Berkeley Investment Advisors

Real Estate Brokerage/Retirement Planning

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A Tale of Three Properties

This month we take a look at 3 properties, all recently listed at the same price, to illustrate local market differences and how future returns relate to local market valuation measures. The first property is a 4 unit building on Merced Avenue in the upscale Montclair area of Oakland, California. The second property is on 54th street in Oakland – a working-class part of the city. The third property is on Huntington Avenue in Fresno California. Oakland is across the bay from San Francisco and Fresno is in the central valley. Each property can be purchased for $995,000 cash, but because of the differences in the incomes generated by the properties, the equity required to purchase them differs dramatically.

Here are the key financial numbers, including the valuation metrics for the 3 properties:

Property:	Huntington Ave Fresno	54th Street Oakland	Merced Ave Oakland
Gross Forecast Rents	$172,000	$106,000	$45,000
Gross Rent Multiplier (Price/Rent)	5.8	9.4	22
Net Operating Income[1] (NOI)	$84,000	$42,000	$12,000
Cap rate (NOI/Price)	8.4%	4.2%	1.2%
Equity Required[2]	$249,000	$398,000	$816,000

Explanation of Terminology

Before we go further, its useful to understand some basic valuation metrics. The Gross Rent Multiplier (GRM) is the price divided by the gross

[1] This takes into account vacancy, credit losses, operating expenses, and reserves for capital expenditures. It is cash flow before financing costs – this determines the size of the loan available.

[2] Assuming banks' underwriting criterion are: minimum debt service coverage of 1.2 and maximum loan to value ratio of 75%.

scheduled rents of the property. The higher this number is, the more expensive the property is – relative to rents. Note that this does not take into account the expenses or vacancy costs of a property and therefore it fails to help us distinguish between high and low operating cost properties at the same rent level. Our next measure is the Capitalization rate – Cap rate for short. This is equal to Net Operating Income (NOI) divided by price. Stock market investors may recognize this as the inverse of the Price/Earnings ratio used when analyzing stock valuations. In contrast to GRM, the higher the Cap rate, the *less* expensive the property is relative to NOI.

Net Operating Income takes into account the operating expenses of the property. It is essentially the cash flow of the property before mortgage payments. The bank uses this number to determine how big a loan the property can safely pay back. Thus it will determine the equity required for the property.

Analysis

The Merced Ave. property has several longtime tenants that are protected from paying market rents by the Oakland rent control law. This at least partially explains the large multiplier: the owner believes the value should reflect market rents rather than actual rents. This property's advantages are that it will have very low turnover, the tenants are likely to pay rent on time, and they will take better care of their units – thus keeping costs down. This is an easy property to manage – especially since it has only 4 units. The disadvantages of buying this property are that the required equity is high and the returns are likely to be low. Based on rent increases of 3%, I forecast this property to generate annual returns on equity of negative 2.2%. Rents are so low relative to price that annual increases won't compensate for the natural deterioration in value that comes from aging.

The 54th Street property is in a less desirable part of the city and should command lower rent per unit – thus drawing a different class of tenant. This building has been milked for cash by delaying repairs and thus there will be some cost of improving the property. These costs may or may not be recouped through higher rents. We would have to take a closer look at the building and the market to determine this. Compared to the Merced Ave. property, this is more likely to generate "problems" and require management attention. The extra effort naturally requires that it be priced to yield higher returns for the buyer. Based on 3% annual rent increases, I forecast returns on equity for the property at 3.9%.

Both of the Oakland properties are in close proximity to the large pool of wealthy investors who reside in the Bay Area. Since many real estate investors are not comfortable investing outside the market they live in (and

know well), they tend to bid up prices when their particular market has too many investors relative to the supply of investment properties.

The Fresno property has large apartments (1,000 to 1,440 square feet) with many amenities – including a pool. It was for a time neglected and rents were kept below market. Recently substantial rehabilitation has been undertaken, including a new roof (guaranteed for 10 years) as well as retrofitting and active rent-up of vacant units at market levels. The advantages of this property are the opportunity to pursue quality tenants, operating efficiencies of a recently refurbished 26-unit complex, and excellent cash return prospects at the listed price. Using the same 3% assumption for annual rent increases as used for the Oakland estimates, I forecast annual returns on equity of 16.7%.

Pricing in the Fresno market is much more favorable for purchasers. I attribute this to its isolation from the state's major metropolitan areas. The number of properties in Fresno at the price point we are looking at is much larger relative to the number of investors in Fresno who have the resources to purchase them.

Investor returns over a holding period of 10 years are determined by the cash flows and appreciation during the period. If all the properties experienced the same percentage growth in NOI and appreciate at the same rate, then the Fresno property, with its lower equity requirement, will provide a vastly superior return to either of the Oakland properties. The Merced Ave. property would, obviously, provide the worst returns. Returns on the Oakland properties could still match or exceed the returns on the Fresno property if rents and prices went up much faster in Oakland than in Fresno. This is, however, highly unlikely given the rent control law in Oakland and the prospects for income growth among the pool of Oakland tenants. Rents and prices in Fresno would have to actually decline over the 10 years for changes in rents and prices to compensate for the current valuation difference.

Conclusion

The message for investors is that they need to work with a broker who can help them see a wider investing universe than a single local market. Berkeley Investment Advisors can help you analyze local economic and regulatory conditions to identify true growth opportunities and find the most promising investment properties across the whole state of California.