The Goodman Report
FOR APARTMENT OWNERS

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IT'S NOT JUST ABOUT CAP RATES

As prices in the Greater Vancouver multi-family market continue their inexorable climb, there is growing controversy over the historic decline of cap rates now hovering in the 3% to 5% range. Active participants in the industry, made up of investors, lenders, appraisers, assessment authorities, realtors and the media endlessly debate the rationale behind the current cap rate environment.

The challenge besetting this group in arriving at accurate valuations looms ever larger as mortgage rates increase. It is apparent that the days of positive leverage (cap rates above cost of financing) are behind us resulting in buyers having to use significantly higher amounts of cash as a down payment just to break even, or use cash reserves to cover negative cash flow.

The question remains as to why today's buyers, in spite of little or no return on equity, are actively seeking to invest in this asset class. Put simply, it's because investors are buying "futures" expecting the demand for rentals to drive gross income substantially higher. Let's examine a number of methods used by investors to determine and measure value starting with cap rate.

Cap Rate

DEFINITION: The Capitalization Rate or Cap Rate is a ratio used to estimate the value of income producing properties. It is a process of converting potential net operating income, by the application of a factor, into an indication of the market value of the subject property.

$$\text{Cap Rate} = \frac{\text{NOI}}{\text{Market Value}}$$

$$\text{Estimated Market Value} = \frac{\text{NOI}}{\text{Cap Rate}}$$

The cap rate is one of the most reliable tools for estimating the value of income producing properties. The overall rate is greatly affected by its risk, liquidity and management profile. The market cap is determined by evaluating the financial data of recent sales and current offerings in a specific area. As cap rates play such a vital role in determining a maximum loan amount, knowledge of appropriate operating expenses is essential.

Location

The oft referred to, intangible barometer of property value heavily relied on by market forces is "location". This subject is known to generate intense feelings ranging from a heart pounding adrenalin rush to a scornful putdown, with every imaginable reaction in between. While investors are all desirous of owning a building west of Denman in Vancouver's West End or Bellevue Avenue in West Vancouver, finances dictate otherwise. Needless to say, because of the quality of an investment in an "A" location (a highly desirable area), investors are prepared to accept lower yields.

News and views from David and Mark Goodman

Fact

The Goodman Team, BC's leading apartment specialist, is number 1 in buildings sold and $ volume 2003, 2004, 2005, 2006 and 2007.

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That being said, there are buyers who only target higher risk income properties in C or D locations in spite of a poor tenant profile, neighborhood decay or specific social issues. They envision added value opportunities such as future gentrification, potential re-development or enhanced income levels brought on by major upgrades. In exchange for less desirable locations, investors expect higher yields that correspond to the quality of the investment and to compensate for the added risk. The correlation between yield and location is proven to be axiomatic.

Concrete vs. Frame

Frame buildings, the standard bearers, make up approximately 90% of the 3,012 rental apartment buildings in Greater Vancouver with the balance consisting of concrete. While a tenant may not differentiate between choosing a suite in a concrete or frame building, an investor does. It's concrete that raises eyebrows and quickens the pulse of those seeking this form of investment. Possessing qualities of longevity, durability, permanence, lower maintenance costs and undeniably a measure of prestige for the owners, the few concrete buildings that find their way to the market garner exceptional levels of buyer interest. It's not unusual to see multiple offers received on concrete buildings during the marketing process.

