Purchasing a Multi-Family Rental Building –

New Construction vs. Older Existing

2350 West 1st Avenue & 189 Keefer Street

There has been a lot of buzz in the Metro Vancouver real estate market regarding the construction of new rental apartment buildings and the sale of these assets on a forward looking basis. Historically this type of development has not "penciled out", and when it has, it has been due to government programs, tax subsidies, etc. The reasons behind why we are suddenly seeing this product entering the market are many and can form the basis for a subsequent article. The purpose of this paper will be to concentrate on some of the income and expense projection nuances between acquiring a new purpose built rental building vs. an older existing rental building. As an example, "Why does the market demand a different capitalization rate when comparing these two types of income producing assets?"

When looking at the potential purchase of any multi-family building (new or old), there are many factors to consider. These can include, but are not limited to: current income and expenses, projected income and expenses, tenant profile, location, unit mix, capitalization rates, building condition, environmental issues, property taxes, redevelopment and/or assembly potential, etc. When considering a new purpose built rental building (presumably either prior to construction or during) the income and expense variables as well as the form in which the ownership transfers (fee simple, free standing, air space parcel, strata, etc.) must also be considered. To illustrate the differences in terms of projecting the value or potential purchase price of a new building as compared to an existing older building, a hypothetical analysis has been included on the following page.

A side by side comparison has been completed to imitate how an investor might look at two different types of apartment building properties. The first would be indicative of a "typical" older stock rental building, which make up the vast majority of purchases. The second is an example of a proposed rental apartment air space parcel within a market condominium development. This type of rental development currently makes up the majority of those being constructed or proposed. Assumptions are as follows:

Assumptions - Hypothetical Analysis "Existing vs. New"

Item	Existing Older Stock	New Rental Building
Age	1970's	To be constructed
Municipality	City of Vancouver	City of Vancouver
Type	4 storey woodframe	5 storey concrete
Legal Interest	Fee Simple (Free Standing)	Fee Simple (Air Space Parcel)
Total square footage	36,350	37,500
Site Size*	10,905	n/a
# of Suites	54	75
Avg sq.ft. per Suite	673	500
Elevator	1	2
Parking **	50 stalls underground	38 stalls underground
Storage	50 storage lockers	35 storage lockers
Laundry	Common laundry room	In-suite laundry

** In the new rental building scenario, the property forms part of a larger development.*

*** Parking in new scenario is reflective of an allocation of stalls within the project's underground parkade.*

Both properties are similar size in terms of square footage and similar in terms of number of storeys. The number of suites varies given that newer buildings are typically more efficient and offer smaller suite sizes than older stock. Income and expense projections have been included below for each property. Information regarding the financial assumptions is included in a chart following this analysis.

Please NOTE: this is strictly a <u>hypothetical analysis</u> and has been included for discussion purposes only.

Hypothetical Existing Older Apartment Building
Projected Year One

PROJECTED ANNUAL GROSS INCOME[1]				Altus Projected Y/E Jan-15
Projected Annual Rental Income ($1.85 per s.f. per month)				**$806,970**
Average Rent per Month per Suite				$1,245
Number of Suites			**54**	
	# Stalls	Monthly	Annually	
Parking ($35.00 per month)	50	$1,750	$21,000	
Laundry ($10.00 per suite / month)		$540	$6,480	
Total Annual Ancillary Income				**$27,480**
Vacancy & Bad Debts	1.00%			**-$8,345**

		Altus 2014 Stabilized Forecast
Effective Gross Income (EGI)		**$826,106**
EGI / Suite per month		**$1,275**

