

# Module 4

# ASSET EVALUATION AND PRESERVATION

## Instructor Guide





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# Acknowledgments

## SUBJECT MATTER EXPERTS

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## **Further Acknowledgments**

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.

# Table of Contents

<b>Message to Apartment Portfolio Supervisors</b>	<b>1</b>
<b>Module Structure and Timing</b>	<b>2</b>
<b>Introductions</b>	<b>3</b>
<b>Learning Goals</b>	<b>3</b>
<b>Section 1 - Property Ownership Life Cycle</b>	<b>4</b>
The Typical Property Ownership Life Cycle	4
Factors in the Typical Property Ownership Life Cycle	5
<b>Section 2 - Property Acquisition and Due Diligence Overview</b>	<b>6</b>
Due Diligence and Risk Assessment	6
Due Diligence Processes	7
<b>Section 3 - Market Analysis</b>	<b>12</b>
The Market Analysis Process	12
Regional Analysis	13
The Effective Market Area	18
Neighborhood Analysis	18
Rent and Competitor Analysis	20
<b>Section 4 - Inspections</b>	<b>23</b>
The CAPS Role	24
What to Look For	25
Types of Inspections	26
Environmental Assessment and Inspections	27
Property Exterior Inspections	28

Building Inspections	31
Accessibility Inspections	33
<b>Section 5 - Operational and Financial Analysis Inspections</b>	<b>47</b>
Analyzing Income Sources	47
Rent Roll Analysis	48
Lease File Audits	49
Resident Profile Data	52
Analyzing Expenses	53
<b>Section 6 - Analyzing and Reporting Results</b>	<b>56</b>
Owner/Company Due Diligence Report Overview	56
Key Content for Owner/Company Due Diligence Report	57
<b>Section 7 - Property Ownership Transition</b>	<b>62</b>
Property Ownership Transition Overview	62
Property Ownership Transition Checklist	64
<b>Section 8 - Property Development Feasibility Analysis</b>	<b>72</b>
The Role of Property Management	73
Areas of Feasibility Analysis	73
Financing the Apartment Development Construction Loan	75
Income and Expense Projections	76
Lease Up Projections	76
<b>Section 9 - Investment Strategies: Renovation, Disposition, and Refinancing</b>	<b>78</b>
Property Renovation	78
Property Disposition and Refinancing	80





# Instructor Guide Introduction

The National Apartment Association thanks you for your time, talent, and expertise in training and developing the next generation of Certified Apartment Portfolio Supervisors.

Whether you're a subject matter expert or lay person...a seasoned instructor or a new teacher...this guide will help you become an even more engaging and effective trainer.

# Fast Facts: Asset Evaluation and Preservation

## COURSE TYPE

- Instructor-led classroom training
- Uses presentations and individual learning activities to teach the course material

## COURSE MATERIALS

- This instructor guide
- The Asset Evaluation and Preservation Participant Guide
- The Asset Evaluation and Preservation PowerPoint Slides
- The CAPS Training Activities Book
- Module 4 Appendix (available online)

## COURSE LENGTH

Approximately five-six hours

## WHERE THIS COURSE FITS IN THE CAPS TRAINING CURRICULUM

*Asset Evaluation and Preservation* is the fourth course in the CAPS training series. Here's how the entire series lays out:


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

# Instructor Guide Features

## PARTICIPATION PROMPTS

Within the text of this instructor guide, you will find a few optional participation prompts. These prompts are merely suggestions, and are there to help facilitate conversation and engagement in the classroom.

These participation prompts will look like this:



### Participation Prompt

These prompts will contain questions to prod the participants into thinking about the issues you're covering.

## Activity Instructor Notes

Activities are included in this instructor guide in the places where they should occur. Along with those activities, there are Instructor Notes. These notes give you a bit of information about the structure of the activity (activity type, approximate time), as well as some suggestions for responding to participants' input and facilitating further discussion. Some suggested answers are provided to stimulate participant answers. These instructor notes will look like this:

### Instructor Notes


Activity Type: Individual

Approximate Time: 10-15 minutes

5-10 minutes - Activity

5 minutes - Discussion

There will be notes here that are designed to help facilitate discussion of participants' responses.





# Message to Apartment Portfolio Supervisors

Asset evaluation is an essential part of property management. It begins before the property is acquired and continues throughout the entire period of investor ownership.

Due diligence supports the purchase decision for existing properties. Feasibility analysis supports the decision to develop new properties. During the ownership period, the same processes that informed the purchasing decision prove invaluable to the annual budgeting preparation. Finally, when the property matures and market conditions change, owners must evaluate the physical and financial condition of the property in order to make a critical decision: renovate, sell, or refinance.

The Certified Apartment Portfolio Supervisor (CAPS) training program is designed to prepare CAPS to provide the analysis the owner needs to make sound decisions about this valuable asset.

**Asset Evaluation and Preservation** 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 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:

<b>Section</b>	<b>Time</b>
Section 1: Property Ownership Life Cycle	5 minutes
Section 2: Property Acquisition and Due Diligence Overview	20 minutes
Section 3: Market Analysis	30 minutes
Section 4: Inspections	90 minutes
Section 5: Operational and Financial Analysis	15 minutes
Section 6: Analyzing and Reporting Results	15 minutes
Activity: Due Diligence Report	40 minutes
Section 7: Property Ownership Transition	40 minutes
Activity: Property Transition	10 minutes
Section 8: Property Development Feasibility Analysis	15 minutes
Section 9: Investment Strategies: Renovation, Disposition, and Refinancing	20 minutes

# Introductions

Welcome to the **Asset Evaluation and Preservation** 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:

- **Have you ever had to recommend a large renovation or remediation project to a property owner?**
- **If so, did you encounter any challenges in making your case?**
- **Name some potential obstacles you might encounter when evaluating a property for potential trouble spots (physical, operational, or financial.)**

[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:

- **Identify the factors that affect the property ownership life cycle, and understand the CAPS role in shaping that life cycle.**
- **Assess legal, financial, and safety risks as part of the due diligence process.**
- **Perform the necessary components of due diligence (or lead others in doing so), including physical inspections and analysis of a property's operational, commercial, and financial health.**
- **Report your findings to the property owner (or potential property owner), along with ramifications and recommended solutions.**
- **Manage the smooth transition of a property from one owner to another.**
- **Advise owners on the feasibility of new developments.**
- **Advise owners on renovation, disposition, or refinancing of existing properties.**



# Section 1 - Property Ownership Life Cycle

A multifamily housing community is a significant investment, and evaluating and preserving the health of that investment is an ongoing process.

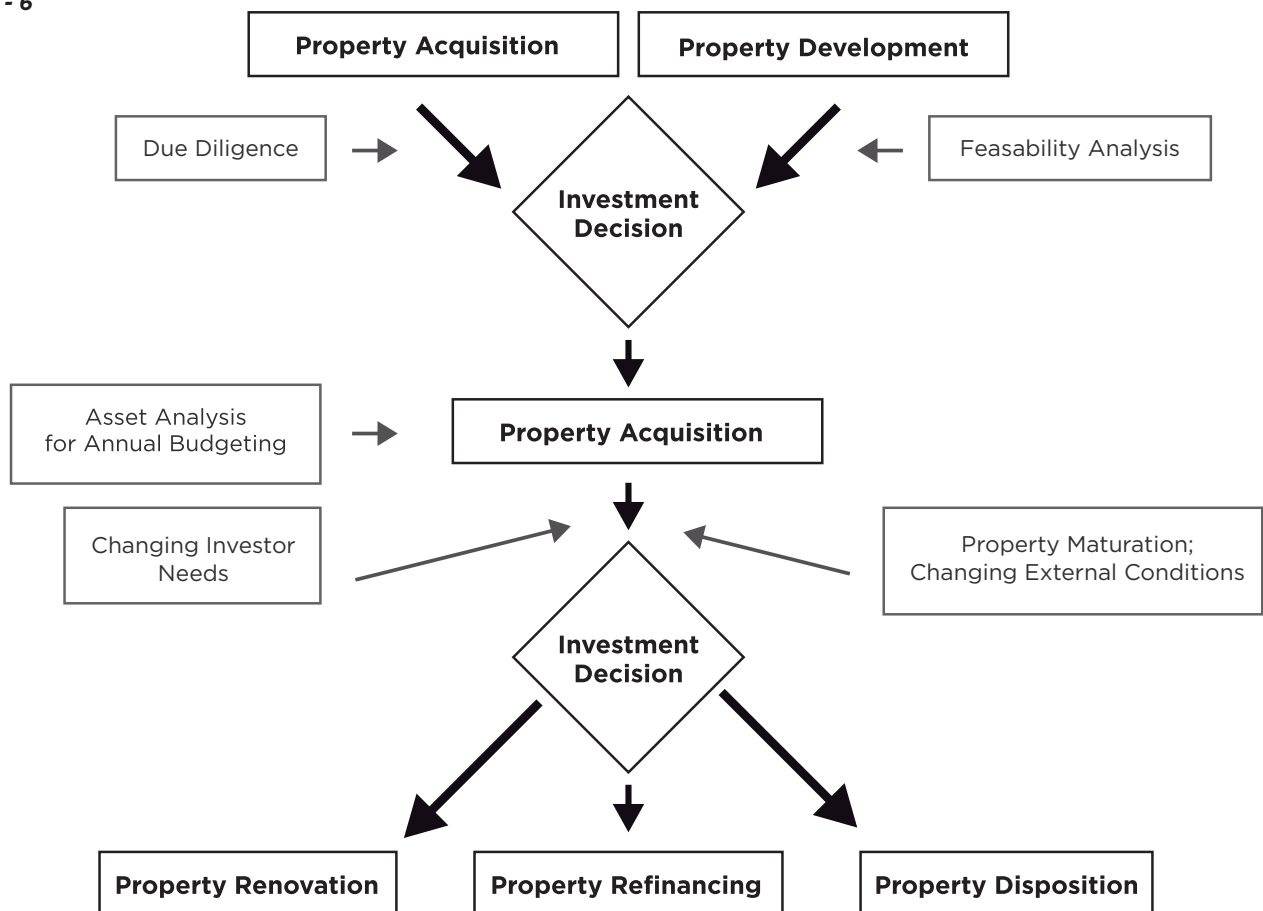
It begins from the time an investor considers acquiring or developing a property, and it continues all the way up to the time the property is sold. Together, the owner and the management company work to expose potential trouble areas and find opportunities for improving the value of this important asset.

Topics Covered:

- The Typical Property Ownership Life Cycle.
- Factors in the Typical Property Ownership Life Cycle.



## THE TYPICAL PROPERTY OWNERSHIP LIFE CYCLE







# FACTORS IN THE TYPICAL PROPERTY OWNERSHIP LIFE CYCLE

## Slide 7 *Due Diligence for Property Acquisition*

Because apartment communities represent such a significant investment, due diligence for property acquisition is a rigorous, time-consuming process. Thorough market analysis, multiple property inspections, and a painstaking analysis of the property's operational and financial condition come together to answer the bottom-line question for the investor: Is this investment worth pursuing?

### ***Feasibility Analysis for Property Development***

When considering the feasibility of new property development, the investor will expect the management company to do a thorough market and cost analysis. To make an informed decision, the investor needs to know the state of the local rental market, the zoning and building requirements, the anticipated costs associated with development (e.g., land, construction, financing), as well as the anticipated income.

### ***Asset Analysis for Annual Budgeting***

Many of the same processes that were used in the property acquisition decision remain useful in preparing the annual budget. Asset analysis in these situations is a lighter, less-detailed process than it is when acquiring a new property, but is still invaluable in revealing areas of concern for the following year's budget.

### ***Changes and Investment Decisions: Renovation, Refinancing, and Disposition***

As the property matures, and as external forces and the investor's needs change, the property's needs also change. The owner will need to make decisions about how to react to these changes. A thorough understanding of the property's financial performance, the state of its physical infrastructure, and the state of the rental market in which it operates will help the owner decide which path to take:

- **Renovation:** The owner may decide it makes financial sense to make improvements to the property. For example, fixing problems and upgrading features may allow a rent increase, or may allow the community to target a different resident profile.
- **Refinancing:** With growing equity, the owner may opt to take advantage of the increased financial leverage offered by refinancing the mortgage loan.
- **Disposition:** If renovation and refinancing don't appear likely to achieve the owner's investment goals, the owner may decide to sell the property.



Slide 8

## Section 2 - Property Acquisition and Due Diligence Overview

The due diligence process helps potential investors discover critical information that might affect the decision to invest in new properties. It can save a buyer from making a bad investment by turning up problems with the property's physical or financial condition. In cases where the investor decides to move forward with an acquisition, due diligence improves their ability to negotiate a favorable purchase price. Once a property has been acquired, those same asset analysis processes can prove helpful when preparing the annual budget. Going through these rigorous steps can help formulate and clarify an owner's goals, and help manage risk by reducing liability.

Topics Covered:

- Due Diligence and Risk Assessment.
- Due Diligence Processes.



Slide 9

### DUE DILIGENCE AND RISK ASSESSMENT

Due diligence means assessing possible risk (legal, financial, safety) to the business when a buyer or investor is considering acquiring a property. The process of due diligence—and the information it generates—is so valuable, however, that you should consider doing an abbreviated form of it for all properties in your portfolio in preparation for annual budgeting. Risk is not an easy concept to measure and evaluate. You'll have to be flexible in how you look at risk factors for each property. You'll find that some properties are more impacted than others by:

- Inflation trends.
- Interest rate changes.
- Management efficiencies.
- Market condition changes.
- Physical improvement needs.
- Obsolescence issues.
- Staff performance.
- Neighborhood or community changes.



