income does not typically include utility reimbursements, which are usually deducted from the gross utility expense.

OPERATING EXPENSES

There are two types of operating expenses to identify on the income (or operating) statement: fixed expenses and variable expenses.

The CAPS and community managers' primary concern will likely be managing variable expenses.

Fixed Expenses

Fixed expenses are not controllable, and they don't vary with the occupancy level of the property. These include:

- Property taxes: Property taxes are usually based on the assessed value of a property and the local tax rate.
- Insurance premiums: Properties will have expenses for various types of insurance, such as liability, casualty, and automobile insurance. (Worker's compensation insurance, however, is a payroll cost.) Other than annual cost increases and coverage changes, insurance is mostly a fixed cost.

Variable Expenses

Variable expenses, also called controllable expenses, are costs that vary as conditions change. Many variable expenses are associated with occupancy. With effective management, most can be controlled. Examples include:

- Utilities: When residents pay for utilities, the property saves money. Even if individual metering isn't available, you can use sub-metering, or a Resident Utility Billing System (or RUBS) to set up a program where residents pay for utilities. Typically, owners pay the utility costs only for common areas and vacant units.
- Contract Services: These include landscape maintenance, exterminating services, trash removal, snow removal, and other service costs typically provided on a contract basis.
- Marketing: Marketing costs include advertising; referral fees; collateral materials; locator fees; model costs; and promotions designed to bring traffic to the property, increase leases, and promote name recognition for the property.
- Management fees: These fees are paid to the company or agent who manages

the property. The fees earned are usually a percent of the total revenue collected or a negotiated fixed rate, such as a monthly amount.

- Repair and maintenance costs: This broad category includes costs for maintaining the interior and exterior of buildings, as well as preventive maintenance and repair for the plumbing, electrical, and HVAC systems. And while the "make-ready" costs associated with move-outs are included here, non-recurring capital expenses, such as replacing a roof, are not.
- Administrative costs: These include expenses associated with operating the management and leasing offices, such as telephone, computer, and software costs.
- Salary and personnel costs: These include salaries and wages for onsite employees, as well as employee apartment allowances, payroll taxes, group health and life insurance, workers' compensation insurance, bonuses and lease commissions, and employer 401(k) or retirement contributions.

Using Software to Calculate Income & Expenses

Thanks to property management software, income and operating expenses can also be easily presented on a per square foot basis, per unit basis, or as a percent of gross potential rent (GPR) (all units occupied at 100% of the market rate). Industry income and expense comparisons also use these measurements of performance.

The Largest Expense Categories

Usually, the two largest expense categories as a percent of gross potential rent are property taxes and personnel costs, though it varies from property to property.

There is little you can do to affect the amount of property taxes owed, but you can make a sizable impact on personnel costs with a little bit of strategic thinking. For example, when a team member leaves their position, you might be tempted to simply fill that position with another person at that same salary, but instead of doing that, consider whether it's necessary to maintain that level of salary in that instance. You might be able to use that turnover as an opportunity to reduce your salary expenses.

CALCULATIONS FOR MEASURING PROPERTY PERFORMANCE

Many property owners will have a particular rate of return on their investment in mind when they purchase a property. This goal is particularly important for owners who intend to live off that income or use that income to make further investments. Return on investment (ROI) and cash-on-cash return are two ways of measuring whether a property is generating the desired return.

You will most often deal with ROI because it is derived directly from a figure that is already the subject of your focus: net operating income (NOI). You should be familiar with both calculations, however, because they allow you to make more informed financial recommendations to the owner.

RETURN ON INVESTMENT (ROI)

The rate of return is the percentage of return—or yield—on the initial investment. It is the ratio of net operating income (NOI) to the down payment on the property. The return on investment is an important number for the owner—especially if the property is held as a source of regular income.

It is calculated as follows:

NOI / Total Initial Investment = ROI

Example: If a property generates $14,300 in NOI to an investor, and the down payment (initial investment) on the property was $125,000, the ROI is 11.4%.

$14,300/$125,000 = .114 (11.4%)

Note: While ROI is a measure of the financial performance of the investment, it does not take into account the time value of money—that a dollar today is worth more than a dollar tomorrow.

CASH-ON-CASH RETURN

Cash-on-cash return measures the cash flow received against the original cash invested. It's a useful method of measuring return on investment for financial institutions and investors interested in purchasing or evaluating a property.