EXPENSES[2]		Per Suite Altus 2014	Total
Management	3.50% of EGI	*$535*	**$28,914**
Realty Taxes	8.47% of EGI	*$1,296*	**$70,000**
Water and Sewer		*$300*	**$16,200**
Utilities		*$600*	**$32,400**
Garbage		*$75*	**$4,050**
Repairs and Maintenance		*$800*	**$43,200**
Caretaker		*$600*	**$32,400**
Insurance		*$370*	**$20,000**
Advertising and Leasing		*$50*	**$2,700**
Elevator, Licenses, Landscaping, Miscellaneous		*$250*	**$13,500**
Total Operating Expenses		*$4,877*	**$263,364**
Operating Expense Ratio			**31.88%**
Net Operating Income (NOI)			$562,742
Stabilized Capitalization Rate			**4.00%**
Indicated Value (Overall)			$14,068,545
Indicated Value (Per Sq.Ft. of Rentable Area)			$387
Indicated Value (Per Suite)			$260,529
MARKET VALUE (ROUNDED)			$14,070,000

[1] *Monthly and Projected Income based on hypothetical existing rents*

[2] *Expenses are estimated based on Altus' experience with comparable properties*

Hypothetical New Purpose Built Apartment Building
Projected Year One

Forecast once complete and fully leased

PROJECTED ANNUAL GROSS INCOME[1]				Altus Projected Y/E Jan-15
Projected Annual Rental Income ($3.00 per s.f. per month)				**$1,350,000**
Average Rent per Month per Suite				$1,500
Number of Suites			**75**	
	# Stalls	Monthly	Annually	
Parking ($60.00 per month)	38	$2,280	$27,360	
Storage ($25.00 per month)	30	$750	$9,000	
Laundry (in-suite)		$0	$0	
Total Annual Ancillary Income				**$36,360**
Vacancy & Bad Debts	2.00%			**-$27,727**

		Altus 2014 Stabilized Forecast
Effective Gross Income (EGI)		**$1,358,633**
EGI / Suite per month		**$1,510**

EXPENSES[2]		Per Suite Altus 2014	Total
Management	3.50% of EGI	*$634*	**$47,552**
Realty Taxes	8.10% of EGI	*$1,467*	**$110,000**
Water and Sewer		*$300*	**$22,500**
Utilities (Hot Water and Common Lighting Only - Tenant pays all other utilities and cable)		*$250*	**$18,750**
Garbage		*$75*	**$5,625**
Repairs and Maintenance		*$900*	**$67,500**
Caretaker and Security		*$600*	**$45,000**
Insurance		*$427*	**$32,000**
Advertising and Leasing		*$75*	**$5,625**
Elevator, Licenses, Landscaping, Miscellaneous		*$250*	**$18,750**
Total Operating Expenses		*$4,977*	**$373,302**
Operating Expense Ratio			**27.48%**
Net Operating Income (NOI)			$985,331
Stabilized Capitalization Rate			**4.75%**
Indicated Value (Overall)			$20,743,803
Indicated Value (Per Sq.Ft. of Rentable Area)			$553
Indicated Value (Per Suite)			$276,584
MARKET VALUE (ROUNDED)			$20,740,000

[1] *Monthly and Projected Income based on hypothetical market rents*

[2] *Expenses are estimated based on Altus' experience with comparable properties*

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Revenues

- Current rents: for the existing building, the rent roll will be reviewed and a stabilized Year One Gross Rent will be established. Some purchasers assume below market rents will be increased by the maximum allowable increase (set each year by the Province). Others look strictly at the existing rents, potential to sharply increase rents on turnover, or by carrying out a major retrofit.
- Ancillary rents: laundry, parking, storage lockers, etc. Existing revenues will be incorporated into the forecast. Some purchasers may consider an increase if revenues are considered below market.

Vacancy & Bad Debt – an assumption based on the historical performance of the asset (tenant turnover) as well as the market will lead to a general vacancy and bad debt forecast.

Effective Gross Income (EGI) – Revenues less vacancy and bad debt equals the property's EGI. Expenses are then deducted from this total.