Slide 10

### *The CAPS Role*

Although buyers and sellers may both be involved in the due diligence process, the primary responsibility falls to the buyer to discover risks and use the due diligence process to ensure an outcome that meets their objectives.

As a multi-property supervisor, you may be involved in the due diligence process in these ways:

- In smaller companies, you may lead the evaluation and due diligence process for the owner.
- In larger companies, you'll be an important member of a larger due diligence and discovery team, and be assigned certain responsibilities in the process.



### Participation Prompt

Have you participated in due diligence? What do you like about it? What don't you like about it?

## DUE DILIGENCE PROCESSES



Slide 11

### *Acquisition vs. Budgeting*

When undertaken for property acquisition, the due diligence process is carried out within the set of investment goals a prospective buyer identifies. When done for annual budgeting purposes, the process is more compact, but still done with an eye to the owner's investment goals for that property.

Some of the most common processes are listed here. Note that some of these processes are primarily geared toward property acquisition, and will be less applicable to annual budgeting for existing properties.



Slide 12

### *Analyzing the Rent Roll and Auditing Lease Files (Property Acquisition; Annual Budget)*

**Purpose:** To determine whether rent information, lease term duration, recurring charges, rent delinquencies, and write-offs are accurate, in line with leasing policies, and compliant with applicable laws. This process can also serve as an opportunity to gather demographic data about current residents.

Methodology:

- Compare resident leases and lease file contents to rent roll data. Always evaluate rent roll data with an on-site file audit, rather than relying on seller or broker pro forma information.
- Compare specifics such as resident names, lease terms, rental amounts, recurring charges, deposit amounts, and amenity features to those represented on the rent roll.
- If preparing the annual budget for an existing property, make sure discrepancies are corrected, with the lease terms taking precedence.



### Participation Prompt

Why is it important to reevaluate rent roll and lease files when determining whether to acquire a property?



### *Reviewing Service and Maintenance Agreements (Property Acquisition)*

Slide 13

**Purpose:** To identify all service and maintenance agreements (or contracts) at the property and carefully examine all obligations relating to price, length and transferability of agreement, and cancellation and renewal clauses.

Methodology:

- Check the terms and pricing for all service and maintenance agreements, including those relating to landscaping, trash removal, elevators, apartment or common area cleaning, carpet cleaning, painting, security, fire protection, and so on. Can these agreements be cancelled, or are they tied to the property regardless of ownership? If they can be cancelled, how much notice is necessary, and under what terms?
- Check for recurring performance issues with service and maintenance providers.
- Do chronic problems indicate future major costs?
- Review equipment warranties.



### Participation Prompt

Why is it important to evaluate service and maintenance agreements and history when determining whether to acquire a property?



### *Reviewing Service Request History (Annual Budget)*

Slide 14

**Purpose:** To identify potential trouble spots and opportunities for improvement in the property's physical infrastructure.

Methodology:

- Pull service requests for the previous year and look for relevant patterns. Look at the types of work done. Are there patterns that suggest specific concerns with the physical condition of the property?



## Participation Prompt

What kind of trends should you look for in service requests?



### **Ensuring Governmental Compliance (Property Acquisition)**

Slide 15

**Purpose:** To ensure that the property is operating in compliance with local zoning, building, occupancy, and environmental regulations and requirements.

Methodology:

- Review statutory and regulatory requirements applicable to the property at local government offices.
- Confirm compliance by answering these type of questions:
  - What is the physical condition of the property?
  - Do local zoning and building codes allow the current or intended uses?
  - Do boundary problems exist? Are utilities, roads, streets, and access to and from the property in compliance?
  - What environmental issues should be considered? (Third party firms will often do an environmental review and provide an opinion report.)
  - Is the property in compliance with the Fair Housing Act's seven design requirements?
  - If not in current compliance, are variances "grandfathered" so they won't require correction?
  - If variances are "grandfathered," does that pass on to new ownership?
- If it is a new construction project, ensure that items such as building heights, floor area ratios, parking space requirements, and setback lines are checked for compliance by federal, state, and municipal authorities.



### **Reviewing Recorded Documents and Litigation (Property Acquisition)**

Slide 16

**Purpose:** To assess the nature and extent of easements granted, to identify potential problems with the title, and to determine the potential benefit or liability they will present for the property. Pending litigation will let the buyer know about any current legal issues, which may affect the purchase price or prevent the acquisition. This task is usually completed by an attorney.

Methodology:

- Check for any financing, mechanics, tax, or judgment liens on property.
- Look for any pending condemnation proceedings.

- Investigate potential governmental or private litigation.
- Conduct a full title search - usually accomplished through a third party provider.




### ***Performing Physical Inspections (Property Acquisition; Annual Budget)***

Slide 17

**Purpose:** To assess the overall condition of the buildings and its mechanical components, including structural defects or limitations that may pose obstacles in repositioning or renovating the property. Provides the analysis necessary to create a comprehensive capital budget.

Methodology:

- Pull service requests for the previous year and look for relevant patterns. Look Review the historical records on repairs, maintenance, and warranties.
- Inspect, in great detail, building exteriors and common areas, mechanical components, and all apartment home interiors in the community.
- Review the “as-built” plans and specifications for the property.  
(Third-party architects or engineers will often perform this review for you.)



**Participation Prompt**

Describe some physical property findings that have significantly altered due diligence or budgeting plans.



### ***Checking for Tax Issues (Property Acquisition)***

Slide 18

**Purpose:** To assess what the expected future tax liability will be for the property.

Methodology:

- Verify the current assessed value.
- Compare the assessed value to similar properties to expose potential tax protests.
- Check for special assessments and fees in previous years’ taxes.
- Look for any expiring tax abatement.



### ***Reviewing Insurance Policies and Risk Management Claims (Property Acquisition)***

Slide 19

**Purpose:** To assess a property’s liability risk.

Methodology:

- Review the property’s current insurance coverage.

- Review claim information if the current owner is willing to share it with you.
- Obtain loss run records from current ownership's carrier to review all claims made over a given period of time.
- Complete a thorough risk analysis. Note the likelihood of incidents and impact to the property. Consult with your insurance provider to estimate coverage options and limitations.



### **List of Personal Property (Property Acquisition)**

Slide 20

**Purpose:** To confirm the personal property that will remain at the apartment community and be included in the purchase price. These items are generally listed, and their combined value stated, on a UCC-1 form.

Methodology:

- Obtain the seller's inventory of all personal property, which often includes apartment appliances.
- Keep a detailed inventory list with photos so that the seller can't substitute other items for items on the original list.
- Verify that the inventory remains by performing a physical inspection just before the closing date.



### **Market Study (Property Acquisition)**

Slide 21

**Purpose:** To confirm the property's market value relative to comparable properties.

Methodology:

- Assess the strength of the local economy, rental rates, operating policies, absorption rates, and growth trends.
- Relate each of these items to the potential impact on the property.
- Analyze the findings to forecast future values and upside values for renovation and new construction.
- Do not rely on a market study provided by the current owner or the broker. Use qualified management company team members to complete the study or hire someone to do it.

### **Participation Prompt**



What could happen if the personal property identified during the due diligence process isn't the same list of items acquired at time of transition?

How could this impact the property's financial health?



## Section 3 - Market Analysis

Market studies deliver the information necessary to allow buyers to make informed judgments on the value and price of acquisitions, and property owners to evaluate plans for existing properties. By collecting different types of information, a viable investment plan can be developed that will lead to achievement of the owner's goals.

It's critical to understand the regional and local market in which the property operates. After all, you can't move the property!

Topics Covered:

- The Market Analysis Process.
- Regional Analysis.
- The Effective Market Area.
- Neighborhood Analysis.
- Rent and Competitor Analysis.

### THE MARKET ANALYSIS PROCESS



#### *The CAPS Role*

The CAPS multi property supervisor will likely either perform the market analysis or lead a team of other property management professionals in that effort. Sometimes this market study may be performed by an outside third party company that specializes in such work.

Ultimately, the CAPS and the management company will be responsible for ensuring that the market analysis presented to the potential owner includes a detailed description of regional economic trends; economic, social, and demographic trends in the neighborhood; and a competitive property analysis.



The Components of Market Analysis:

- Regional analysis: Focuses on the larger geographic area in which the property is located (for example, a major metropolitan area.)
- Neighborhood (or effective market area) analysis: Focuses on the localized area—such as a small city, or a neighborhood in a larger city—in which properties compete for prospective residents. This area is also known as



the property's "effective market area." Changes in the social, economic, and demographic characteristics of the market area will likely impact the financial performance at the property.

- Subject property analysis including competing properties: Focuses on how the property compares to other properties in its market area.



Slide 25

## REGIONAL ANALYSIS

### ***Extra Information: MSAs and PMSAs***

---

Metropolitan Statistical Areas (MSAs) are composed of:

- One or more counties, at least one of which includes an urbanized area (UA)
- A city with a population of 50,000 or more UAs consist of a central city (or cities) in a metropolitan area, along with the surrounding closely settled territory constituting its "urban fringe" (a density of at least 1,000 persons per square mile)

MSAs with populations in excess of one million are often further subdivided, and primary MSAs (PMSAs) within them are identified. A PMSA may comprise one or more large urbanized counties, all of which have strong internal economic and social links, but it may not have a central city. MSAs in which such PMSAs are identified are re-designated as consolidated MSAs (CMSAs.)

**Purpose:** To investigate the economic conditions in the larger geographic area that serves the apartment community with its:

- Amenities.
- Educational facilities.
- Entertainment venues.
- Job sources.

- Shopping areas.
- Job growth.
- Unemployment rates.
- Household formation.
- Population growth or decline.
- Demographic data.
- Population size.
- Density.
- Age.
- Race.
- Gender.
- Educational attainment.
- Income levels.
- Family composition.

Demographic changes affect the competitive environment for your community by impacting basic demand for rental apartments as well as the potential supply of available housing for sale and for rent.

### ***Sources of Data***

There are many resources that can be used to analyze the region, neighborhood, and demographic profile for a specific property. Data is available even down to the census tract level where the property is located although this is often not as current as recently updated data. In particular, a wealth of information can be drawn from local and governmental resources, made easily accessible via internet websites. The following is a list of organizations that may provide data and other information that is useful when performing a market analysis:

#### **U.S. Bureau of the Census ([www.census.gov](http://www.census.gov))**

- Population size, density, and distribution.
- Population forecasts.
- Age, education, and family size.

- Per capita income.
- Consumer spending and savings.
- Disposable income.

**American Housing Survey (<http://www.census.gov/hhes/www/ahs.html>)**

- Vacant housing units.
- Household characteristics.
- Housing and neighborhood quality.
- Housing costs, equipment and fuels.
- Size of housing unit.
- Recent movers.

**U.S. Bureau of Economic Analysis (<http://www.bea.gov>)**

- Reports on regional business activity and personal income.
- Employment data on available labor force, types of jobs, and major area employers.
- Forecasts of expanding job markets.

**State Agencies and Local Governments (<http://www.statelocalgov.net>)**

- State taxing authority.
- Zoning laws and use restrictions.
- Construction permits issued for housing.

**Local Chambers of Commerce**

- Local tax regulations.
- Variety of companies and industries.
- Strength and vitality of businesses.

## ***Additional Resources***

The National Apartment Association's Annual Income and Expense Survey, which publishes annual data from market rate and government assisted housing. Individually metered and master-metered property data is available as are comparisons of garden and high rise communities. See [naa.org](http://naa.org).

- Income/Expense Analysis®: Conventional Apartments–Published by the Institute of Real Estate Management ([irem.org](http://irem.org).)
- Dollars & Cents of Multifamily Housing®-Published by the Urban Land Institute.

There are different member and non member costs for NAA, Urban Land Institute, and IREM income and expense data.

## ***Fieldwork***

Property managers can sometimes obtain demographic data from surveys and articles from major newspapers, chambers of commerce, and local economic development and planning organizations that may be more current than government gathered data.

In addition, commercial real estate brokers can be a valuable source of information. Consider getting on brokers' mailing lists for offering memoranda.



**Slide 26**

## ***Key Items to Research***

While it's unlikely that the CAPS will be the person responsible for conducting all facets of the research, you should be familiar with the most important elements. There are a few key items that are especially important because they have a direct impact on the property.

- Zoning Restrictions: Almost every city has a master plan, which outlines patterns of permitted growth. Some jurisdictions will have an inclusionary zoning requirement for a property's initial approval, which means that a certain number of apartments must be designated as affordable to renters at or below a certain income level. Contact the city or county zoning department/board to acquire a copy of the zoning map and explanation of zoning regulations.
- Rent Control: Determine if any state and/or local rent control or tenant/landlord laws exist or are pending. In the interest of the owner, you will need to determine what effect these laws will have on the investment. The local apartment association typically monitors ordinances, codes and laws on local and national levels that impact property operations.

- **Building Codes and Restrictions:** Speak with a staff member of the city’s Building Department to learn about building codes, restrictions and guidelines for growth or development. Ask how the city handles violations and, if applicable for an older property, if the city expects a property to be upgraded to new code standards or whether a “safe harbor” exists. Common upgrades for older properties include vehicle parking ratios, density, fire and safety requirements and environmental concerns.
- **Licensing Fees:** Research any annual fees or business licensing fees required by local, regional, and state governments.
- **Infrastructure:** Proposed changes to the infrastructure, such as the development of bypasses, road construction and street repair, public transportation upgrades, the creation of utility easements that can alter traffic patterns and increase or decrease the desirability of a specific location.



Slides 27 - 28

One of the best ways to understand and interpret all the facts you gather is to personally visit the region.