The formula for cash-on-cash return is:

Cash Flow / Total Initial Investment = Cash-on-cash Return

Example: If a property generated annual cash flow of $52,500, and the down payment (initial investment) on a $1,750,000 investment was $350,000, the cash-on-cash return would be .15 or 15%.

$52,500 / $350,000 = .15 (15%)

In figuring a cash-on-cash return, the original investment amount—the down payment—is always the same. More or less cash flow over time obviously changes based on investment performance.

Extra Information: Cash Flow

Cash flow is similar to net operating income (NOI) except that, in addition to subtracting operating expenses (OE), you also subtract capital expenses (CE), replacement reserve payments (RR), and debt service (DS).

Effective Gross Income (EGI) – OE = NOI

NOI – CE – RR – DS = Cash Flow

- Positive cash flow means there's a positive amount of money remaining.
- Negative cash flow means total expenses are greater than income and the owner will need to put money into the property.

REPORTS FOR MEASURING PROPERTY PERFORMANCE

A full financial analysis of a property answers two important questions:

- How has the property performed over a period of time?
- What is the current status of the property at this particular point in time?

The operating statement answers the first question by documenting details such as income, expenses, and variances in NOI and cash flow. The balance sheet answers the latter by detailing assets, liabilities, and owner equity at any given moment in time.

The general ledger provides the detailed documentation of all financial transactions necessary to generate accurate operating statements and balance sheets.

The most important of these for the CAPS is the operating statement. It is unlikely you will have much interaction with balance sheets, but the operating statement is a document that you and your community manager will use regularly to prepare budgets and owner's reports. When unexpected discrepancies and variances pop up, you may be able to use the general ledger to help track down the source of those variances.

THE OPERATING STATEMENT

How an Operating Statement Measures Performance

The operating statement (sometimes called the income statement, profit and loss statement, or P&L statement) measures performance over a certain time period —a month, a quarter, or annually. Most often, the operating statement reflects both monthly and year-to-date (YTD) results as compared to the budget.

This statement compares the income and expenses over that time period to the budget for the same period. It shows the difference or variance between the budget and the actual Net Operating Income (NOI) or cash flow (depending on the detail provided in the statement). It may also reflect performance compared to a prior time period (also known as "same store"), such as "same month last year" or "YTD last year."

The operating statement will also include a year-to-date listing of actual versus budget activity and the variances between actual and budget, expressed in dollars or as a favorable or unfavorable percentage.

The Key Indicator of Financial Health

The operating statement is the key indicator of a property's financial position and should be used to define: progress, trends, the relationship to the competitive marketplace, and the continuing ownership strategy. An operating statement is used to make comparisons, set goals, and exercise better control over a property.

THE BALANCE SHEET

The balance sheet is a financial statement that summarizes a property's assets, liabilities and shareholders' equity at a specific point in time.

THE GENERAL LEDGER

The general ledger is a group of accounts that support the major financial statements. It is the formal record for all financial transactions for the property and transfers journal data from the book or page where accounting entries are posted.

Uses of the General Ledger

You can use the general ledger to identify:

- Sources of variances between planned (or budgeted) performance and actual performance.
- Trends in business operations.
- Cash flow needs (and, perhaps, the need for financing.)
- Operational areas that may need improvement.

Most frequently, you and your community managers will use the general ledger to track down the source of unexpected variances in the operating statement. The general ledger may reveal a transaction that was coded to the wrong expense category, or an expense that showed up twice in one month because it didn't accrue the previous month, for example.

Once the problem is identified, you and your team can do the research to explain the circumstances behind the numbers, and then take appropriate steps to improve operations. These steps will help the owner meet or exceed the financial goals for the property.

Format of the General Ledger

Debits and credits are the double-entry values used, and for every debit or credit, there is an offsetting debit or credit. Debits represent outflows of cash, and they can increase assets (through purchases), decrease liabilities (through bill payments), and decrease equity (through decreased cash on hand); credits represent inflows of cash, and they have the opposite effect (see chart on the next page).

Debits	Outflow of cash.	Increase assets (through purchases made).
		Decrease liabilities (through bill payments made).
		Decrease equity (through decrease of cash on hand).
Credits	Inflow of cash.	Decrease assets (through sale of assets).
		Increase liabilities (through acquisition of debt).
		Increase equity (through increase of cash on hand).

