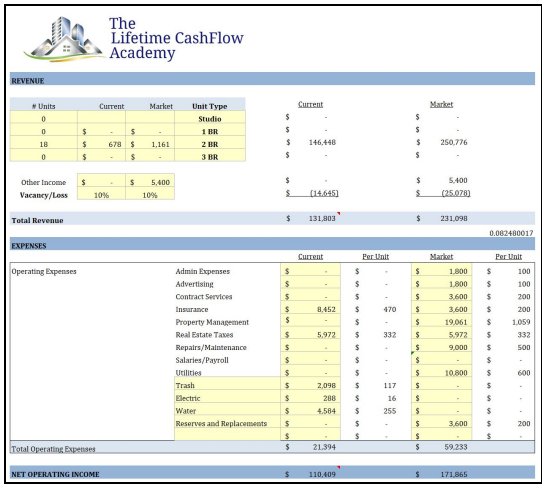
Top 5 Observed Mistakes When Reviewing Deals

One of the unique services that we offer is to provide a customized deal review for each one of our students. With it, we host a dedicated email box where our students are encouraged to send in deals that they are considering investing in. When an email is received, the information is compiled and compared against our customized deal deal review template. Comments, feedback, and suggestions are made and the deal is returned to the student with them.

We believe that this is an incredibly valuable service for our students and are happy to offer it as a way to leverage our experience and expertise when it comes to underwriting deals. But, after reviewing hundreds of deals, we have noticed that our students tend to make similar mistakes. So, with this document, we are going to review the top 5 most common issues in the hope that you can learn from them when submitting your own deals for review.

#1 - Using the Wrong Model / Not Completing All Inputs / Not Providing Supporting Data

Our review is only as good as the information submitted to us. To start, we prefer that our students use our model and complete all inputs. There are two tabs, “Financials” and “Background” and screenshots are provided below:



The Lifetime CashFlow Academy

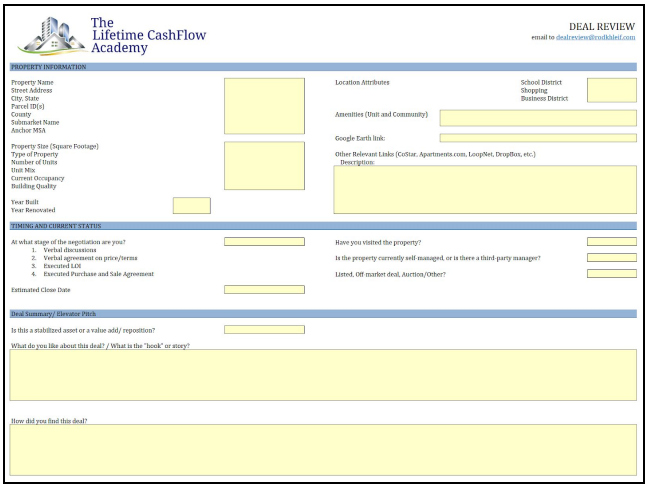
REVENUE

# Units	Current	Market	Unit Type	Current	Market
0			Studio	$ -	$ -
0	$ -	$ -	1 BR	$ -	$ -
18	$ 678	$ 1,161	2 BR	$ 146,448	$ 250,776
0	$ -	$ -	3 BR	$ -	$ -
Other Income	$ -	$ 5,400		$ -	$ 5,400
Vacancy/Loss	10%	10%		$ (14,645)	$ (25,078)
Total Revenue				$ 131,803	$ 231,098

0.082480017

EXPENSES

		Current	Per Unit	Market	Per Unit
Operating Expenses	Admin Expenses	$ -	$ -	$ 1,800	$ 100
	Advertising	$ -	$ -	$ 1,800	$ 100
	Contract Services	$ -	$ -	$ 3,600	$ 200
	Insurance	$ 8,452	$ 470	$ 3,600	$ 200
	Property Management	$ -	$ -	$ 19,061	$ 1,059
	Real Estate Taxes	$ 5,972	$ 332	$ 5,972	$ 332
	Repairs/Maintenance	$ -	$ -	$ 9,000	$ 500
	Salaries/Payroll	$ -	$ -	$ -	$ -
	Utilities	$ -	$ -	$ 10,800	$ 600
	Trash	$ 2,098	$ 117	$ -	$ -
	Electric	$ 288	$ 16	$ -	$ -
	Water	$ 4,584	$ 255	$ -	$ -
	Reserves and Replacements	$ -	$ -	$ 3,600	$ 200
		$ -	$ -	$ -	$ -
Total Operating Expenses		$ 21,394		$ 59,233	
NET OPERATING INCOME		$ 110,409		$ 171,865	