Drive around and take note of existing and new developments including office, retail, industrial and residential properties.

- What seems to be the general economic condition of the area?
- Are more businesses opening or closing?
- What is the condition of the roads?
- Does the traffic pattern work?
- What makes a neighborhood unique or more desirable?

Be sure to visit or at least view the competing multifamily communities and learn as much as you can about them.

An excellent way to obtain information is to join the local affiliate of the National Apartment Association and other professional community organizations, such as the Chamber of Commerce. Attend meetings and participate in activities. Talk to commercial real estate brokers and municipal officials, as well. Not only will you gain knowledge about your local area, but you may have the opportunity to network with professionals in other areas of the city, state, or nation, thus extending your skills and resources.



Slide 29

## THE EFFECTIVE MARKET AREA

The property's immediate neighborhood may encompass a small geographical area, such as a few nearby properties, or a larger area, such as multiple blocks. These boundaries can be natural, such as rivers and lakes, or manmade barriers, such as streets and highways. For market analysis purposes, the boundaries of the property's effective market area, i.e., the physical perimeter within which prospects are looking at properties, are best defined by competition. You are competing with these properties on the basis of such factors as:

- Location.
- Rent.
- Age.
- Quality and type of construction.
- Amenities.
- Appearance.

You must be able to identify how your property compares on multiple levels against your competitors in order to develop your marketing strategy and set rent levels. An effective way to map the market area of a residential property is to determine where the competition is located. It may also be helpful to plot out existing residents' places of employment. Plot these points, along with the location of the property, on a map. The entire encompassed area will determine where residents live and work and help determine the market area as it exists today. Renovation, rehabilitation, and modernization may be a strategy to target other geographic areas or a new resident profile.



### Participation Prompt

How do you determine who your competitors are? How do you identify other properties that might not be direct competition but still influence your market?



Slide 30

## NEIGHBORHOOD ANALYSIS



### Video Clip

Broker packets are designed to sell you on the property. You should go out and visit the neighborhood to make sure it doesn't look better on paper than it does in person.



Since a neighborhood is not a static environment, one of the central tasks of market analysis is to understand why neighborhood conditions may have changed and how they will affect your property.

To analyze a neighborhood, you should do both of the following:

- Investigate data available in public records.
- Visit the neighborhood.

Visiting the neighborhood of the subject property is key to its analysis. It's a good idea to drive at least several blocks in each direction from the property (and at different times of day), so that you can assess the neighborhood. There is a direct correlation between a neighborhood's appearance and rent levels at the properties in the neighborhood. Rents are affected significantly by the prestige and economic conditions of the neighborhood. In addition, when you identify a neighborhood's strengths, you can build your marketing strategy around them, attracting those prospective residents who value those strengths. Defining the neighborhood correctly is the most important beginning task.

### ***Sources of Data***

Neighborhood information can be researched from many of the same public sources previously noted for regional analysis.



### ***Key Items to Research***

- Changing demographics may impact the popularity of unit types. For example, if a study of the demographics suggests a growth in the amount of young, single professionals, then one-bedroom apartments may become more desirable than two-bedroom, two-bathroom units.
- Fluctuating real estate sales prices may impact the demand for rental apartments.
- Economic forces (local and national), which are evaluated in a regional analysis, will affect the neighborhood's vacancy rates, property development and land value. For example, if unemployment levels are high in an area, then vacancy rates for larger, more expensive apartments may likely be high as well.



### ***Neighborhood Conditions***

- Neighborhood Amenities: Shopping, entertainment, churches, recreational and cultural facilities. Note the proximity to the property.
- Property Comparisons/Condition: Does the subject property match the general appearance of the area? Is the age and construction relatively similar? Is the property well located for its purpose? Have recent improvements been made in the neighborhood? Is the neighborhood kept in good condition by local government and residents? Are there specific issues or problems in the area such as crime rate, flooding, adverse traffic patterns, and industrial waste or environmental issues?

- **Planned Infrastructure Improvements:** Determine if there are plans for new or upgrades to existing utilities such as power, water or sewer services. Contact the local public works department to find out if there are plans to upgrade local roads or construct new roads and highways. Will new roads or improvements affect access to the property?
- **Transportation and Walkability:** Look up the neighborhood's bike, walk, and transit scores. Are neighborhood amenities within walking distance? Are the roads bike-friendly? Is public transportation available and convenient?
- **Schools:** Local school districts can provide information about the schools and student transportation. Additionally, determine the quality of the school district relative to others in the area.
- **Employment and Income Data:** What is the median or average income for the surrounding area? How do those income levels fit with the owner's screening criteria? What are the local employment opportunities? What's the general unemployment rate of the area? Obtain employment trend reports for the past 18-24 months. Are specific businesses planning to enter or leave the area? What kinds of employment opportunities are available? Worker income can determine rental structure.
- **Neighborhood Government - Associations:** Deed restrictions, conditions, covenants and restrictions (CC&Rs), municipal utility districts (MUDs), and planned unit developments (PUDs). Determine if any deed restrictions and CC&Rs apply to the subject property and whether it is located in a MUD or PUD. Are there financial obligations related to prior financing mechanisms such as tax credit or bond financing provided by state or local government. Obtain a list and explanation of restrictions, rules and associated fees from the local governing organization.



Slide 34

## RENT AND COMPETITOR ANALYSIS

It's important to examine the economic characteristics of the area and their effect on the rental market. Supply and demand, vacancy rates, and absorption rates provide insight into the economic environment of the area. In a soft market, supply will go up, which increases vacancy rates, and demand will decrease.

### *Supply and Demand*

Supply and demand for residential property can be affected by demographic characteristics such as household income, age, and family composition. In turn, these very same characteristics can, themselves, be affected by supply and demand. An in-depth market study will determine unit mix, floor plan features, amenities, targeted



profile, and rent recommendations based on what is currently in the market. This study should also include projected job growth and city plans for infrastructure, including building permits, construction already permitted but not yet built, and raw land sales.



Slide 35

### **Rental Comparison**

Obtain or create a market rental schedule for each competitor and compile a rental comparison chart. It is important to compare base rents and market rents. Establish specific comparisons for:

- Unit type.
- Square footage.
- Market rent including additional recurring charges for amenities.
- Market rent per square foot.
- Amenities.
- Incentives – these will reduce market rents to effective rents.

Define all unit types (e.g., number of bedrooms, bathrooms, den areas), compare rental rates for each unit type (including amenities and incentives), and create a chart that shows both absolute rents and rents per square foot.

All of this comparison work will produce a complete and objective analysis of the community and its competition. This data can be used to write a comparative market analysis that will explain the property's overall market position, whether it be advantageous or disadvantageous.



Slide 36

After you have analyzed area rates and compared them to the subject property, consider:

- Can rents and amenity charges be increased, and if so, how much and how soon?
- Can rents be increased after capital improvements have been made?
- How much of an increase is appropriate based on the current condition of the property or renovation plans?
- Can rents be increased for selective units?

- What is the competitive leasing edge for the subject property, or what needs to be done to improve it?
- What improvements must be made to meet or beat the competition?

The current reputation of the subject property will have a bearing on future marketing plans. Ask others for their opinion about the property as you compile your surveys - particularly the competitors. Shop the competition in person, and find out their improvement plans. If there are plans at the subject property to improve, upgrade, or rehabilitate the property, you may consider changing the property's name and advertising campaign.

An analysis should be detailed and objective. Note the strengths and weaknesses of the neighborhood and those of the subject property and its competitors. This will help you to advise or offer recommendations to an owner.



## Section 4 - Inspections

Slide 37

Whether it's for acquisition of a new property, or for budgeting and maintenance on an existing property, a thorough physical inspection of both the interior and exterior is necessary to identify problems, flaws, or concerns that may impact future investment decisions.

Identifying any problems prior to purchasing an asset can influence the investor's offering price and expected rate of return on the investment. It can also influence any cost-benefit analysis associated with renovation of an existing property. In some instances it may cause an investor or owner to abandon a previously planned action.

The property inspection is intended to identify physical and environmental concerns, and document the inspection of:

- Exterior structures.
- Interior apartment units.
- Mechanical facilities.
- Maintenance.
- Leasing/business offices.
- Common areas and amenities.

It is important to determine when professional or technically qualified personnel such as architects or engineers should conduct inspections and assist with cost estimates.

Topics Covered:

- The CAPS Role.
- What to Look For.
- Types of Inspections.
- Environmental Assessment and Inspections.
- Property Exterior Inspections.
- Building Inspections.
- Accessibility Inspections.

- Mechanical Inspections.
- Interior Inspections.
- Using Inspections to Think About Marketing.



Slide 38

## THE CAPS ROLE

Inspecting a property is a time-consuming, rigorous task. It must be performed in a thorough and professional manner, and the results must be reported back to the owner along with ramifications of the findings and possible solutions to any problems found. Much is at stake for the owner/investor, and the management organization's reputation will be judged based on their competence and professionalism in performing this task.

The multi property supervisor will likely be leading the management team's inspection effort on behalf of the acquiring entity, along with other management company personnel and third-party professionals.

Community personnel from other portfolio properties are likely sources of inspection help. Further, company personnel in other disciplines such as accounting, asset management, construction, information technology, training, marketing, or human resources are additional resources for inspection purposes.



Slide 39



### Video Clip

You need to make sure due diligence inspections are conducted in a thorough manner. If you don't, it may be costly later.



Slides 40 - 41

Before beginning the inspection, consider the following:

- Make sure you understand the owner's objectives as well as the purpose and intended result of the inspection.
- Use detailed, standardized inspection checklists for interior, exterior, and mechanical inspections. There are a variety of software programs and apps that can reduce the amount of manual recording, provide a consistent and thorough format for reporting, and make the process seamless by integrating directly with property management software and budgeting formats.
- Pay particularly close attention to known areas of potential risk (e.g., areas where leaks are most likely.)
- Know the useful life of the property's important systems, and where they are in their life cycle.
- Rely on people with more expertise than you when inspecting things that are out of your area of expertise (e.g., have a maintenance supervisor evaluate electrical wiring.)

- Take checklists, notebooks, tape measures, cameras, video equipment, and tape recorders. Measure, photograph, and document everything. Write down model and serial numbers of appliances and equipment (this can help you plan your budget by letting you know how old everything is, or whether it's under warranty.)
- Work closely with current onsite management to encourage their cooperation, and provide suitable and legal notice as needed for onsite interior inspections.
- Allow enough time for a thorough inspection that is the least disruptive to current management and residents.

*NOTE:* Make sure you are aware of what information the current on site team knows. Sometimes sellers do not tell existing site personnel that they are considering selling a property.



Slide 42

## WHAT TO LOOK FOR

Each step for inspecting a property must be carefully and diligently undertaken. Begin with an overview focusing on deferred maintenance and functional and economic obsolescence.

### ***Deferred Maintenance***

This is property upkeep that has been “deferred” or not completed that should have been done to maintain the asset. Peeling exterior paint and leaking roofs are two examples. Maintenance may have been deferred if the property owner has attempted to save operating costs in the hopes of reflecting a stronger net income than may be realistic. Evaluate conditions carefully.

Deferred maintenance can cause costly damage and result in repair costs considerably larger than if the problem had been taken care of when first discovered. The inspection should note all related or extended repairs and/or replacements associated with the needed maintenance.

### ***Functional Obsolescence***

Functional obsolescence refers to those items that may not be worn out or needing replacement but which are outdated or obsolete. Examples might include a 3-bedroom, 1-bath unit that requires residents to walk through one of the bedrooms to get to the bathroom; or a unit with all shag carpeting or laminate countertops. Once again, the inspection should note what should be replaced and the estimated cost.

### ***Economic Obsolescence***

Economic obsolescence is the result of those problems that can not be remedied such as a property located in a rapidly declining area without potential for

improvement or turnaround. Examples might include an area where the only grocery store has closed, where a major employer or retail center has left, or where public transportation is no longer available. These issues are likely caused by problems in the neighborhood rather than by the property.

Economic obsolescence is typically external to the property and makes it even more important to learn about the area surrounding the property as well as the property itself. Businesses across the street, around the block, or down the road will give relevant clues as to the strength of the area and therefore the pay back of any significant investment.

### ***Curb Appeal and Location***

In general, also evaluate property curb appeal and location. Well located properties even with negative features, aging or less-than-new amenities, can outperform better maintained, newer assets in poor locations.

- Assess the condition of the buildings, grounds, signage, landscaping, lighting, parking areas, common areas, and amenities.
- Identify the first impressions that the property conveys to residents and visitors.
- Evaluate why a prospective renter would want to lease at this property instead of elsewhere.



**Slide 43**

## **TYPES OF INSPECTIONS**

Several broad types of inspections should be performed:

- Environmental Hazards.
- Exteriors.
- Buildings.
- Accessibility.
- Mechanical Systems.
- Interiors.

You will eventually, as part of the inspection process, be required to identify the problems as well as the cost necessary to fix, repair, upgrade, or replace in these areas:

- Deferred maintenance.

- Major repairs.
- Capital improvements.



Slide 44

## ENVIRONMENTAL ASSESSMENT AND INSPECTIONS

Under the Superfund Amendments and Reauthorization Act of 1986 (an amendment to the original EPA Superfund act that authorized the identification and cleanup of hazardous waste sites), in order for an owner/developer to claim no prior knowledge of the land, an environmental assessment must be performed.

The CAPS does not generally handle environmental inspections, but it is imperative to know what they're about, and be aware of the results of any such inspections, as they can have important financial implications. Environmental inspections can lead to additional lender requirements that need to be fulfilled by the management company. In addition, you will need to know what disclosures are legally required, and what steps need to be taken to remedy any problems.