The sub-accounts (or ledgers) are assigned names or numbers and provide details of financial activities that occurred. These sub-accounts are often called the chart of accounts. In order to properly record and track financial transactions for your properties, you'll need to know—and correctly use—the account categories and numbers used by the management company (although, if errors are found, reclassification to the correct code may be allowed).

The balance sheet and operating statement are based on data entered into the general ledger. Although the general ledger doesn't provide easy-to-use information about a property's financial performance, it does provide necessary detail for each income and expense item, and the codes assigned to each transaction roll up and form income and expense categories on property income statements.

BUDGET VARIANCES

NA variance is the difference between a budgeted income or expense number and the actual income or expense in a particular month or year-to-date.

Your community managers should:

- Keep track of budget variances.
- Use them to prepare a new forecast of future results.
- Analyze and explain variances to the owner.
- Take action when necessary.

Each month, your community managers will need to look at the monthly operating statement to compare the budget estimates with the actual numbers in order to identify, understand, and explain variances. Depending on the size of the variance, they will have to create a variance report to explain variances and recommend action.

The CAPS Role

It is the CAPS' job to coach community managers on spotting and tracking variances, and to review their variance reports to ensure that:

- All variances requiring explanation are represented. Criteria for this may be detailed in the Management Agreement, or may be based on a company wide default value (e.g., variances that are greater than $5000 or +/- 5%).
- Explanations of variances are sufficiently detailed such that the owner will understand the situation. You want to present a clear and detailed picture to the owner, but still keep it succinct enough to produce a manageable report.
- The report anticipates and answers questions the owner will have about addressing the variances. It should include not only an explanation of why they happened, but also whether they are likely to continue happening, and what (if any) changes are recommended as a result.

The CAPS is also responsible for monitoring long-term trends in variances, especially across the portfolio.

Analyzing Variances

When you are coaching your community managers through the preparation of variance reports, it's critical to help them understand that it's not enough to report, for example, that rental income is down because vacancy is up. They need to be able to explain why actual vacancy is greater than projected in your budget. For example, projected move-ins may not have occurred in a certain month. A certain month may have more move-outs than budgeted. Increased evictions will affect vacancy and revenue collection. In any event, both positive and negative variances will need analysis and explanation.

When looking for reasons for budget variances, have them ask questions like:

- How many move-ins and move-outs were budgeted for a particular month? What factors could account for the difference? Less traffic? A lower closing ratio? More evictions? These reasons, too, must be explained.
- Is a new or established competitor attracting residents? If so, why?
- Do competitors have lower rental rates or offer more amenities? How might the property respond?
- Are competitors running successful advertising campaigns? Are they offering concessions?
- Have I been able to raise rents compared to budget? Why or why not?
- Are my budget variances a timing issue or likely to be permanent? For example: Am I receiving my utility bills late? Did I receive the cable revenue payment in the month budgeted? Will my current occupancy, and the time or cost needed to increase it, prevent occupancy goals from being met for subsequent months?

Some variances will be easier to figure out. For example, if a major expense was incurred to make an emergency repair, the expense would be a one-time event, but would nevertheless affect the budget.

Explaining Variances

When explaining variances, make sure your community managers are using terms like "favorable to NOI" and "unfavorable to NOI" rather than "up," "down," "good," or "bad."

- Increased expenses versus budget are an unfavorable variance.
- Increased income versus budget is a favorable variance.

Stated another way, favorable variances increase NOI, while unfavorable ones lower it.

Be sure to they are indicating what they're doing to deal with unfavorable variances, and discussing the strategies they used to achieve favorable variances, as well as the likelihood that they will continue.

It may also be worth noting how the current variance is similar to, or different from, historical data. This may help provide the necessary context to better understand the current variance.

Recommending Action

The community manager should determine what (if any) action should be taken in response to a budget variance, and when it should be taken.

This might include:

- Increasing advertising or outreach marketing to generate additional traffic.
- Increasing or decreasing rents as dictated by market conditions.
- Adjusting fees to increase revenue or attract rentals.

These recommendations should be specific. Have them explain:

- Where and how they'll increase advertising or marketing, how much it will cost, what the expected results are, and how it will affect the budget.
- How much they'll adjust rents, and how it will affect their property revenue.
- How fee changes (for parking, applications, premiums) will increase revenue and be competitive enough in the market to attract new residents.