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DEAL REVIEW

email to dealreview@rodkhleif.com

PROPERTY INFORMATION

Property Name
Street Address
City, State
Parcel ID(s)
County
Submarket Name
Anchor MSA

Property Size (Square Footage)
Type of Property
Number of Units
Unit Mix
Current Occupancy
Building Quality

Year Built
Year Renovated

Location Attributes

School District
Shopping
Business District

Amenities (Unit and Community)

Google Earth link:

Other Relevant Links (CoStar, Apartments.com, LoopNet, DropBox, etc.)

Description:

TIMING AND CURRENT STATUS

At what stage of the negotiation are you?
1. Verbal discussions
2. Verbal agreement on price/terms
3. Executed LOI
4. Executed Purchase and Sale Agreement

Estimated Close Date

Have you visited the property?

Is the property currently self-managed, or is there a third-party manager?

Listed, Off-market deal, Auction/Other?

Deal Summary/ Elevator Pitch

Is this a stabilized asset or a value add/ reposition?

What do you like about this deal? / What is the "hook" or story?

How did you find this deal?

In this example, it can be seen that there are a number of missing inputs in the “Current” column of the “Financials” tab and the “Background” tab is completely blank. In order to perform the most detailed review possible, this information should be completed in full for both tabs.

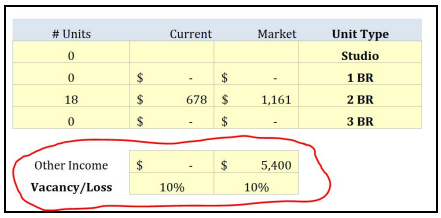
And, to validate the model assumptions, we request that our students provide as much supporting documentation as possible. As best practice, the following information, as long as it is available, should be submitted along with the deal:

- ❏ Lifetime Cash Flow Academy Deal Review Financial Model (with both tabs completed)
- ❏ Property Trailing 12 Months Operating Statement
- ❏ Property Rent Roll
- ❏ Property Offering Memorandum (if available)
- ❏ Property Photos, Maps, and Aerials
- ❏ Renovation Budgets

So, to avoid mistake #1, be sure to use the right model, complete the inputs for all fields, and include as much supporting documentation as possible.

#2 - Market Vacancy

Our model includes inputs for the “current” and “market” vacancy rates as shown in the screenshot below:



# Units	Current	Market	Unit Type
0			Studio
0	$ -	$ -	1 BR
18	$ 678	$ 1,161	2 BR
0	$ -	$ -	3 BR
Other Income	$ -	$ 5,400	
Vacancy/Loss	10%	10%	

It is common, particularly in value-add acquisitions, for a property to have a “current” vacancy rate that is significantly higher than the market. In a value-add acquisition, the idea is that the property is purchased, units are renovated, and then leased up to full occupancy. But, even if a property is fully occupied with all units leased, it is still a best practice to include some level of market vacancy.

Often, we find that our students estimate 0% market vacancy. While this is possible, it isn’t common. Markets and occupancy rates are always changing so it is a best practice to estimate a minimum of 5% vacancy and up to 10%, depending on the specific supply and demand conditions in the local market.

So, to avoid this mistake, give thoughtful consideration to the local market conditions, anticipated economic conditions, and comparable properties when choosing a market vacancy rate. At a minimum, it should be 5% and higher may be justified.

#3 - Stabilized Taxes

In every jurisdiction, taxes are calculated based upon the property’s “assessed value.” Each year, the jurisdiction’s appraiser goes through all of the properties in their portfolio and uses a proprietary formula to determine the assessed value for each. Then, based on the assessed value, property taxes are calculated.

While the process is relatively straightforward, it can become challenging to estimate future taxes when a property is purchased, particularly if it has been owned for a long period of time. The reason is that it is common for a property’s market value to rise faster than its assessed value. So, if a property has been owned for a long period of time, the difference between the assessed value and the market value can be significant. When the property is purchased and the value is re-assessed, the change in taxes can be significant.