### *What to Expect from an Environmental Inspection Report*

The full assessment generally consists of three phases:

- Phase I: Previous Owner History.
  - Title search.
  - Aerial photographs.
  - Federal and state database search for known areas of contamination.
  - Local interviews.
  - Site visit.
- Phase II: Environmental Sampling.
  - Soil and groundwater testing.
  - Verification of underground storage tanks.
  - Determination of any necessary additional assessments.
- Phase III: Assessment of Discovered Contamination.
  - Thorough soil and groundwater testing of contaminated areas.
  - Examination of underground storage tanks.
  - Determination of extent and nature of contamination.
  - Determination of remediation options.

Most lenders and prudent buyers will require at least a Phase I Environmental Survey before funding a loan or acquiring a property. Based on the extent of any renovation or rehab, environmental inspections may also be required. This is especially true with regard to asbestos, lead, mold and other indoor air quality assessments.

The information provided in this report is critical because the property owner is responsible for a site's environmental clean up, even if that owner did not cause the original problem. It ensures that during the life of the property, no one will be mandating that the current owner clean up a property long after acquisition.

## PROPERTY EXTERIOR INSPECTIONS

The following discussion highlights a few key areas in order to illustrate the types of things you should be looking for when conducting property exterior inspections. For a more comprehensive (though still not exhaustive) checklist, see the online Appendix of this modules.



### *Hazards and Liabilities*

Slide 45

An important part of your total inspection begins with knowing applicable local and state building codes and regulations. You need to know this information to determine if the property is meeting these standards or needs updating. If upgrades are required, calculate the potential cost of correcting any hazards. A photo record made during your inspection is especially helpful.

As you walk the property, look for potential hazards. Pay special attention to areas where you may not have a lot of expertise, such as:

- Unsecured electrical junction boxes or loose wires.
- Faulty or incorrectly grounded wiring.
- Ineffective or nonexistent pool fencing, life saving equipment and GFI switches.

These are things that should be evaluated with the help of a maintenance supervisor.



### *Resident Safety*

Slide 46

Safety is always of prime importance. A safe community retains and attracts residents— and protects the owner's investment.

Make sure to check doors, locks, fences, gates, intercoms, and lighting features. Carefully check the maintenance records of electronic security features, such as:

- Keyless/Electronic Locks: What happens if the system goes down? Does it need a system upgrade? Are software upgrades included?



- Electronic fences and gates: Are they working currently? How often are they out of commission? Be sure to examine the maintenance records for historical data on these systems.
- Intercom or intrusion alarm systems and devices.

It may be necessary to visit at different times of day to perform some of these checks. Lighting issues may be more evident at night, for example.

In addition to the physical surroundings, you will need to know the state and local ordinances regarding resident safety. Check with the local police and/or the local NAA affiliate office if you need information or clarification of existing laws. Determine if the property is in compliance with these laws. If the property is not in compliance, determine what must be done, and estimate the cost for compliance.



Slide 47

### ***Drainage and Irrigation Systems***

Water damage from improperly functioning drainage and irrigation systems can cause structural damage and be very costly to repair. It is most useful to conduct drainage and standing water inspections after a recent rainfall, but even drought conditions can reveal issues.

- Examine the topography of the site for adequate drainage. Note the site's location in terms of surrounding development, including streets and alleys for draining run-off water.
- Inspect the grounds and note the areas water may collect, particularly around the foundations of buildings. Are the grounds properly graded? Are the interior walls of foundations completely dry? Are sewers, drain connections, and sump pumps (if applicable) working properly?
- Check detention ponds. Detention ponds are flood control features, and should be dry unless immediately following heavy rain or snow melt.
- Check retention ponds. Retention ponds are meant to retain water at all times.
- Look for standing water in places where it should not be. You can have this water tested to identify what it is, and where it's coming from.
- If undergoing drought conditions, look for cracked soil, which may indicate the previous presence of standing water that dried too quickly.
- Do French drains or flumes exist? If so, determine location and condition. Note that French drains can be difficult to see. They may be underground or at ground level. Look for standing water after rain, evidence of erosion near where water should be draining, or standing puddles of water.

- Check for weep holes. See if they are plugged.
- Check fountains and swimming pools. Are they properly maintained and inspected regularly as part of the preventive maintenance program?
- Inspect the irrigation and sprinkler system. Are there city or local water restrictions that apply to the property? Is there a preventive maintenance program in place, including a winterization program, if applicable?



Slide 48

### ***Trash Chutes, Containers, and Compacters***

Waste removal facilities should be inspected to see if they are well-maintained and adequate to the task. Be sure to examine waste removal contracts, as well, so you know who is responsible for providing dumpsters and removing waste, and what costs are involved.

- What kind of system is it? Hydraulic? Gravity?
- Trash chute systems should be clean, in good working condition, and adequately ventilated.
- Dumpsters and compacters should be in good condition, and located in strategic areas.
- Both interior and exterior dumpster and compacter areas should be clean and controlled for odor and pests or infestation.
- Determine if dumpsters are owned by the property or provided by the trash removal service. Is trash removal done by the municipality? Is there a cost involved?
- Is there a standing trash issue? Are pick-ups adequate? Are there enough dumpsters?



Slide 49

### ***Energy Evaluation***

Conservation of energy and natural resources is important for every part of the country. Recent technological advances have produced many energy efficient measures.

During your inspection, note:

- Weather-stripping on doors and windows.
- Exterior caulking.
- Roof and foundation vents.
- Insulation.

Consider what changes might be made to conserve energy and water, and the estimated costs for these changes. Items to consider include energy efficient lighting, low flow toilets, high pressure faucet heads. Also check to see if there are city or energy company incentive programs that encourage these purchases and possibly provide rebates.

## BUILDING INSPECTIONS



### Video Clip

Your maintenance supervisor offers invaluable expertise when you're conducting building inspections.



The following discussion highlights a few key areas in order to illustrate the types of things you should be looking for when conducting building inspections. For a more comprehensive (though still not exhaustive) checklist, see the Appendix. Building inspections should be comprehensive and detailed. You may want to consider hiring experienced professionals, such as engineers or architects, to assist with inspections. At minimum, you should perform these inspections with your maintenance supervisor.

A glossary of building terminology is provided in the online Appendix of this module.



### Roofs

A comprehensive and responsible roof inspection involves actually standing on the roof to inspect it. Generally speaking, this is not something the CAPS should be doing themselves. Have your maintenance supervisor or other experienced professional perform this part of the inspection.

Among the most important things you'll want to do during a roof inspection is identify the type and structure of the roof:

- Identify the type of the roof.
  - Flat roof with mineral sheet cap – characterized by its light-colored granular surface with many seams because it is applied in narrow coils.
  - Flat roof with built-up surface – usually has a gravel surface to deflect the sun's rays from the underlying emulsion.
  - Flat roof with membrane surface – typically EPDM, modified bitumen, or other synthetic rubber material, useful for preventing leaks.

- Mansard – roof with two slopes or pitches on each of the four sides, with the lower slopes steeper than the upper slope. May be part of a flat or pitched roof system.
- Pitched or hip – sloped or inclined sides and end slopes that are connected by a ridge.
- Gable – a ridged roof, the ends of which form a gable (generally a triangular shape.)
- Identify the structure of the roof.
  - Trusses: Large, usually wooden, triangular forms used to form the ceiling joists and rafters.
  - Joists and rafters: Rafters are the structural member extending from the down slope perimeter of a roof to the ridge or hip and is designed to support the roof deck and roof system components.
  - Post and beams: A post supports the beam. It's a vertical piece of lumber or metal pipe with a flat plate on top and bottom. A beam runs horizontally and is used to support the weight of the joists or a roof.
  - Panels



### ***Façade and Carpentry***

*Slide 53*

When inspecting the façade and carpentry, note:

- Types of materials used: cedar, pine, brick, stucco, Hardiplank (fiber concrete siding that looks like wood clapboard), Masonite, T-111 (plywood siding), etc.
- The condition of siding and trim for evidence of rot, buckling or warping. Test areas with suspicious appearance – i.e. cracking, bubbling, warping – for problems below the paint surface. Pay close attention, as many problems may be covered with a coat of paint. Note any new wood.
- Schedule a termite inspection. Most termite damage is unseen and cannot be easily detected by an inexperienced person. In coastal areas, dry wood termite and subterranean termite inspection are advisable.
- Inspect outdoor stairways, stringers and handrails for condition and secure attachment to the building.



## **Foundations**

Slide 54

Foundation types vary and may include:

- Poured concrete walls, concrete or cinder block walls that rest on concrete footings.
- Older buildings may have foundations of cut stone, stone or brick.
- Mat and raft foundations, also known as floating foundations or monolith slabs are used over soils that have low load-bearing capacity. They are made of concrete slabs that are reinforced with steel.
- Pile foundations are made of columnar units of concrete, metal, or wood that transmit loads through soils with poor load bearing capacity to lower levels where the soil's load bearing capacity is adequate.
- The foundation should show no sign of seepage, entrance of rodents into the building or settlement.
- It should be structurally sound and free of large cracks, holes or loose material. If foundation cracks are detectable, consult an engineer. Foundation repairs can be costly and should be estimated by an expert.



## **ACCESSIBILITY INSPECTIONS**

Slide 55

As you conduct your building inspection, you need to be aware of certain conditions required under federal and state Fair Housing laws, as well as Section 504 of the Rehabilitation Act of 1973. The Americans with Disabilities Act (ADA) may also be relevant in some instances (you can find more information about ADA requirements in the Appendix to this module.)

You need to know whether (and how) these laws apply to your property, and you'll need to notify the owner of any non-compliance issues. In addition, you'll need to make recommendations for changes needed to bring the property into compliance. This may require additional research on your part.

Note that accessibility non-compliance problems can delay closing on a sale, so it's critical to proactively identify and remedy these issues.



## **Fair Housing: New Construction Accessibility Requirements**

Slide 56

The first thing you need to know is when the building was first occupied. Housing that consists of four or more units that was built for first occupancy after March 13, 1991 must comply with the seven technical requirements for new construction.

## MULTIFAMILY HOUSING POST 1991

If your property was first occupied after March 13, 1991, it must comply with these seven design requirements for new construction:

1. Wheelchair accessible entrances on an accessible route.
2. Wheelchair accessible public and common use areas.
3. Doors wide enough to accommodate wheelchairs.
4. Wheelchair accessible routes into and within the dwelling.
5. Switches, outlets, and environmental controls at specific heights.
6. Wheelchair accessible kitchens and bathrooms.
7. Bathroom walls reinforced for grab bar installation.

The standards apply to ground level units of a building with four or more units with no elevator, or to all units in a building that has an elevator. Note that there may be more than one floor that qualifies as a ground floor. State construction requirements may be more stringent. There are eight “safe harbors” for compliance including the ANSI and International Building Code.



Slide 57

### ***Fair Housing: Accessibility Requirements for Renovations***

The Fair Housing Act has not established accessibility requirements regarding renovations. Therefore, an existing building going through renovations may not be required to make the building accessible, but state building codes may require it.

An applicant or resident is always allowed to make reasonable modifications at their own expense whenever necessary because of a disability.

### ***Fair Housing: Accessibility Requirements for Existing Rental Housing***

The housing provider must allow applicants and residents with disabilities to make reasonable modifications to the residence and common areas in existing housing at their own expense, unless the property is subject to Section 504 or if the property was not built in compliance with the Design Requirements (depending on the modification needed.)

An excellent source of information on fair housing accessibility is provided at [www.fairhousingfirst.org](http://www.fairhousingfirst.org).



Slide 58

### ***Section 504 of the Rehabilitation Act of 1973 Accessibility Requirements***

- Federally-funded or assisted housing must be readily accessible to and usable by individuals with disabilities.
- Requires property “self-evaluations,” and plans for removing any barriers.
- Housing provider must pay for removing barriers.
- 5% of the total number of units must be wheelchair accessible and 2% must be hearing or vision impaired accessible.
- Housing provider must pay for reasonable modifications requested by disabled residents.

Section 504 requirements are extensive. The regulations are found at 24 CFR 8.3. Additionally, HUD provides an excellent and thorough discussion of the many requirements at <http://www.hud.gov/offices/fheo/disabilities/sect504faq.cfm> in a useful question and answer format.



Slide 59

### ***General Accessibility Compliance Checklist***

Some of the items to consider as you conduct your inspection for Fair Housing accessibility compliance include:

- Parking – number, size, location, striping, and signage.
- Entryways – ramps, entryways wide enough, and accessible door handles.
- Corridors – non-slip floors and wide space needed.
- Stairs – width, traction, secure handrails.
- Elevators – doors that remain open long enough, accessible controls, audible floor signals, etc.
- Drinking fountains – must meet height and knee space requirements.
- Bathrooms – accessible urinals and mirrors, special door handles and grab bars and wheelchair accessible.
- Alarms – must be accessible.
- Signs – raised letter and Braille signs where needed.
- Phones – accessible height and volume control.

- Common areas - flashing warning lights in areas like the community center are advisable.
- Building to Building Access via sidewalks and ramps.
- Access to office/units from parking lots, public transit.



## MECHANICAL INSPECTIONS

Slides 60 - 61

Mechanical inspections include the major systems that serve the property, such as:

- Electricity.
- Gas.
- Water.
- Sewer.
- CATV and SATV.
- Broadband/high-speed Internet.
- Telephone service.
- Trash disposal.
- Boiler rooms.
- Fire command centers.

The focus of the inspection should be on how services are metered and billed, as well as, the current physical condition of the systems.

Most of these inspections should be conducted by a third-party specialist.