VARIANCE TRENDS

A variance trend takes place over a period of months, and can be a clue to an unresolved problem or an indication of sound management decisions on the part of you or your community manager (especially if it is a positive result). Common industry trends related to occupancy (better/worse), turnover (more/less) and move-outs (high/low) are part and parcel of analyzing a property's performance.

To help identify trends, use the operating statement. Look at the actual results year-to-date and the budgeted amounts for the remaining months in the year.

In particular, examine occupancy trends for the next 30 to 60 days at the property. How many move-ins and move-outs are scheduled in each time period? Without

more or less move-ins and move-outs, what will the property's occupancy be at the end of each future month? Accounting for such trends is essential for projecting future income results and taking action to improve projected occupancy.

Keep in mind that trends are clues. Look for additional supporting evidence before making quick decisions, especially if they involve significant changes or expenses.

The Portfolio Perspective

For the CAPS, trend spotting involves more than just analysis of variances across time; it also involves performing that analysis across properties. Perhaps there is something affecting multiple properties in your portfolio; or perhaps there is one significant outlier property, which can be an indication of possible problems at that property, or even an indicator that something is going unusually well at that property.

The Time Management Challenge

Analyzing variance trends (and maintaining a portfolio perspective while doing so) can present a time management challenge. Variance reports often involve very quick turnaround times, and when you're tasked with reviewing several in the same window of time, it can be difficult to resist looking at each one as isolated from previous months and from other properties in the portfolio. You should make an effort to do so, however, because comparing variance reports in this way can help you identify areas of opportunity that might be missed otherwise. It is worth taking the time to make sure you're not just focused on any one month or on any one property at a time.

Section 6 - Property Valuation

In order to make sound financial decisions about the future of an apartment community investment, you need to have a firm grasp on the property's value. You may be asked by the property owner to give advice on decisions about selling, refinancing, insurance, tax revaluation, or any number of other situations in which you'll need to understand the property's value.

You will also need to understand how you can directly affect that number. The decisions you make every day—about even the smallest changes in revenue and expenses—can have a surprisingly large impact on property value.

There are multiple ways to value a property, and this section will cover a few of the most common methods.

Topics Covered:

- Property Value Fundamentals.
- The Cost Approach.
- The Sales Comparison Approach.
- The Income Capitalization Approach.

PROPERTY VALUE FUNDAMENTALS

Property value, as the name suggests, is what the property is worth at a point in time, based on certain standard valuation techniques used in apartment management. There are different types of value: market value, appraised value, insured value, replacement value, investment value, and even sentimental or emotional value.

Knowing the value of a property helps a property owner analyze and interpret financial data, and make decisions about the future of the property, such as:

- Deciding what price to offer when buying a property.
- Coming up with an acceptable price when selling a property.
- Establishing a basis for real property exchanges.
- Determining the terms of a sale price for a proposed transaction.
- Estimating the value to get a mortgage loan.

- Establishing the market value for condemnation proceedings or tax purposes.
- Deciding the feasibility of construction, modernization, or renovation projects.
- Estimating liquidation value for forced sale or auction proceedings.

Because you may need to advise property owners on such matters, you'll need to know how properties are valued. Moreover, the management decisions you make can have a significant impact on property value, so you'll want to have that in mind when you make decisions that affect the property's income.

The Three Approaches to Valuing Property

There are three main approaches to valuing property, and it's critical to understand how they work because the decisions you make as a CAPS can have a significant effect on the property values that result from these approaches:

- Cost Approach.
- Sales Comparison Approach.
- Income Capitalization Approach.

In practice, you will most often encounter a combination of the sales comparison and income capitalization approaches to valuing property. The cost approach is rarely applied to multifamily housing properties, but it's valuable to understand what it is in order to provide context for understanding the other approaches.

THE COST APPROACH

The cost approach looks at the current cost of the "bricks and sticks" to rebuild the property. It answers the question, "What would it cost me to reproduce or replace the buildings at today's cost, using current materials and construction standards?" It includes both direct costs (labor, material) and indirect costs (administrative expenses, fees, taxes, interest, insurance).

The cost approach is important when there's no market activity, and a sales approach can't be used to value a property. It is generally not used to value income-producing property. Moreover, the cost approach doesn't work well for older properties with architectural elements or appointments that are no longer available (or which would have to be reproduced at great expense).

