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## For the novice apartment investor: What to look for and what traps to avoid

Since this decade began apartment investment transactions in the Upstate New York area have been occurring at a strong pace for a variety of reasons. The four traditional reasons for real estate investments have been: Cash Flow, Amortization, Tax Deductions, and Appreciation. I will explain two of the most common reasons, followed by some common concerns novice investors should be aware of, and I will offer my personal opinion on the marks of an "Ideal Deal." How many can you find in your prospective purchase?



In our market, Appreciation is not a certain thing as we all now by now. Tax Deductions have been slammed by the Tax Reform Act of 1986. Amortization is simply the equity growth of the principal portion of the mortgage payment that mounts over time. I will expound upon the Cash Flow perspective and one other not mentioned above, Creation of Value.

Due to the soft markets we have been experiencing in most all types of real estate in our area, investors are looking primarily to Cash Flow and Creation of Value as the prime motivators to buying apartments here. Cash Flow is simply the rate of return on the invested cash required to purchase the property. With alternate forms of investment like Stocks and CDs, the buyer must simply weigh the risk factor of apartment ownership and the cost of their time to manage it and come up with a minimum required rate of return produced by the cash flow to make the purchase worthwhile. Creation of Value is the end result of increasing Cash Flow by either Income increases or Expense reductions or both. Some obvious sources

of extra income are:

- Rent Increases: Provided something is offered in return like interior upgrades in carpets-appliances, more exterior amenities, or tenant utility cost reductions as a result of conversion from electric to gas.

- Vending Income: Adding coin-op laundry or soda machines.

- Garage Income: Offering covered parking especially during winters is always a sure bet.

- Pet Deposits: With few properties allowing pets, requiring stiff deposits and higher rents will frequently have pet loving tenants lining up. Limiting the pet by maximum weight should keep the problems minimal.

Sources of Expense reductions are numerous and might include:

- Tax Assessment Grievances: Lowering the single highest expense item of most apartment properties is a great place to start. In recent years more than half of the 500 largest complexes in our area have been reduced by some amount due to years of unnoticed over assessments.

- Insurance & Trash Removal: Getting "new policy" and "hauling" quotes in these increasingly competitive industries is also a good idea.

- Utility Costs: Conversion to gas heat and hot water from electric is a must in our area. There are a few different methods to accomplish this now, each with their own costs and payback periods. Some projects are billed for water on a flat per unit charge. Metering the buildings by water usage can mean big savings. There are also firms that will audit your gas and electric usage which could mean thousands owed to you retroactively if they find errors in your billings. Certain capital improvements to the property in the form of extra insulation, thermal pane windows, and even constructing pitched roofs over flat are other

methods of lowering heating and air conditioning costs.

- Management: Not understanding the importance of quality management, some properties are small enough to be operated efficiently by the owner without the aid of a management company. Eliminating a 4-6% of gross collections fee off the top is a great savings if the owner is prepared to put a price on his own time.

Creation of Value is the primary motivator for most apartment investors. Due to the uncertainty of appreciation, they feel the best way to insure a higher future resale price is acquire properties that have the "right things wrong." For a bargain price they will take properties that need the Income and Expense enhancements as described above and through creative management techniques and cost considerations turn a loser into a money maker.

The novice apartment investor must be aware of a few basic concerns outside of simple physical property inspections before putting up a nonrefundable cash deposit. 1) Environmental hazards affecting apartments may include: asbestos, lead paint, and underground oil/gas tanks. Hiring a licensed environmental engineering firm to run a phase I inspection as a condition of a mortgage commitment will usually be required by the bank. 2) Certificate of Compliance: Cities such as Syracuse require all multifamily properties to be inspected every five years or upon sale for safety code violations. Unless otherwise specified in the contract, the buyer will have to pay to correct any code violations. 3) Wetlands: Expensive flood insurance if not required by a lender would be advisable if the property is located within designated wetland areas or a 100 year flood plain. 4) Title Insurance: Though not required in all instances, it is a good idea. Choosing quality legal representation to review title and abstract is a

must. 5) Never! Never! Never! Accept an owner's written or typed statement of annual income and expenses as fact without the option of reviewing a copy of the Schedule E or 8825 Form off their most recent IRS tax return. Many owner's proformas of operating history are understated or over simplified. Vacancies are frequently minimized at 5% and maintenance/repair, salaries, legal, and advertising expenses are oft too low or omitted entirely.

Apartment investors have a wide variety of requirements and philosophies on the hallmarks of an "Ideal Deal," but these are a few I consider desirable:

- Large Units: Projects with a high percentage of two or three bedroom units as opposed to one bedroom or efficiencies. Two full bathrooms in the two bedrooms are hard to find today and a great asset.

- Gas Heat & Hot Water: Is cheaper for either owner or tenant as opposed to electric.

- Pitched Roofs: Are cheaper to maintain than flat roofs and provide better insulation from heat or cold.

- Thermal Pane Windows: Again will provide better insulation than outdated single pane windows.

- Brick/Vinyl/Aluminum Exteriors: Require little maintenance and are good insulators. Wood siding requires periodic painting or staining and will weather poorly over time if not done.

- Assumable Mortgage: This can create high leverage if the price to mortgage balance ratio is low. Otherwise lenders will typically require a buyer to put down 20-25% of the price in cash.

- Location: Near a lot of large employers or shopping malls is a big plus. Being highly visible off a high traffic count street is also a good idea.

Try to find at least a few of these in your next apartment investment.

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