## *Metering and Billing*

Slide 62

Determine how each utility is metered and subsequently billed to residents. It's important for the CAPS to understand how billing works in order to make operational and budget recommendations.

- In most instances, individual metering of each residence is the most desirable option since residents can be billed directly, and management has less administrative work.
- RUBS - Residential Utility Billing System. The property receives the bill for



services and must assess a part of the total bill to each residence. There are companies that specialize in administering RUBS programs. They generally charge a fee per unit.

- Sub-metering: A separate company reads the meters each month and manages the billing. The metering company may also monitor some central systems such as gas heating and bill each residence (a modified RUBS.)



Slide 63

## Gas

Since most gas lines are underground, it may be difficult to determine the actual condition of the gas system. However, you should check:

- The age of the system and type of pipe used. Some materials deteriorate naturally with time and natural causes such as ground shifts. You should be able to determine the age of the system from maintenance or building records.
- Major repair work completed and type of work done.
- Warning signs for gas leaks, such as odor, hissing sounds, and dead or dying vegetation located near gas line connections. Problems should be reported to and repaired by the gas company.
- Check for compliance with the Gas Pipeline Safety Act.
- In most cases, a licensed plumber can pressure test gas lines to determine if any leaks exist.



Slide 64

## Electricity and Lighting

Your inspection should include:

- The age of the overall electrical system.
- Type of wiring – aluminum or copper.
  - If apartment homes are wired with aluminum, make sure that all receptacles, switches and connection points were made for aluminum wiring. Remember to consider conversion alternatives such as pig tailing, Ko/Lar receptacles, etc.
- Total panel amps. This will help determine whether new appliances can be installed.
- Type of exterior lighting. Are energy-saving lights used? Are they on a timer or photocell?

- Visible contacts and junctions for corrosion. Corrosion causes increased resistance to electricity and can cause increased consumption.



Slide 65

## **Water and Waste Water Systems**

Inspect the property for wet areas. Again, since water lines are below ground, deterioration and problems caused by ground shifts may cause damage. Clogged drainage and sewer pipes may cause water to collect. Check:

- Sidewalks for excessive repair work. Look for evidence that additional concrete or paving has been laid over existing surfaces or that sidewalks may have been reduced by grinding or a similar method to make them level.
- Maintenance records for a history of past problems.
- Individual hot water heaters:
  - Note any water damage and obvious discoloration that may have been caused by leaking water tanks.
  - Check or ask about sufficient water pressure in all residences. Low pressure in many units may indicate repairs needed in the main water lines.
- Boilers or central water heaters: Unless you have extensive expertise, you may want to hire a more experienced or licensed technician to inspect the system. However, you can review maintenance records, inspect pipe insulations and the general condition of the system.
  - Note the rate at which the boiler can supply hot water. The output of a boiler is expressed in gallons per hour (gph) and should be indicated on the boiler. The supply to each unit can be calculated by dividing gph by the number of units served. For example, a boiler rating of 1,500 gph serving 100 units would provide 15 gallons per hour to a unit. Under normal conditions, 10 to 15 gallons per hour is sufficient.
- Find out who supplies water to the property. Note the quality of water and if water softeners, filters, purifiers or chemical treatments are used. These devices can be costly to operate and maintain. Balance the continued use of these items with probable plumbing repair costs caused by calcium buildup in the lines or other materials that may cause clogged lines or leaks.
- Waste water systems/sewers:
  - Sewers and pipes function well and are free of debris and clogs.
  - Property drains properly – no water accumulation, wet spots.
  - Are retention ponds used on the property?



Slide 66

## **Heating and Air Conditioning**

A thorough assessment of heating and air conditioning systems requires an experienced technician. However, your visual inspection should include:

- Type of heating and air conditioning systems installed.
- Central systems: Most equipment should be located in one area. Check the condition of the pumps, chillers, compressors, boilers, cooling towers, etc.
  - Chilled water systems can be two-pipe or four-pipe systems. Four-pipe systems provide heating and cooling simultaneously, while two-pipe systems either heat or cool.
- Individual heating and air conditioning units: Each unit will have its own condenser outside and near the residence. Note the percentage of units not yet upgraded from R22 refrigerant to R410A. Note the number of units per apartment and the number of new condensers – this will give you a hint about future replacements. Also inspect air filters and coils to get an idea about how the units have been maintained. Dirty ceilings near air ducts are an indication that units are not working efficiently. Complete your inspection by checking cracking around the air ducts coming out of the units, and by looking at condensation pans and lines to determine if the system is functioning or requires service.



Slide 67

## **Irrigation**

Turn the irrigation system on, if weather permits. There should be sufficient water pressure and coverage for the intended area. Dry locations may indicate damaged or missing water heads or clogged pipes.

- Ask about the preventive maintenance program for the system.
- Note if the system must be manually turned on or is operated by timers or sensors.
- Check for proper positioning of irrigation heads.



Slides 68 - 69

## **Emergency Alarms and Fire Suppression**

- Note the type of intrusion alarm system used – individual alarms or alarm monitoring service.
- Who pays for the alarm system, permits and monitoring – management or residents?

- Are there mandatory pull downs on fire alarms on exterior locations or building interiors and are there fire extinguishers in apartment units, if applicable?
- Are smoke alarms located in the areas required by safety codes?  
Are they battery or hard-wired?
  - Most codes require one smoke alarm for each bedroom.
  - Some codes specify the location of alarms in terms of distance from the ceiling.
- Ensure fire suppression systems are working properly. Check for the presence of paint on the sprinkler heads, as this is costly to correct.



Slide 70

### ***Cable Television***

- Note conditions of antenna(s) (if any) and proper installation during your inspection of roofs.
- What are the state/local regulations regarding individual satellite dishes?
- Who pays for the cable service – management or residents?
- Are resident satellite systems installed properly and legally?

### ***Elevators***

Elevators are expensive, and when they're not working, it's a very big deal. Be sure to ride each elevator and check/do the following:

- Have qualified personnel inspect elevators.
- Check for service contracts for preventive maintenance. Full service contracts that include parts and labor are preferable.
- Are all operating and maintenance inspections current?
- Are all elevators up to code and do they have permits?



Slide 71

### ***Controlled Access Systems***

- Determine the type of access system installed, and general operating condition. Some examples are card access control systems, electric locks, automatic or electric gate controls.
- Check for compliance with local ordinances or codes.
- Is the system programmable?

- Is there a back-up system such as an emergency power system?
- Is special training required to maintain the system?

### ***Required Permits***

Be sure to contact local government authorities regarding required permits prior to commencement of work. Permit requirements vary within each local jurisdiction. If you are inspecting a property in an unfamiliar region, all municipal codes are listed by county at [www.municode.com](http://www.municode.com).

Note expiration dates of all permits and replace or renew those that have expired. Expired permits can incur substantial fines. Also check that permits are properly displayed.

Following is a list of commonly required permits:

- Business license.
- Certificates of occupancy in some cities.
- Combustible waste (dumpster or compactor.)
- Elevator operation.
- Boiler.
- Access gate.
- Signage (Generally, main identification signs only. Older signs may be grandfathered in, but new signage would need to follow current requirements.)
- Pool/Spa operation.
- Alarm systems.
- Communication - if property controls resident telephone access line or similar systems.

### **Participation Prompt**



Are there any other areas of the exterior property that should be assessed during the due diligence process?

If a major red flag was uncovered during the exterior inspection process, would you stop the due diligence process and report it to the owner immediately or complete the process first?



Slide 72

## INTERIOR INSPECTIONS

The following discussion highlights a few key areas in order to illustrate the types of things you should be looking for when conducting interior inspections. For a more comprehensive (though still not exhaustive) checklist, see the online Appendix of this module.

Inspecting the interior of every occupied and vacant unit is a critical exercise in establishing the current value and estimating the future value of the asset. This section contains useful information and checklists that help organize inspections and record information.

### ***Key Points to Inspect***

As you conduct your inspection:

- Stay alert and look for existing and potential problems. For example:
  - Leaks under the sinks, poorly made repairs, window leaks, odors and unlevelled floors.
  - Cracks around doors and foundations and/or doors and windows that do not close properly may indicate settling or foundation problems.
- Note the general design of the units. Note the unit sizes, room sizes and wall spaces. The layout should be functional and attractive. Ask yourself if you would be able to rent each unit or if there would be certain marketing problems.
  - A tape measure is handy for measuring rooms that appear to be smaller than the seller claims.
  - Is there space to add washer and dryer connections? Can the plumbing and electrical systems accommodate it? Can dryers be properly vented?
  - Is there adequate closet space and resident storage areas?
- Note the general condition of appliances, plumbing fixtures, floor coverings, window treatments and lighting fixtures. Check these items against the owner's inventory list.
- Consider the view from each unit. Attractive views of landscaped courtyards, pool, and wooded areas can command higher rents.
- Ask maintenance where they store things, and inspect those areas as well.
- Review the costs and usage patterns of common areas.

**A good rule of thumb: Inspect all units.** Don't assume that the condition of a few of the units is an accurate representation of the condition of all of the units.



Slide 73

## *Individual Units*

- Appliances:
  - Operable and color matched.
  - Brand. Is it a top quality brand or an economy brand?
  - Is it energy efficient?
  - Age. Management may be able to furnish information about frequency of replacements.
- Flooring and floor coverings:
  - Type: hardwood, carpeting, tile, linoleum, vinyl.
  - General condition.
  - Type and condition of sub floors.
- Windows:
  - Missing or cracked glass.
  - Caulking, moisture and rot.
  - Coverings - drapes, blinds.
  - Window air conditioners - operable, condition, maintenance schedule.
- Smoke and carbon monoxide detectors:
  - Check city code requirements. Can they be battery operated or must they be hard wired? If detectors are required and not installed, the owner should be told as he/she may want to secure these funds from the seller at closing.

- Fire sprinkler heads:
  - Check to ensure that fire sprinkler heads are not painted over.

### Participation Prompt



How do you ensure that everyone is on the same page when conducting unit inspections, given that there will likely be multiple teams of unit inspectors?

In other words, how do you set the tone for what is satisfactory so that the results are consistent from team to team?



Slide 74

### Common Areas

- Check all common areas, such as elevators, business centers, conference rooms, and package rooms:
  - Clean, well lit, odor free and well ventilated.
  - Walls and floors in good condition.
  - Evidence of previous poor repairs, location of repairs that might indicate other problems such as leaks.



Slide 75

### Recreational Facilities and Areas

- Pool:
  - Condition of pool surface and deck area – cracks, holes, paint, slip-resistant
  - Pool equipment, pumps, skimmers – functioning, repairs needed.
  - Deck furniture – needs to be replaced or updated.
  - GFI switches on pool lights and pumps.
  - In compliance with local and state laws – i.e. emergency phone available, drains and drain covers compliant.
  - ADA-compliant, if applicable.



- Spa/Sauna:
  - Operable, well-maintained, clean, working timer.
  - GFI switches on lights and pumps.
- Club, Exercise or Party Rooms:
  - Type of equipment provided.
  - Condition of furnishings.
  - Do the furnishings and equipment provide a safe environment?
  - Audio or A/V equipment provided and in working order.
  - Clean, well lighted, secure.

### ***Employee Work Areas***

- Maintenance shops:
  - Location and controlled access.
  - Clean and orderly.
  - Equipment and materials properly stored, labeled, use of MSDS sheets.
  - OSHA and local code compliance.
  - What equipment will transfer with the property – complete inventory with model and serial numbers.
- Storage:
  - Adequate or more is needed.
  - Locked, clean.
  - Vented, if required by law or ordinance.



Slide 76

## USING INSPECTION FINDINGS TO EVALUATE MARKETING

When you have completed the inspection of exterior areas of the property, as well as some common areas and amenities, you will be able to assess changes or improvements that could or should be made to make the property more attractive and marketable.

Here are a few questions that will help you reflect on a property's marketing strategy in relation to its physical appearance:

- What is the overall “first impression” of the property? What is its “curb appeal?” Is it well maintained and inviting?
- Review the signage. Does it need redesign, repair, or repainting? Are there sufficient signs to direct traffic and visitors? Should the property's name be changed? How much will new materials cost?
- Can anything be done to modernize property appearance if needed?
- Would additional landscaping or change in decorative motif help? Removal of overgrown or dead trees, plants, bushes?
- Would it be helpful to add or upgrade a furnished model?
- Do drives and parking areas need resurfacing?
- Do common areas and/or the rental office need updating, refurbishing, or redecorating?



## Section 5 - Operational and Financial Analysis

Slide 77

Operational and financial analysis is a critical part of the property evaluation process. In order to determine the property's viability and identify potential problems, you should pay close attention to income sources, data accuracy, and potential unforeseen costs.

Topics Covered:

- Analyzing Income Sources.
- Rent Roll Analysis.
- Lease File Audits.
- Resident Profile Data.
- Analyzing Expenses.



### ANALYZING INCOME SOURCES

Slide 78

Once you begin an operational and financial analysis of a property by looking at its financial statements—in the best-case scenario you'll have actual results from the past 3 to 5 years—there are many details that require attention.

**Note:** Sometimes you will work with pro-forma statements, since a seller may not wish to provide financial statements until a sale is more likely to occur. But pro-forma data, rather than actual results, is the least preferred option for providing a sound assessment of property potential.

Often multifamily brokers representing sellers can provide actual income/expense data and future pro-forma estimates of property performance based on future income and expense assumptions.

When an intent agreement has been reached between buyer and seller, actual financial statements, and property operating and financial information, are available for more detailed evaluation.

It is usually at this point in time that the buyer's representatives will begin physical inspections in earnest.