THE SALES COMPARISON APPROACH

The fundamental principle of the sales comparison approach is that the market value of a property is directly related to the prices of comparable, competitive properties.

This approach works best when there are several similar properties in the local market that have been recently sold or are currently for sale. In general, the more limited the area or neighborhood used for comparison, the better the value determination is likely to be.

If an owner (or potential owner) wants to obtain a sales comparison valuation, the CAPS may be called upon to help identify comparable and competitive properties in the area. The key is to correctly identify what constitutes comparable and competitive. If a high-rise apartment community is next door to a garden-style apartment community, the properties aren't comparable or competitive, despite their proximity to one another.

Because the sales comparison approach does not account for differences in properties' income generating ability (NOI), and because of the difficulty of finding truly comparable and competitive properties, this approach is usually unsuitable for valuing multifamily real estate on its own. It can, however, be a useful tool for obtaining some of the data necessary for the income capitalization approach to property valuation, which does account for differences in a property's ability to generate income.

THE INCOME CAPITALIZATION APPROACH

The income capitalization approach is the most common method for determining value for any income-producing property. Its utility lies in the fact that it takes a property's ability to generate income into account when assigning a value to that property. It estimates that value by comparing how much the property costs to how expensive it is to run, and it does so by applying a current capitalization (or cap) rate to the annual stabilized NOI. This means that a property's value can vary greatly depending on its annual NOI, which is why the CAPS must maintain such focused attention on increasing this critical performance indicator.

Cap rates are determined by dividing a property's annual NOI by its sale price (its value). In practical terms, this is usually calculated on recently sold properties in order to determine an average cap rate for properties in that market. That average cap rate can then be used to determine a fair asking price (value) for other similar properties.

You may be able to do the research yourself to determine the average cap rate for comparable and competitive properties in your market (see the example below),

but there are likely to be resources you can tap for current cap rates instead. These might include multifamily appraisers, multifamily sales brokers, and major buyers of apartments, such as pension funds, REITs, life insurance companies, banks, and other lenders.

Practical Applications

The basic formula for determining a property's value based on a cap rate is this:

Annual NOI/Cap Rate = Value

As long as you know any two of the three elements in that equation, you can determine the third. That means that the following two equations are just different ways of stating the same thing as the equation above:

Annual NOI/Value = Cap Rate
Value x Cap Rate = Annual NOI

In the world of multifamily housing real estate, flipping the equation around like this is usually done to accomplish one of two things:

- Determine a cap rate when you know the annual NOI and property value: **(Annual NOI/Value = Cap Rate)**.
- Determine a property value when you know the annual NOI and cap rate: **(Annual NOI/Cap Rate = Value)**.

We can see how this works by substituting actual numbers:

Imagine a property with the following values:

Annual NOI: $75,000

Property Value: $882,353

Cap Rate: 8.5%

Scenario 1:

Imagine you have a property you're considering selling, so in order to know how to value your own property, you are trying to determine cap rates for similar properties in your market. You find the hypothetical property above. It's similar enough to be a valuable comparison, and it has sold in the past few months. You know the property's annual NOI and the price it sold for (it's value). If you wanted to determine the cap rate for that property, the calculation would look like this:

Annual NOI/Value = Cap Rate

75,000/882,353 = .085 (or 8.5% cap rate)

Scenario 2:

Now imagine that you are a buyer, and this hypothetical property is one you are considering buying. You are trying to determine its real value in order to decide if the asking price is fair. In this case, you know the annual NOI and the cap rate (because you've done the research to determine the average cap rate for similar properties in the market), but what you don't know yet is the value. The calculation for determining that value would look like this:

Annual NOI/Cap Rate = Value

75,000/.085 = 882,353

Note: This is the exact same calculation you would make if you were a seller trying to determine a fair asking price for your own property. Once you'd determined the average cap rate for comparable properties in the market (Scenario 1), you would then apply that cap rate to your own property to derive the property's value.

The CAPS Impact

Because property values are so dependent upon annual NOI with the income cap approach, the CAPS can have a huge impact on the value of the properties in their portfolio. Even small adjustments to the annual NOI create large variations in property value.

Example: If an apartment property is selling for $1,000,000 (its value), and it has an annual NOI of $80,000, the cap rate is 8% ($80,000/$1,000,000). In other words, the investor would receive 8% of his or her investment each year.