Expenses

- Management: a management forecast will be incorporated. Typically a percentage of EGI.
- Property Taxes: current property taxes are reviewed. A projection for the following year will be completed and subtracted (based on the current mill rate and value or assumed purchase price).
- Utilities: water, sewer, heat, hot water, electricity, etc. Historical consumption levels will be considered when projecting future utility costs. It is typical within the older stock that the tenant will pay for electricity and cable / phone, however, the Landlord is usually required to provide heat and hot water as part of the rent.
- Garbage: waste and recycling removal and disposal.
- Repairs & Maintenance: an allowance is considered for the ongoing annual maintenance of the building (painting, minor wear and tear, odd jobs, carpet maintenance, etc.). Capital costs items (roof replacement, etc.) are excluded from R & M.
- Caretaker / Staffing: caretaker and fees for on-site staff.
- Insurance: actual annual insurance premium will be deducted.
- Advertising & Leasing: an allocation on a $ / suite basis will be forecast. Some purchasers may exclude this cost, or consider it part of the caretaker's responsibility.
- Miscellaneous: can cover any additional costs such as licenses, landscaping, elevator, etc.

In the new build scenario, all of the above will be normalized as per acceptable industry standards, as no historical data will be available.

Capitalization Rate & Market Value

- A review of comparable transactions will be completed. A market capitalization rate will be applied to the subject's Net Operating Income (NOI). An estimate of market value (or potential acquisition price) will be established. Any perceived opportunity to increase market rents (if they are below market) or decrease expenses may impact the selection of an appropriate capitalization rate. Assembly potential for future development or future redevelopment of the site on its own (high underlying value) may also influence the pricing beyond the existing income.

Capital Items

- A review of the building condition will be completed. Immediate and short term capital repairs, such as new piping, roofing, elevator or balconies, are typically deducted below the NOI line or will have the effect of increasing the capitalization rate.

The following chart details some of the differences in projecting income and expenses, as well as stabilized capitalization rates when comparing a new build vs. an existing building scenario.

Explanation of Assumption Differences

Item	Existing Older Stock	New Rental Building
Revenues		
- Rents	Current in place rents (potential for upside if below market).	Lease at Market Rents (no upside).
- Parking	Typically more stalls but less revenue / stall / month.	Less stalls typically but higher rate / month.
- Laundry	Will have common laundry. Typical to feature a rental contract.	In-suite - no revenue. Tenants prefer in-suite laundry.
- Storage	Will typically have 1 per suite but generally limited or no revenue.	Newer buildings may feature storage for revenue stream. Others may not or include it in rent as an incentive.
Vacancy Rates	In line with building history and CMHC.	Slightly higher vacancy rate - higher rents = more potential for turnover.
Expenses		
- Management	Typically forecast as % of EGI.	Percentage may be similar but cost will be more due to higher EGI.
- Realty taxes	Take existing and inflate for following year.	Property taxes will be higher based on new build and higher value.
- Water and sewer	Likely covered by Landlord.	Likely covered by Landlord.
- Utilities	Heat and hot water included in most rent. Sometimes hydro as well.	May be lower if tenant pays all.
Garbage	Similar.	Similar
R & M	Expressed as a rate / suite. Excludes capital expenditures.	May be higher on a $ / suite basis. Tenant paying higher rent would expect a building with highest standards of maintenance. Some new systems may require maintenance by specialized professionals.
Caretaker and Security	Usually a tenant is offered a break on rent to act as caretaker.	Likely higher cost given security usually provided for newer buildings.
Insurance	Woodframe and older product will have a more expensive basic premium (in terms of rate applied to value).	Based on value of building. Institutional investor will likely require at least $10 M liability + "all the bells and whistles".
Advertising and Leasing	May only use Craigslist and resident caretaker.	Potentially require more incentives for newer buildings. Esp. during initial lease up.
Elevator, License, Landscaping, Misc	Older elevator may require more upkeep.	Tenants may expect higher level of groundskeeping / cleaning / upkeep.
Total Operating Expense	Likely lower than new.	Likely higher on a $ per suite basis as compared to old.
Operating Expense Ratio	Likely higher than new.	Likely lower than old given high rents.
Cap Rate	Market capitalization rate depend upon other comparable transactions in the marketplace. A purchaser who perceives signficant "upside" may accept a lower cap rate.	Higher cap rate as limited upside on rents and no opportunity to update facilities to run more efficiently (ie. decrease expenses). Airspace parcels are seen as less attractive. No tenant profile history. Rollover may be higher due to a younger tenant profile and / or higher rents.
Indicated Value	Lower value than new.	Similar square footage but much higher value than old.
Market Value / Sq.Ft.	Lower value / sq.ft. than new.	Higher value / sq.ft. than older stock.
Market Value / Suite	Lower value / suite than new.	Higher value / suite than older stock.
Cap Ex	As buildings age, more likely to have major repairs.	All building and systems new - not likely required.