From the actual statements, you should be able to review all sources of income for the property, including:

- Fees for water, gas or electrical sub metering (RUBS.)
- Fees for garage or covered parking spaces.
- Fees for pets.
- Fees for cable access, use of exercise club or other services.
- Fees for storage.
- Fees for trash pickup.
- Fees for damages.
- Income from laundry and other vending facilities.
- Income from furniture, appliance or other rentals.
- Administrative fees for applications, returned checks and late fees.

If you are working with pro-forma financial statements, you will need to rely on your inspection, your experience and knowledge, and industry standards to develop a number that you feel best represents these sources of income.



Slides 79 - 80

## RENT ROLL ANALYSIS

The rent roll is a record of occupancy and collection activity at a given time. It allows you to compare rent potential with lost income due to vacancy, concessions, and collection loss.

You are trying to determine if rental and collection targets for the current management company are being met.

A rent roll is analyzed to:

- Ensure the correct amount of rent being paid.
- Determine the actual number of vacancies.
- Analyze delinquency charges.
- Note prepaid sums.
- Verify the mix of unit types.
- Calculate lease expirations.

- Identify month-to-month leases.
- Compare market rent to current rents.
- Match lease terms, lease rent, and other fee charges on the rent roll with those on the lease.

If discrepancies are found between the rent roll and the lease, the lease takes precedence, and the discrepancy should be corrected as soon as possible.



*Slide 81*

A rent roll analysis may occur in these steps:

- Request a current rent roll from management:
  - This request may be routed through an owner to a third party manager or through a broker.
  - If current management can provide a rent roll, your analysis will be easier.
  - If a rent roll is not provided, you may develop one from leases or computer printout.
- Develop a draft rent roll using a basic grid or Excel spreadsheet.
- Use the rent roll to conduct a lease file audit and compare to file documents
- Verify data. This will also be an opportunity to determine if leases are executed properly.
- Look for anomalies to make sure a seller isn't inflating occupancy numbers.

Property management software providers can assist when operating platforms are similar, and can even provide “bridge” software to convert data from one system to another, saving considerable manual work.



*Slide 82*

## LEASE FILE AUDITS

Auditing leases is important to discover irregularities and determine if leases have been executed properly.

A copy of a blank standard lease and standard riders should be included in your report to the owner. Note any unique features and whether subleasing and assignments are permitted, or if alternative security deposit programs are in place (i.e. bond or premium paid in lieu of deposit.)

After reviewing all leases:

- Compare the information about rents, deposits, and dates with the rent roll.
- Prepare a report or matrix with lease expiration dates and anticipated turnover.
- Compare leases with unit-by-unit inspection to determine if all leased units are actually occupied.
- Create a summary report identifying areas of concern along with the risk or cost impact they could create. For example, if you discover that 40% of the leases on file aren't signed, that means the owner has 40% more month-to-month leases than they thought they had.



### ***Rental Application***

Slide 83

In file:

- Completed and signed by all applicants of legal age.
- Signed by owner's representative.
- Verified information.
- Credit or criminal background screening documents present.
- Meets stated or anticipated income and occupancy qualifications (i.e., maximum occupants per unit, minimum income to rent ratios, senior, assisted or other regulated housing qualifications.)

### ***Lease Processing Checklist***

- In file and completed properly.

#### **Participation Prompt**



Why should we look for a lease processing checklist in each file?

What could be the implications if there is no checklist being used at the property?

Or if many of the files don't have it?



## ***Lease Agreement***

***Slide 84***

In file:

- Signed and initialed by resident(s.)
- Signed and initialed by owner's representative.
- All changes initialed properly.
- Term of lease is accurate.
- Date lease expires. (Record this date.)
- Amount/accuracy of rental rate and any recurring monthly fees.
- Amount/accuracy of security deposit.
- Amount/accuracy of subleasing (if permitted) fees.



## ***Lease Addenda***

(Community Policies, RUBS, Submetering, Safety, Access Gate, etc.)

***Slide 85***

In file:

- Initialed and signed by residents.
- Initialed and signed by owner's representative.
- Amount and accuracy of additional fees.



## ***Move In Inventory & Condition***

***Slide 86***

In file:

- Completed and signed by owner's representative.
- Checked against move-out checklist for previous resident.
- Additional service needs noted.
- Signed by resident(s).



## ***Pet Agreement,***

(if applicable )

*Slide 87*

In file:

- Description of pet(s) accurate.
- Deposit amount accurate.
- Signed by resident(s.)
- Signed by owner's representative.
- Amount/accuracy of additional fees.

List other addenda in the file and determine accuracy of data.

You can find a sample lease file audit spreadsheet in the online Appendix to this module.



## **RESIDENT PROFILE DATA**

*Slide 88*

Resident profile data is usually readily available as part of the reporting capability of the community's property management software system, but that data is only useful if it is complete and accurate. Sometimes site teams record incomplete data—or skip entering it entirely—because they don't see it as critical.

Good resident profile information is a must, however. It can help you analyze occupancy conditions, rent collection practices, and resident selection criteria. It will provide information about work locations and special interests which may be helpful in future marketing and advertising efforts. This information may result in a recommendation that the property's resident profile needs changing to improve the likelihood of better financial performance to meet owner objectives.

You can use the lease file audit process to collect and double-check this resident profile data.

If resident profile data is thin, you can pull data from rental applications to determine the age, gender, and household size of residents. Collect data on where they work and where they lived previously. With this information, you can segment resident profiles by unit type, which will be valuable in developing future marketing initiatives for the property.

When you're cross-referencing resident profile data with lease files, keep an eye out for inaccuracies. For example:



- Was household income reported correctly?
- Was it listed as monthly income when it should have been annual income?

Annual incomes at higher rent properties will range from \$40,000 to over \$100,000. If annual household income data is showing \$4,000-\$10,000, then the data was probably entered incorrectly.



Slide 89

## ANALYZING EXPENSES

When evaluating a potential property acquisition, it is necessary to analyze current and potential expenses in these areas:

- Operating expenses.
- Capital expenditures.
- Renovation costs.

### *Operating Expenses*

Information about operating expenses can be gathered from:

- Previous and current financial statements for the property.
- Data you have gathered about the property or the seller.
- Your experience and personal contacts.
- Local, state and National Apartment Association reports.
- Multifamily brokers.



Slide 90

### *Capital Expenditures*

The physical inspection should reveal any necessary capital expenditures that will be needed. Note however, infrastructure, software, and other data systems may need to be provided or upgraded. Consider these costs.

Capital expenses are generally defined in the accounting reports and property budget. Capital expenses are often classified differently by different owners and may vary by property depending on ownership requirements. It is necessary to understand what constitutes a capital expense compared to major repairs at each property. Such expenses may be classified differently by the seller and the buyer.

**Example:** Major exterior paint jobs will be classified as capital expenses by one owner and major repairs under operating costs by another owner.



Slide 91

Capital expenditures generally include:

- Appliances.
- Furniture/Fixtures.
- Roofs.
- Floor coverings.
- Mechanical equipment.
- Major plumbing and electrical replacements or repairs.
- Major interior and/or exterior repairs.



Slide 92

### ***Critical Operating and Financial Information Review***

- Utility costs.
- Maintenance contracts (HVAC, elevator, landscape, etc.)
- Service contracts (laundry, pest control, trash removal, furniture/equipment rental etc.)
- Employee wages and benefits.
- Advertising costs (apartment magazine contracts, locator fees, internet costs, collateral material.)
- Delinquency reports - documentation of who owes rent and other fees, how much they owe, when and how they have been contacted about their delinquency, and the results of those contacts. What is the percentage and dollar value of monthly delinquency compared to the total rent and other income potential at the property? Collection summaries will show prior results; compare it to budget and prior actual results. It will further tell you how well the existing staff is performing in the essential task of revenue collection. (It will be very important to know who will be responsible for collecting this money after closing, and to which party the money belongs.)
- Leasing expenses (credit checks, commissions, model apartment, resident activities, etc.)

- Office administration (supplies, forms/printing, equipment, postage, telephone, answering service, mobile phones and pagers, evictions, bank charges, data processing, professional association dues, etc.)
- Employee administration (hiring, testing, training, uniforms, contract labor, etc.)
- Always determine if contracts automatically transfer to a new owner, or if contracts can be renegotiated or cancelled.
- It would also be helpful to know the average number of move-outs each month and the costs to paint and clean units for new residents. Knowing the cost of carpet and vinyl floor covering will also help you estimate make-ready costs.
- Occupancy reports of varying types including weekly activity reports reflecting traffic, sales, move ins, move outs, and notices to vacate.
  - What are occupancy/vacancy trends, and what is the property turnover year-to-date and for prior years?
  - How well are lease expirations managed?
  - Occupancy trends and turnover ratio information is essential to forecasting. Your recommendations that result from the property evaluation will need to take this information into account so that anticipated/forecasted performance is factored into investment decisions.
  - Will the property perform generally as it has, or is it feasible to expect improved performance—and why as result of new ownership or management?



## Section 6 - Analyzing and Reporting Results

Slide 93

When all of the due diligence work is complete—the market analysis, the property inspections, and the operational/financial analysis—the results need to be gathered and presented in a report for the investor/owner. The focus of this report should be on the bottom line: Does this investment make sense? What impact will these findings have on next year's budget?

Topics Covered:

- Owner/Company Due Diligence Report Overview.
- Key Content for Owner/Company Due Diligence Report.



Slides 94 - 95

### OWNER/COMPANY DUE DILIGENCE REPORT OVERVIEW

The report to the owner about the inspection and analysis of a property may include:

- Executive summary of the property.
- Market and competitive surveys.
- Regional and neighborhood analyses.
- Interior and exterior property inspections.
- Income and expense analysis.
- Lease file audit.
- Recommendations and preliminary budgets.
- A disclaimer about the reliability of any data that may have changed.

The focus of the report is the bottom line. If the analysis is being done as due diligence for property acquisition, the two main questions that your report will answer are:

- What will it cost?
- Does the investment make sense?

If the analysis is being done as preparation for the annual budgeting process, the focus of the report will be on how it impacts the allocation of time and resources for that property during the year.

Comments should be brief but informative, presented in a formal package, and include photographs and resource/research materials. If the subject property is being considered for acquisition, and there are not going to be any renovations, major repairs,

or capital improvements, the focus of your report will be on the marketing information, lease audit, and rent roll, and your recommendations to improve certain areas.



Slide 96

## KEY CONTENT FOR OWNER/COMPANY DUE DILIGENCE REPORT

A sample template for an owner's report follows.

### ***Section 1: Title Page***

- Property name and address.
- Name of the person who requested the analysis.
- Name of the individual who completed the analysis.
- Date of preparation.

### ***Section 2: Letter of Transmittal***

Type the letter of transmittal on company letterhead and include the date you are preparing the letter. Address the letter to the person who requested the analysis (the same person listed on the title page.)

The body of the letter should include an executive summary that outlines the purpose and scope of the report, as well as the final conclusions and recommendations.



Slide 97

### ***Section 3: Description of the Property***

- Name, address, and location of the subject property in relation to the region and the neighborhood. (Include an area map with the data property identified.)
- Total number of buildings and units; property acreage and density.
- Age of the structure(s) and a description of their construction, including the materials used and the architectural style.
- Unit types, mix, and square footage.
- Description of amenities (pools, models, recreational facilities, laundry facilities, parking spaces and/or garages, etc.)
- Type of security measures used on the property.
- Vacancy by unit type and percentage; models and employee units.
- Physical condition of the property and evidence of deferred maintenance and capital improvement needs.
- Number of property employees and titles.
- Current marketing strategies and promotions.



Slides 98 - 100

#### **Section 4: Market Analysis**

- List, description, and photos of competing properties.
- Comparisons of demand and vacancy.
- Geographical summary of the region including property location, climate, topography.
- Regional economic conditions.
- Demographic data including income, education, gender, family composition, household formation, age groupings.
- Population and job growth.
- Major employers.
- Natural resources, shopping, business, education and recreational/entertainment venues.
- Comparisons of rent, square feet and amenities to comparable properties.
- Trends and possible future changes and how it will impact the subject property.
- Area map showing location of competing properties to subject property.
- Neighborhood analysis.
- Boundaries.
- Infrastructure and proposed improvements.
- Shopping, employment and recreational venues.
- Community services and transportation.
- Competitive properties including occupancy and rental data.
- Undeveloped land.
- Existence of substandard or abandoned structures.
- Age and condition of neighborhood.



Slide 101

#### **Section 5: Physical Condition of the Subject Property**

- Interior Inspection Report.
- Exterior Inspection Report.
- Photographs: Each floor plan, landscaping, signage, typical exterior, office and common area amenities.

## **Section 6: Operational Analysis**

- Lease Audit Findings.
- Resident Profile.
- Rent Growth History and Future Potential.
- 5-year Projected Capital Improvement Plan.
- 3-5 year projected pro-forma based on your assumptions.



Slide 102

## **Section 7: Conclusions and Recommendations**

- Conclusions.
- Recommendations.
- Current and historical financial reports.
- Budgets.

It's not always necessary to make a specific recommendation to invest or not invest in a property or renovation project. However, you should be very thorough and clear in the information and analysis you provide so that the investor or owner has the tools necessary to make an informed decision.

Budgets should only be provided if you have the management contract in hand.




Slide 103

## **Section 8: Disclaimer**

A disclaimer is a paragraph that explains that the report contains data that was accurate at the time it was reported and that you are not responsible for changes that occurred after the report was written.

If the report is going to your owner or management company, the title page and transmittal letter may not be necessary.