If a similar property is selling at the same 8% cap rate and has an annual NOI of $87,500, the property would be valued at $1,093,750. ($87,500/.08 = $1,093,750).

Here's an example showing how an increase in income and a reduction in property operating expenses might increase the value of the same property:

Example: If an apartment community could build income by $10 per month on a 250-unit property, $30,000 in additional revenue would be generated each year ($10 x 12 months x 250 units = $30,000 annually).

If that same community could reduce property operating expenses by an additional $6,000 annually, the annual NOI would grow by an additional $6,000, for a total of $36,000 ($30,000 in additional revenue + $6,000 in expense savings).

Using the same 8% cap rate and the value formula (Annual NOI/Cap Rate = Value), the community would have added $450,000 to the value of the property!

$36,000/.08 = $450,000

This reliance on annual NOI for property valuation, and the outsized impact the CAPS and community managers can have on property values through annual NOI, are one of the main reasons it's so important for the CAPS to understand it, and to take measures to increase it.

Using Projected NOI

In the event of a new property or where historical or current stabilized annual NOI is not available, it is vital to project it as accurately as possible (using extrapolation and annualization techniques). Appraisers must establish the most probable annual NOI because buyers and sellers see the issue differently. Sellers focus on future NOI; buyers, on past NOI or actual results.

Cap Rates as an Investment Comparison Tool

In addition to their utility as a valuation tool, cap rates also serve as a valuable investment comparison tool. Because cap rates are an indicator of a property's rate of return, they allow investors to target properties that will generate the particular yield they're looking for. This makes it easy for investors to compare property investments with other types of investments, like stocks or mutual funds.

Measuring Investment Performance

Real estate investors choose real estate assets to put their investment dollars to work – they expect a return on the dollars they invest. The investor wants to be able to determine if a particular property is providing an adequate risk-adjusted return.

A rate of return (yield) is the percentage return on each dollar invested for each period it is invested. As a measure of investment performance, rates of return are useful for comparing investment alternatives. They can be estimated on either a before-tax or an after-tax basis.

Return on Investment (ROI)

ROI is the ratio of net operating income (NOI) to the down payment on the property.

NOI/Total Initial Investment = ROI

Example: If a property generates $14,300 in NOI to an investor, and the down payment (initial investment) on the property was $125,000, the ROI is 11.4%.

$14,300/$125,000 = .114 (11.4%)

Cash-on-Cash Return

Cash-on-cash return is the ratio of cash flow to the down payment on the property.

Cash Flow/Total Initial Investment = Cash-on-cash Return

Example: If a property generated annual cash flow of $52,500, and the down payment (initial investment) on a $1,750,000 investment was $350,000, the cash-on-cash return would be .15 or 15%.

$52,500/$350,000 = .15 (15%)

Note: Cash flow = NOI – Capital Expenses – Debt Service – Replacement Reserve

Calculating Investment Value

Consider the following example:

Loan Amount: $1,200,000
BTCF: $22,000
Required rate of return: 8%

To calculate what an investor would pay for the property:

BTCF (I) ÷ Cash-on-Cash Rate (R) = Equity (V)
$22,000 ÷ 8% = $275,000 Equity Value

Investment Value = Equity Value + Loan Amount
$275,000 + $1,200,000 = $1,475,000

MODULE 2 ACTIVITY 1: IN THE OWNER´S SHOES

You are an owner who is purchasing a property.

The seller was asking for $25,900,000, but your competitive bid of $25,100,000 has been accepted. You have $6,275,000 in cash.

There is a fair amount of competition in the submarket, though the property has been performing satisfactorily. There has been little rent growth in the past 18-24 months, however.

You hired a property management firm to provide a comprehensive due diligence report.

Review the River Commons Property Assessment and Due Diligence Summary (in the Resources section), and answer the following questions:

- What are your ownership goals – short term and long term?
- What type of loan will you pursue and why?
  - Consider your short and long term goals.
- Propose two loan packages (down payment, retained cash, percent borrowed, term of loan) that would work for your plans for the property.
- List five operating and/or activity positions you will be watching closely in the first six months of transition.
- Identify at least three financial benchmarks you will set for the CAPS and site team to hit in the 2017 Budget
- Review the five year capital investment plan. Are the first two years targeting the right projects? Why or why not?

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