Condition

The very moment a buyer steps from their car and stands before a potential acquisition, a mysterious set of mental processes are set in motion. While the investor has likely previewed the subject online or in a brochure, it is the physical inspection which ultimately tells the real story. Let's assume for a moment that the important first impressions are not all that favourable (i.e., exterior not painted in 10 years, poor landscaping, debris around the building and parking lines worn out). While this factor alone won't deter a sale from happening, it succeeds in telegraphing vital clues to the buyer about the vendor's lack of devotion to the rest of the building. Conversely, should the prospective buyer experience positive impressions, their interest in viewing the entire building is heightened. During the first walk through, a buyer normally views a few suites, the furnace, laundry, locker rooms and parking areas, all the while gathering in countless images and mentally sizing up the building's "feel". They also determine the financial outlay required for deferred maintenance or major capital improvements such as re-piping, a new roof or balcony upgrades. Their negotiating stance hardens once it's discovered that the building's overall condition is somewhat disappointing. This becomes even more apparent once it's realized that a significant cash infusion is required for improvements upon acquisition. On the other hand, a buyer's level of resistance in paying a higher price (a lower cap rate) eases as "pride of ownership" serves to remove doubts or concerns about the building's investment merit.

Suite Mix

A building's value is a function of actual or potential income derived from the suites. Thus, the dollar per suite value attributed to two bedroom units over bachelors or one bedroom units is clearly evident. Imagine a 10 unit (all bachelor) building next to a 10 unit (all 2-bedroom) with the same age and building type. To an investor, the two bedroom building would have approximately 50% more value. As well, buildings with a high percentage of bachelor suites may indicate that the subject building has a less stable, higher turnover tenant base.

Net Rentable Square Feet

Of late, sophisticated and often institutional buyers have been seeking out the precise net rentable square footage in buildings they are targeting. Recognizing the importance of extracting the optimum rent from a given suite, they are aware that a 680 square foot one bedroom at $1.50 per square foot will normally generate a higher rent than a 560 square foot one bedroom at $1.50 per square foot. Armed with this crucial data, it allows them to anticipate future levels of income with greater certainty.

Current Rent Levels

Most owners, especially those who have extensive portfolios or are highly levered, diligently monitor their building's rent levels on an ongoing basis. They are privy to the area's vacancy rates and the competition's rents. Further, the permissible rent increases are issued and when a turnover of a suite provides for a vacancy, management is quick to take full advantage of "market rents". There exists, however, a significant ownership group who knowingly or unknowingly subsidize their tenants with rents pegged below market. This condition occurs when they neglect to issue yearly rent increases or adjust to market on suite turnovers. In some instances these rent levels are found to be 10% to 50% below the prevailing market. Profiling this group, they can best be described as equity rich, long term owners.

In order to detect unrealized income, astute buyers carefully scan rent rolls. Aware of the untapped income potential, many succeed in acquiring buildings by outbidding less knowledgeable investors.

Price Per Suite

The price per suite is utilized to provide some supporting evidence of value. This method is limited however, due to the differences in average rental levels, suite sizes (mix), building efficiencies in operating expenses, the quality and age of accommodation, the level of re-modeling, construction type and existence of any unauthorized suites.

All things being equal, smaller apartment buildings, say in the eight to fifteen suite range, will typically command a higher price per unit than larger buildings (20+ units). This is because a far greater percentage of investors can afford this category (more demand) and management and/or caretaking expenses are reduced or eliminated in cases where the property is self managed.

Land Value

Land suitable for new condo projects in Greater Vancouver has become increasingly scarce and expensive. Developers continue to search for sites that qualify in terms of zoning and location. Notwithstanding the existence of a moratorium on the demolition of rental apartment buildings in Richmond, Vancouver and the District of North Vancouver, we are seeing older and increasingly inefficient 40 to 60 year old buildings, classified as “land value”, succumb to the wrecking ball and re-developed as condos. Expect to see this category increase in importance, especially with communities in Greater Vancouver finally beginning to embrace the idea of higher densities in multi-family jurisdictions.

Gross Rent Multiplier (GRM)

DEFINITION: A ratio that is used to estimate the value of income producing properties. It is calculated by dividing the effective yearly gross income into the sales price.

$$\text{GRM} = \frac{\text{Sales Price}}{\text{Effective Yearly Gross}}$$

$$\text{GRM} \times \text{Effective Yearly Gross} = \text{Estimated Market Value}$$

The GRM provides for a rough estimate of value. The seasoned investor understands its limitations as the property’s operating expenses and vacancy rates are not included. Instead, GRM is used to get a quick feel for the potential market value of an income property.