### **Participation Prompt**

Why is the disclaimer paragraph critical when providing the due diligence report to a 3<sup>rd</sup>-party owner or agency?

What could happen if this paragraph isn't included?

## MODULE 4 ACTIVITY 1: DUE DILIGENCE REPORT



Slide 104

### Instructor Notes

Activity Type: Group

**Goal:**

Portfolio supervisors are often asked to take responsibility for a situation with only a limited amount of information. This activity asks a CAPS to act with only the information contained in this report.

**Materials Needed:**

CAPS Training Activities - Module 4 Activity 1

CAPS Training Activities - Activities Resources - River Commons Property Assessment and Due Diligence Summary

Approximate Time: 20-30 minutes

15-20 minutes - Activity

5-10 minutes - Discussion

Divide the participants into groups, and have each group review one section of the due diligence report (River Commons Property Assessment and Due Diligence Summary) in the Resources section of their activity book. Groups should glance through the report and pick out red flags rather than attempt to read all of the material. Adjust the size and number of groups as appropriate.

Have each group answer the activity questions, and then spend some time discussing their answers with the class.





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

- Identify three trends you see that could/should impact the buyer's decision. Explain why.
- Identify three rehab or renovation projects that would add value to the property. Detail how these would convert to value (i.e., dollars spent vs. dollars gained).
- What operational efficiencies would you recommend to the owner? Identify specific gains (i.e., process/protocol/practice change vs. gain).



## Section 7 - Property Ownership Transition

Once an owner decides to acquire a property, they may rely heavily on your property supervisory skills to oversee the transition in ownership and daily operations of the newly acquired property. While the actual tasks that must be performed may vary according to size and depth of the management company, you will want to be as organized and professional as possible to ensure a smooth and successful transition.

In the event that property ownership is not changing, but the management entity is, you will find many of these tasks and functions will still need to be completed. In many cases they will be easier because new accounts, deposits, and utility changeovers may not have to be completed. Nevertheless, a management transition can still be challenging for staff and residents.

Topics Covered:

- Property Ownership Transition Overview.
- Property Ownership Transition Checklist.



### PROPERTY OWNERSHIP TRANSITION OVERVIEW

The CAPS leads the transition from old ownership to new, works to make it as smooth as possible, and makes sure that property and staff are up to the standards of the new owner and manager.

#### *Departing a Property*

If the owner has decided to use another management company to manage the property, you will want to gather and organize as much information as possible to hand over to the new property manager. Be thorough and cooperative. Remember, both your reputation and that of your company's is involved in this transition. You do not want to create situations where complications, errors, or misunderstandings put you or your company at risk.



#### *Taking Over a Property*

If your company will manage an acquired property, there are several important tasks that can be completed before actually being on-site, and a cooperative relationship with the seller and departing management company may allow this pre-close preparation. It is recommended that these tasks be completed prior to transition by as many as 30-60 days, but if this is not possible, you should complete them as soon as possible after transition.

- Insurance: Determine who is responsible for providing insurance coverage for the property. If the owner is responsible, make sure your management company's name is added to the policy as "additional insured." The owner must furnish the name and phone number of the insurance contact should a claim arise.
- Prepare and later send a notice to residents about the change in management.
- Verify that vacant units are market-ready.
- Print new forms, leases and applications to replace the former management company material.
- Notify utility companies. Determine when and if any service deposits are due. If there is simply a management change, there is no need to close and open new accounts – but confirm correct mailing address for your payables processing.
- Notify vendors of the management change and establish accounts in the name of the new owner, if necessary.
- Notify the bank(s). Open new accounts, order new bank account checks, deposit slips and endorsement stamps. It can be a good idea to change banking institutions so that errors are not made based on the name of a community and funds deposited into "old" accounts.
- Order new office forms and stationery if there is a name change.
- Prepare new leasing material for use by leasing staff.
- Review collateral and leasing presentation material to ensure company and property names are correct and that fair housing and accessibility logos appear. Make professional looking modifications to material you wish to retain.
- Review or develop job descriptions and employee handbooks for distribution at the proper time.
- Review staffing and meet with each staff member, if possible. Determine which staff members you will be retaining.
- Recruit replacement staff, if necessary, to have adequate personnel to cover the property the first day.
- Create checklists for action items to be completed following acquisition (see Property Ownership Transition Checklist.)
- Alert group plan, worker's compensation and other benefit providers of additional staff coming on board.



## *Closing Documents*

Slide 109

Some or all of the following documents will be provided to the new management company.

- The current rent roll at closing. It should include information about all residents and details about vacancies and delinquencies.
- All original lease agreements, if not maintained on-site, and resident files, applications, and pertinent correspondence.
- Security deposit list and funding instructions.
- Property tax records.
- Utility accounts list and unpaid bills.
- All outstanding bills if the purchaser agreed to assume them as a condition of closing.
- List of vendors used by the property.
- Current vendor and service contracts.
- Pest inspection records.
- Inventory of personal property.
- Physical inspection reports written for the owner.
- Legal records including pending evictions and/or any litigation. Include aged delinquency report.



Slides 110 - 111

## **PROPERTY OWNERSHIP TRANSITION CHECKLIST**

Once a property has been acquired, there are numerous tasks you and your team will need to complete in a relatively short amount of time. Following is a sample prioritized checklist of such tasks, along with the party who is usually responsible for completing them. Keep in mind, however, that property transition is a chaotic time. You may find that you need to delegate or divide tasks in a different way than is presented here.

**Priority 1:** Urgent. Day 1 or before.

**Priority 2:** Medium urgency. Within the first few days.

**Priority 3:** As time allows within the first few weeks.

Priority	Property Ownership Transition Task	Responsible Party
1	Secure all keys from the seller. Identify and label master keys, if used, with the help of on-site staff. It is recommended that master keys not be used.	CAPS
1	Meet with on-site personnel. If the staff is large, you may want to meet separately with office and maintenance personnel. The property manager and maintenance supervisor should attend both meetings.	CAPS
1	Inform employees of their job status - permanent or temporary. In some states, employees may be considered permanent if they work even one day without being told they have a temporary status.	CAPS
1	Gather data and forms from each employee, including basic employment application, W-4s, I-9 information, and copies of support material, employee leases, and addenda.	CAPS
1	Send a list of home phone numbers and cell phone numbers of property personnel to the corporate office.	CAPS
1	<p>Employees new to your organization or to the property:</p> <ul style="list-style-type: none"> <li>• Conduct new hire processing, drug screening and any pre-employment testing. If drug testing is required at one property, it is legally required at all properties for all employees.</li> <li>• Arrange orientation session. Schedule training as needed.</li> <li>• Distribute employee handbooks and review job descriptions with each new employee.</li> </ul>	CAPS

Priority	Property Ownership Transition Task	Responsible Party
1	Explain emergency procedures and provide key staff members with emergency telephone numbers of upper management or support maintenance personnel. Emphasize procedures to follow in the event of fire or other emergencies.	CAPS
1	Change the office, maintenance shop and vacant unit keys.	Maintenance Supervisor
1	Change the security alarm code for all alarmed areas.	Community Manager
1	Create a key authorization list for signing out keys.	Community Manager
1	Notify the answering service, if applicable, of the change in management.	Community Manager
1	Establish procedures for cash control and rent deposit practices. Audit the petty cash.	CAPS, Community Manager
1	Send notices to all residents about the new ownership and management and include status of rental payments and security deposit, if required by law.	CAPS, Community Manager
1	Begin review of the status of onsite maintenance: <ul style="list-style-type: none"> <li>• Issue petty cash and explain procedures for its use.</li> <li>• Review necessary operating permits, and obtain any that are required, if missing.</li> </ul>	CAPS, Maintenance Supervisor, Community Manager

Priority	Property Ownership Transition Task	Responsible Party
2	If the staff will be retained, or new employees are in place, inform them of the new company's employment policies regarding salaries, pay periods, timekeeping, payroll processing, incentive programs, vacations, apartment discounts, insurance and other company benefits.	CAPS
2	Explain the new owner's immediate priorities, the company's goals, code of ethics and other professional requirements.	CAPS
2	Address uniform/dress codes for staff.	CAPS
2	Review delinquency policies and procedures with the community manager and determine if any changes should be made.	CAPS
2	Establish and post office hours along with the fair housing poster, leasing requirements, occupancy criteria and company logos.	Community Manager
2	Initiate office procedures and introduce in-company systems and schedules.	Community Manager
2	Make sure all necessary office supplies have been ordered and that the new applications, leases, inventory move-in forms, etc. are on-site.	Community Manager
2	Physically inspect the property with the maintenance supervisor, noting any hazards and scheduling immediate repairs. Consult the pre acquisition inspection checklists.	CAPS, Maintenance Supervisor
2	Inspect all vacant units and list all make-ready tasks. If necessary, consult with staff to explain your make-ready standards. Compare the vacancy list with the rent roll received from the seller at closing. Note any discrepancies and report them to the owner.	CAPS, Maintenance Supervisor

Priority	Property Ownership Transition Task	Responsible Party
2	Implement new office procedures.	CAPS, Community Manager
2	Review delinquency reports. <ul style="list-style-type: none"> <li>• Reconcile the delinquency report received at closing with current collections.</li> <li>• Make sure action is being taken on delinquent rents and set goals for collections.</li> </ul>	CAPS, Community Manager
2	Prepare a lease file audit or update if performed prior to acquisition. Compare to any pre- acquisition file audit information. <ul style="list-style-type: none"> <li>• Review each lease and resident file. Confirm that all required documents are in each resident file. Review lease addenda for pets, employee discounts, etc.</li> <li>• Verify security deposits and balances on leases and rent rolls.</li> </ul>	CAPS, Community Manager
2	Review leasing procedures. <ul style="list-style-type: none"> <li>• Review and confirm rental rates for each unit type.</li> <li>• Establish leasing terms to include term of lease, security deposit amounts, and number of residents permitted in each unit type, etc.</li> <li>• Determine new resident income requirements, credit check and application approval procedures.</li> </ul>	CAPS, Community Manager



Priority	Property Ownership Transition Task	Responsible Party
2	<p>Continue review of the status of onsite maintenance.</p> <ul style="list-style-type: none"> <li>• Schedule maintenance for all outstanding service requests.</li> <li>• Prepare, if not provided, a master list of meter numbers. Include locations of the meters and any gate valves located on the property.</li> <li>• Make sure all chemicals in the maintenance shop are identified and labeled per OSHA guidelines.</li> <li>• Make sure all logs required by OSHA or EPA, such as Freon recovery, are being kept and are current.</li> <li>• Schedule immediate clean up of grounds, parking areas and common areas, if needed, to demonstrate the new management's dedication and professionalism to residents.</li> <li>• Review the vendor listing and make sure all vendors have been notified of the new ownership and management.</li> <li>• Establish contact with key vendors</li> </ul>	CAPS, Maintenance Supervisor, Community Manager
2	<p>Property inspection.</p> <ul style="list-style-type: none"> <li>• Review the hazardous material management plan.</li> <li>• Explain the new owner's requirements and policies regarding the property's physical appearance.</li> </ul>	CAPS, Maintenance Supervisor, Community Manager
3	<p>Continue review of the status of onsite maintenance.</p> <ul style="list-style-type: none"> <li>• Locate, review and file all warranties and guarantees for equipment and appliances.</li> <li>• Implement a purchasing procedure and define the limitations.</li> </ul>	CAPS, Maintenance Supervisor, Community Manager
3	<p>Property inspection.</p> <ul style="list-style-type: none"> <li>• Inspect the property and recheck the physical inspection report made prior to closing.</li> <li>• Check again for hazards and liabilities and prepare a repair schedule.</li> <li>• Prepare and schedule capital improvements or major repairs with the community manager and maintenance supervisor or advise who in the management company will be handling this if not property management.</li> </ul>	CAPS, Maintenance Supervisor, Community Manager

## MODULE 4 ACTIVITY 2: PROPERTY TRANSITION



### Instructor Notes

Activity Type: Group

Materials Needed:

CAPS Training Activities - Module 4 Activity 2

CAPS Module 4: Asset Evaluation and Preservation - Property Ownership Transition Checklist

Approximate Time: 10-12 minutes

6-8 minutes - Activity

2-4 minutes - Discussion

Break class into small groups of 3-5 participants. Have them review the CAPS items from the Property Ownership Transition Checklist and suggest a plan for ensuring all of those items get done.

Remind them that they have to balance the needs of a full portfolio of properties with the priority needs of this property transition.



You have been assigned a new property in addition to the nine other properties in your assigned portfolio. The transition will take place on November 10, right in the middle of the budget process and just before the holiday season starts. The property is located Tampa, Florida, and you are based in Denver, Colorado.

This acquisition is extremely important to the organization as the owner plans to purchase more properties in the coming months, so the success of a smooth transition will impact his decision to hire your organization to manage future purchased properties.

Review the CAPS items from the Property Ownership Transition Checklist in Module 4, and map out a plan for ensuring those items get done. Identify the five most important tasks to complete ahead of time, and draft a delegation tree for major responsibilities. Name three specific actions you would take to ensure the remaining portfolio properties receive appropriate supervision.

While thinking about these challenges, consider:

- The timing of the transition
- The distance between you and the property.
- Property and CAPS resources needed.
- Follow-up needed.
- Time management challenges.

Remember: you have a full portfolio, but you have to add this transition to your already full plate as a priority.



Slide 122

## Section 8 - Property Development Feasibility Analysis

In addition to performing due diligence for property acquisition, you may also be called upon to help evaluate the feasibility of new property development. In this case, a particularly vital part of your job is to understand the proposed development's market supply and demand.