To illustrate this point, an example is helpful. The following is an actual deal for a property in Houston, TX. The property had a current assessed value of $6.25M and a proposed purchase price of $10.1M. Given the difference between the two figures, it would be fair to assume that post-sale taxes would rise significantly. The following table provides more details:

	Current	Potential		Current	Potential
Jurisdiction	Taxable Value		Tax Rate	Taxes	
Harris County	$ 6,257,906	$ 10,010,000	0.407130	$ 25,477.81	$ 40,753.71
Harris County Flood Control	$ 6,257,906	$ 10,010,000	0.027920	$ 1,747.21	$ 2,794.79
Port of Houston	$ 6,257,906	$ 10,010,000	0.010740	$ 672.10	$ 1,075.07
Harris County Hospital District	$ 6,257,906	$ 10,010,000	0.165910	$ 10,382.49	$ 16,607.59
Harris County Department of Education	$ 6,257,906	$ 10,010,000	0.005000	$ 312.90	$ 500.50
Houston Community College System	$ 6,257,906	$ 10,010,000	0.100263	$ 6,274.36	$ 10,036.33
Emergency Serv Dist	$ 6,257,906	$ 10,010,000	0.100000	$ 6,257.91	$ 10,010.00
				$ 51,124.78	$ 81,778.00

When a purchase occurs, and the property is reassessed, the assumption is that the sales price will be the new taxable value. So, from the table above, it can be seen that the tax rate stays the same, but the increase in taxable value causes taxes to rise dramatically. In this case, the student modeled "current" taxes correctly because the number was pulled from a recent tax bill. But, their "market" assumption was for $55,000, which proved to be far too low. Using the sales price as the new taxable value, it is estimated that property taxes will be closer to $82,000.

To avoid this mistake, it should be assumed that the sales price will be the new taxable value. Then, apply the same tax rate to the new taxable value to estimate market taxes. The taxes may not rise all at once or in the year following the purchase, but the safe assumption is that they do.

#4 - Property Management / Salaries & Payroll

For properties that have more than ~25 units, it is likely that some level of administrative support will be needed to ensure operations run smoothly. As the number of units rises, so does the likelihood that full time support staff is needed. These individuals can be hired directly, they can be employed by a third party property manager, or both. Often, we find that our students do not model the requisite expenses for support staff.

Depending on the size of the asset, the property management fee can range anywhere from 3% to 10% of Gross Rents and the fee may or may not include full time support staff. This is the key point. When modeling property management and salaries, it is important to understand the staffing plan for the property management company. If their model includes support staff, there may not be a need for a salaries budget line item. If it doesn't include support staff, additional budget is needed for salaries and $1,000 - $1,200 per unit, per year is the target.

To avoid this mistake, take a moment to understand the cost structure and staffing plan of the current or proposed property management firm and model the expenses accordingly.

#5 - Capital Expenditures & Rental Increases

Capital expenditures are funds invested into improving or renovating a property. For value-add properties, the business plan typically includes an acquisition and then some level of capital investment to bring the units up to market standards. Once complete, the rents can be raised to recoup the investment.

However, we have found that many of our students miss that there is a critical relationship between the amount of money invested in capital improvements and the modeled rental increases. As a best practice, capital expenditures should be recovered within 36-48 months by increasing the property's rents. To illustrate how this should work, an example is helpful.

Assume that a property has 100 units and the investor is planning to invest $500,000 in capital improvements ($5,000 per unit). To recoup this investment within 48 months, rents must go up by at least $104 per month ($5,000 / 48), per unit. If the modeled rental increases are lower, or more importantly, the market cannot support the increases needed to recover the investment, the overall return is going to suffer.

So, when considering the capital improvement budget, it can be helpful to work backwards from the difference between the current rents and the market rents. For example, assume that a property's current rents are $650 and the supportable market rents are $725. If the $75 difference is multiplied by 48, it is implied that the capital improvement budget should be ~$3,600 per unit. Anything more than this could cause overall returns to be lower than anticipated.

Summary & Conclusions

For each deal that is submitted to our deal review mailbox, we review each line item of the model carefully to ensure that the assumptions are conservative and supportable. To ensure that they are, take heed of these common mistakes and incorporate the best practices into your next model prior to submitting it for review.