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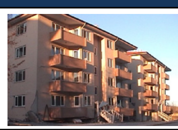
Summary & Conclusion

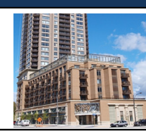
As can be seen from the above, there are many variables to consider when analyzing both types of properties. Existing older stock buildings will generally have historical expenses and a current rent roll for review. The financial statements will provide an appropriate snapshot of the asset and help a potential purchaser forecast for future years. Historical tenant rollover assumptions and vacancy can be best predicted from a review of a "typical year". All of this will form the basis for forecasting a stabilized year one net operating income. Additionally, the analysis will bring awareness of any opportunity for increases in revenues, and / or savings in expense line items.

In terms of analyzing the potential purchase of a new building (one to be constructed), none of the above is available. A purchase price or offer must be garnered from a projection of all of these variables. Research regarding new rental rates can be completed in the surrounding area, as well as from a review of stratified condo suites which are offered for rent. Expenses are forecast based on what is anticipated, though none can be confirmed until the property is complete, fully leased and operating for at least a few months.

The purchase of either type of property presents some risk. However, both feature positive attributes to help offset that risk.

Qualitative Summary





Existing Older Stock		New Rental Building	
POSITIVE	NEGATIVE	POSITIVE	NEGATIVE
- Most variables are known. - Lots of comparable transactions. - Lower rents - larger rental pool. - Add value through: - Increases in revenue + decreases in expenses. - Renovate, expand, add suites*. - Demolish and rebuild, assemble. - Take advantage of municipal programs : - Rental 100, West End Infil 2.00, Heritage Revitalization. - Buying well under replacement value. - High underlying land value potential.	- Ongoing maintenance of older product. - Large capital replacement items. - Zoning may affect redevelopment potential.	- All facilities are brand new. - Easy to show and lease (at appropriate rents for the market. - Tenants enjoy condo quality / amenities. - Tenants likely prefer to rent a purpose built building as they can be evicted from condos if they are sold or if owner would like to occupy. - May have car sharing program. - Often near transit, shopping, etc.	- May have issues as an ASP neighbouring a larger stratified condominium development. - Competition for tenants with condo suites. - Limited or no opportunity to increase NOI. - Initial lease up period could be lengthy. - Deal structures can be very complicated. - Financing may be difficult prior to completion and full occupancy. - No future development potential.
** Depending on municipality and current zoning.*			

Overall, the type of real estate investment one is willing to purchase depends on internal requirements and levels of acceptable returns. Each property features unique characteristics and not all possible assumptions and scenarios can be explained in one hypothetical comparison. Hopefully the above analysis has outlined some of the nuances in dealing with these two types of apartment properties. Should you have any comments or questions regarding this report or require an appraisal for sale, estate or refinancing purposes, please feel free to contact the undersigned.

Industry expert Cynthia Jagger, AACI, P.App, is a Senior Consultant with Altus Group Limited. She has a significant amount of experience valuing apartment buildings, as well as many other income producing assets and developments. Cynthia works in the Research, Valuation and Advisory Group in the Vancouver office. She has been provided professional services in the real estate industry for over 10 years.

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