Such an evaluation must determine the level of vacancies, rents, new construction, apartment units permitted and planned in the market, and the availability for occupancy of units coming into the inventory. With this evaluation you can prepare a forecast of rents, vacancies, and operating expenses.

You must also be aware of all stages involved in the process of new apartment development:

- Land acquisition.
- Construction of the apartment community.
- Completion.
- Stabilization of occupancy (can take 12-36 months depending on the size and complexity of the project.)
- Management phase, which may be long-term or short-term, depending on owner objectives.
- Eventual sale of the property.

Topics Covered:

- The Role of Property Management.
- Areas of Feasibility Analysis.
- Financing the Apartment Development Construction Loan.
- Income and Expense Projections.
- Lease Up Projections.



Slide 123

## THE ROLE OF PROPERTY MANAGEMENT

While it is rare for the CAPS to have primary responsibility for feasibility analysis for new developments, the information gathering process involves tasks for which the CAPS is uniquely suited. Your experience with multiple properties, level of knowledge, and background in regional and neighborhood market analysis means you will likely be called upon for significant pieces of the feasibility analysis process.

For the study of new development feasibility it's both necessary and advisable to have property management involved for the most realistic projection of income and rents.

It is property management that is best prepared to provide basic market information on local conditions, rents, and operating expenses. This is particularly true if the management company already operates in the market in question with the availability of historical operating data and in depth knowledge of the market in question.

It is also important to include management even if it is new development feasibility in a market where the management company would be new as well.

Property management personnel are most likely to best interact with other property management personnel from different companies when entering a new market and thus are better able to gather and evaluate the necessary information.

## AREAS OF FEASIBILITY ANALYSIS



Slide 124 - 126

### *Supply and Demand Issues*

To begin the analysis of a new property's supply and demand status you have to look closely at the following factors:

- Local occupancy rates.
- Interest rates and available financing.
- Age and type of existing apartment inventory.
- Construction costs.
- Land cost.
- Potential supply of new apartments under construction, permitted, or planned.

Be sure that when working with property management personnel you don't rely on them for all feasibility analysis because they are less likely to know construction and land costs for example.

Demand factors that need to be considered when evaluating investment decisions include:

- Number of households.
- New household formations, age, size and gender.
- Job growth and job quality (higher paying job opportunities.)
- Household income levels.
- Interest rates.
- Affordability of both single family and multifamily housing options.
- Local rent levels at potential competitors existing and proposed.
- Absorption of under construction units.
- Historical occupancy trends.

In apartment development, many companies begin projects with the intent of owning and managing these apartment communities for long periods of time after completion. Leasing and management is a significant part of the business of these companies as well as development.

Other developers intend to sell their developments after the lease up phase is completed and stabilized occupancy (often 93-95%) is achieved.

Such sales are often made to large institutional investors or larger owner/managers such as REITs, who will also manage the acquisition. Some companies are retained to manage these properties; in other instances new fee management companies are hired to manage the property.



### ***Cost Feasibility***

Slide 127

In the preliminary feasibility evaluation, physical feasibility and economic feasibility are analyzed. Here are some questions that need to be asked:

- Does the potential project meet zoning and building code requirements?
- Are building densities, heights, finishes, boundary line setbacks, floor to area ratios, and parking ratios satisfied?

- Will the project be able to obtain the necessary building permit to commence construction?
- What is the land cost and the anticipated construction cost per unit?
- What is the initial “rough” estimate of revenue and expenses?
- What is the anticipated return on cost and anticipated value at various cap rates?

This initial, “rough” feasibility analysis might conclude that no additional evaluation effort should be done and the project should not go forward—or it may conclude that the evaluation process should proceed to a more detailed level. Not all this information to be gathered and analyzed will be the responsibility of property management.



Slide 128

### ***Other Feasibility Assumptions***

During the development of a new property, there are several risks that must be evaluated. You should include in these:

- General market demand and potential absorption.
- Location as it relates to the anticipated demand for the new product and competing product in the same area.

If you assume that the better the location the greater the anticipated value of the site, then just know that the higher land cost will likely result in a higher quality apartment community that will cost more to develop.



Slide 129

## **FINANCING THE APARTMENT DEVELOPMENT CONSTRUCTION LOAN**

Be attentive to the construction requirement of an interim loan along with owner equity/investment in the project. The construction loan will differ from the permanent loan provided at the time of completion. It may be from different lending sources or one source may provide both. Personal liability for the construction loan is often a feature of such loans until the project achieves lease up.

Lease up may be defined as a certain percentage occupancy, but usually is determined based on the achievement of a defined monthly dollar rent level.

This protects the lender against the developer “filling” the property to achieve a certain occupancy level by deeply discounting move in rents to reach occupancy goals. Construction loan amount repayment obligations will vary as construction

progresses since “draws” are provided on construction loan availability as money is advanced to build the project based on progress to date.

Such construction loans are used to fund hard costs (building materials and labor) and soft costs (permits, fees, and construction administration). In some instances, such loans will also finance necessary lease up costs (personnel, marketing, etc.) until the property reaches stabilized occupancy.



*Slide 130*

## **INCOME AND EXPENSE PROJECTIONS**

This is the most necessary part of the property management role and is the most logical since property management is often best positioned because of market knowledge and operating experience to provide this information.

Property management is sometimes asked to prepare this information initially and in other instances is asked to evaluate the numbers provided by development personnel.

Give and take between development and management is often the norm in order to produce “realistic” numbers that allow the development to go forward and when stabilized be operated in a profitable manner that meets owner investment goals.

Be aware that the definition of “realistic” can vary between management and development personnel. The goal is to find the appropriate base to allow a project to go forward.



*Slides 131 - 132*

## **LEASE UP PROJECTIONS**

Lease up assumptions that project the leasing of units received from construction is another vital role for property management personnel and especially the multi property supervisor.

It projects how quickly property units will be leased and at what rent levels. This information is necessary for property stabilization to be able to receive the permanent loan from the lender. There are usually contingency requirements associated with obtaining a loan to provide permanent financing and “take out” (pay off) the interim or construction loan.

A developer usually obtains such a permanent loan commitment prior to commencing construction and often even before obtaining construction financing. If the developer fails to meet these contingencies it will allow the lender not to fund the permanent loan.



Such contingencies include:

- Certain time period to acquire a construction loan.
- Construction completion date.
- Minimum rent up requirements.
- Provisions for gap financing if rent up targets are not accomplished.
- Expiration date and extension provisions for permanent loan commitment.
- Lender approval of any proposed design changes or building material substitutions to prevent a quality “downgrade” to reduce costs.

Thus the developer is agreeing to certain performance goals in return for the permanent financing. Lenders will not loan without requiring developers to carry out these responsibilities.

As is evident, property management and in particular the multi-property supervisor can and should play a significant role in assessing new apartment development feasibility.

This major role is a likely responsibility of the CAPS level person in companies involved in new apartment development.

Some companies do not build new developments and thus this possible responsibility is not present in companies that only manage. However, even management only companies are sometimes called upon to evaluate new development feasibility especially if they are to eventually manage the asset.



Slide 133

## Section 9 - Investment Strategies: Renovation, Disposition, and Refinancing

As a property matures, its physical and financial condition will change. The physical infrastructure may begin to break down. Routine repairs may not be sufficient to maintain the property in an optimal state. Likewise, external conditions may change. The local economy may shift in ways that affect occupancy and resident profiles.

Property owners respond to changing conditions by evaluating them and deciding how to react to them. Typically, the owner will look at three options:

- Renovation.
- Disposition.
- Refinancing.

It is the job of the CAPS and the management company to put together the analysis that allows the owner make a sound investment decision.

Topics Covered:

- Property Renovation.
- Property Disposition and Refinancing.



Slide 134

### PROPERTY RENOVATION

When the physical and financial condition of a property changes, some owners/ investors opt to renovate instead of selling the property. Often, renovation is more cost-effective than selling the property and buying another. It also means an owner/investor is willing to work on the property's modernization or upgrading.

#### *The CAPS Role*

The potential renovation must be evaluated to make sure it is compatible with owner investment goals.

For that purpose you must assess the need for the renovation, project cost and benefits, participate in the bid process and handle the leasing and marketing during renovation.

You may need to consult with professionals to obtain cost estimates for thorough cost-benefit analysis.

Items might include:

- Exterior paint, structural repairs, carpentry and lighting.
- Parking lot repaving and striping.
- Repairs to building foundations or roof systems.
- Landscaping.
- Drainage and irrigation system repairs.
- Pool, spa, tennis court and other amenity repairs or upgrades.
- Signage.
- Clubhouse or office renovation.
- Model upgrade.
- Interior upgrades or renovation work (i.e., kitchen counters or cabinets, bathroom vanities, plumbing upgrades, commodes, adding W/D connections, etc.

In larger companies, it is possible that property management will have a lesser role in evaluating and managing renovations. Asset management personnel may assess property needs, prepare the renovation budget, and complete the bid process and contract execution work. In other instances, construction personnel or third party renovation specialists may be used for the sole purpose of supervising and managing the renovation.



### **Residents**

Slide 135

Renovation projects directly impact residents one way or another, so you will want to do all you can to keep them informed and prepared for coping with the noise and inconvenience of the project. Tell residents about the renovation work before it begins and emphasize that the work will provide a better place to live.

Make sure to give residents sufficient, and any required legal, notice about particular renovations to their building and parking and sidewalk areas so they experience as little inconvenience as possible. Be aware of all environmental hazards. If any renovation work involves entering occupied apartments, always be sure to provide adequate notice as required by law and common courtesy.

## ***Leasing During Renovation***

If renovation is scheduled for weeks or months, there may be the temptation to focus only on the renovation. However, this is the time when there should be aggressive marketing and leasing activity. Instruct the staff to emphasize what has been improved and describe with positive imagery what will be renovated soon.

Make sure the leasing office is accessible to both residents and prospects during renovation. You may have to temporarily relocate the office and post signs to direct residents and prospects.

Generate some excitement about the renovation – particularly if the name of the community is changing. Use bright banners or signs to attract attention and create interest.



**Slide 136**

## ***Personal Protection Awareness and OSHA Issues***

Obviously, during renovation, residents, staff, and sub-contractors need to be aware of potential risks and hazards.

- Use community newsletters and special notices to make residents aware about potential risks and hazards.
- Place adequate signage and barriers around working areas.
- Make sure contractors keep their work areas clean and orderly.
- Make sure proper lockout/tag out procedures are followed.
- Identify potential dangerous activities or situations and discuss them with the contractor to ensure all OSHA requirements are met.

## **PROPERTY DISPOSITION AND REFINANCING**



**Slide 137**



### **Video Clip**

Advice offered to the owner results in a changed perspective on disposition of the property.



**Slide 138**

The owner/investor may decide to sell a property, or you might propose this option after conducting a property evaluation and determining the costs and benefits associated with such a plan. They may also decide to refinance the asset.

Investors purchase apartment communities for the benefits they expect to receive over the period of time they plan on owning the property. At the time of the property's acquisition, certain performance expectations were assumed. Results may have differed,

or the anticipated holding period has concluded. During ownership, the owner/investor is constantly evaluating whether a property is meeting investment goals. With time, however, changes affecting the property's performance take place. For example, tax laws may change, neighborhood conditions may decline, or market rent increases are more limited than anticipated in the pro-forma or original evaluation performed at the time of acquisition.

The periodic evaluation of market conditions and property physical and economic conditions can be important factors in an owner's decision to dispose of or refinance a property. Even if projections at the time of acquisition or development are being met, there are other factors to be considered.



Slide 139

### ***Key Factors to Consider Before a Property Disposition Decision***

Know that even if in your evaluation you find that a property's disposition is the best option, there are other important factors to consider.

First, consider the potential benefit of leverage:

- With positive amortization, the outstanding mortgage balance decreases annually and the investor's equity position increases.
- Advantages: Although positive in terms of receiving more cash at the time of sale, it also means that each year the investor/owner has more funds committed to the property. This increase in value increases the investor's equity buildup and represents the opportunity cost of not selling the property because funds could be used for another investment if the property were sold. A greater portion of equity capital remains committed compared to the cash flow being received from continuing property operations. Additionally, lower tax deductions are available since the interest portion of the mortgage payment decreases each year.

Second, consider expected future property performance.

- Whether the property performed as well as expected, it still may be a good investment for the future. Current sale price will depend on the expected performance of the asset in the future and that future performance will not necessarily relate to prior historical outcomes. Both buyers and sellers must evaluate anticipated future property performance.
- Incentives for property ownership will differ from investor to investor even if evaluations result in the same projections for future income, expenses, and investment return.



## *Refinancing*

Slides 140 - 141

As equity builds over time due to increase in value and loan amortization, the loan balance relative to current value will be less than at the time of original property purchase.

There is thus less financial leverage than when the property was initially financed and the investor may consider refinancing as an alternative to selling.

The investor could then increase the property's financial leverage. This could provide additional investment funds and might provide a sales alternative.

The new loan can be based on the property's increase in value. This current value increase would likely be based on a professional appraisal. Although new loan fees would be incurred, there would be no taxes on the funds from the additional borrowing whereas if the property were sold taxes would be paid.

The borrower must evaluate the incremental cost of the refinancing.

- If the interest rate on the new funds borrowed is higher than the interest rate on the current loan, the incremental cost is even higher than rate on the new funds.
- If the rate were lower, there would also be a lower incremental cost of the additional funds.
- Additional funds available from refinancing, either due to property value increase or a reduced loan balance from amortization, represent additional resources that can be invested in another property. This has the additional benefit of providing diversification with the ownership of additional apartment properties. In general, refinancing should produce an effective debt cost that is less than the unleveraged return on the property being financed.



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