Financing

Values may be positively or negatively influenced by the financing attached to the building.

The purchaser taking over an existing mortgage makes a cash down payment for the remainder of the purchase price. Due to appreciating values and the previous amortization (pay-down) of the loan, this existing financing is typically for a lesser amount than would be obtainable with a new loan. However, this financing avenue often provides the benefits of a lower interest rate and fewer loan origination fees (such as loan points, appraisal fee, environmental review, etc.).

On the other hand, a mortgage being assumed which is higher than the available market rate, contributes additional and unexpected costs for the buyer. This may result in the buyer, during the negotiations, seeking a downward adjustment on the purchase price to compensate for the difference between the lower available market rate and the higher assumed mortgage.

Replacement Cost or Cost Approach

DEFINITION: This valuation approach is based on the assumption that an informed purchaser will not pay more than the cost of producing a substitute property with the same utility as the subject. This involves valuing the site as if it was vacant and then adding depreciated value of the improvements.

Purpose-built rentals are becoming an endangered species. Of the approximately 3,012 known buildings in Greater Vancouver, probably 90% were built prior to 1974 when the federal government had tax policies in place which encouraged construction and investment in this field. Since that period, the few additions for the most part have either been subsidized or investor-owned condos.

It is common knowledge that the economics to develop rentals in Greater Vancouver today are not viable, even with vacancies in many communities below 1%. Soaring land and construction costs, coupled with tax disincentives, DCC’s and GST, etc., have essentially killed any new rental market initiatives, in spite of the demand. With this in mind, rental buildings, unlike other asset classes, often trade at a 50% discount below replacement cost, a fact not lost on a growing segment of the investment community.

However, since investment properties are not traded on the basis of replacement value, this approach is not considered applicable or relevant to the valuation of rental apartment properties.

Conclusion

With access to the entire range of market trends and data from sources such as *The Goodman Report*, appraisers and lenders, and often armed with their own experiences as principles, buyers are “tuned in” showing market savvy not previously seen before. Their investment decisions are carefully weighed, whether pursuing 8 or 200 suites, frame or concrete, urban or suburban, or acquiring a building in pristine or poor condition.

Entering our 25th year of publishing *The Goodman Report for Apartment Owners*, which has brought news, views and market intelligence to our industry, we've distilled in this most recent report our collective experiences in understanding investment decisions as seen through the eyes of the "investor".

Should you wish to discuss or review any portion of this report, or perhaps have questions pertaining to your building(s) please call David or Mark at 604-736-5611.

Goodman REPORT

NOVEMBER 2007

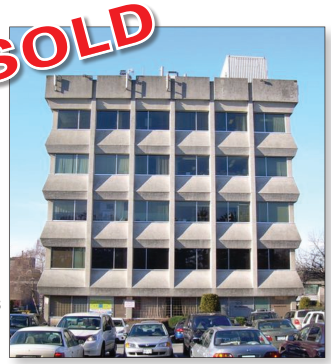
RECENT SALES ACTIVITY

NEW LISTINGS

Burnaby
Southeast
7428 6th St.
20 Units
Ask $2,950,000
(Offers)

Burnaby
Willingdon Heights
1280 Madison Ave.
22 Units
Ask $2,959,000
(Offers)

Kamloops, BC
619 Victoria Street
11 Office Strata Units
17,361 rentable sq. ft.
Ask $2,650,000



East Vancouver
Commercial —
Broadway corridor
1750 East 10th Ave.
23,840 rentable sq. ft.
5 Storey
Concrete Office Building

Comox, BC
1811 Comox Ave.
3 Commercial
Strata Units
7,269 rentable sq. ft.
Ask $2,060,000

New Westminster
Uptown District
435 Ash Street
43 Units
Ask $4,995,000

New Westminster
Uptown District
908 Sixth Ave. / 529 Tenth St.
Total of 69 Units
Ask $8,190,000

FACT:
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