

Day 2

UNDERWRITING

Investment Thesis

- Goals (operational, estate, legacy, etc)
- Time Horizon
- Involvement

Our Focus - Repositioning

We Focus on Value add – “Forced Appreciation”

1. Strong location
2. 15% minimum AAR
3. 3-5 years for refinance or sale

The Hunt for Value

Determining if a deal is worth pursuing?

1. Systematic Approach for initial screening
 - Having market knowledge of rents
 - Price per Door
 - 1% rule
 - 50% expense
2. Interpreting Current state and Projecting Future state (The Model)

Underwriting – The Model

3 Main Questions

1. What is the property performance today?
2. What would be the value after stabilization?
3. How much will it cost to bring up the value?

Underwriting - Terms

Capitalization Rate (“Cap rate”)

Return Metrics

Cash on Cash (CoC)

Return on Investment (ROI)

Average Annual Return (AAR)

Internal Rate of Return (IRR)

Underwriting – The CAP Rate

What is Cap rate?

Capitalization rate = $\text{NOI} / \text{Purchase Price}$

Example

Revenue:	\$240,000
Expenses:	\$120,000
NOI:	\$120,000
Purchase price	\$2,000,000
Cap rate:	6%

*Unlevered yield (calculated before mortgage payment)

Underwriting – The CAP QUIZ

POP QUIZ

Example

Revenue:	\$1,000,000
Expenses:	\$400,000
NOI:	\$600,000
Cap rate:	6%
Purchase price	???????????

Underwriting – The Real Valuation

- Applying Cap rate in real life
 - Take the NOI of the property, divide it by the PP, **to determine the cap rate**
 - Take the NOI of the property, divide it by the going cap rate **to determine the fair price**
 - Estimating stabilized value of a property
 - Broker should know the cap rate for the market and class
 - Cap rate has a correlation to the debt rate
 - They move together
 - Arbitrage between the cap rate and debt rate

Underwriting – Return Metrics

Cash on Cash (CoC) % = Cash Flow / Equity Invested

How much cash am I getting annually?

Invested \$100,000, received \$10,000 in cash flow Year 1, Coc = 10%

Return on Investment (ROI) =

(Accrued Cash Flow + Proceeds from Sale) / Equity Invested

What's the total return of my investment (no time value)?

Invested \$100,000, received cash flow of \$20,000 in 2 years plus \$80,000, ROI = 100%

Average Annual Return (AAR) = ROI / Years Held

Total return divided by the number of years

Invested \$100,000, received total distribution of \$100,000 over 2 years, AAR = 100% / 2 = 50%

Internal Rate of Return (IRR)

Similar to AAR but with a Time-value component (needs excel to calculate)

Underwriting – Return Metrics

<u>Acquisition</u>			
purchase price	8,000,000		
units	100		
price/unit	80,000		
rent/unit	1,000		
<u>Operation</u>			
revenue	1,200,000	1,000 x 100 x 12	
expenses	600,000	50%	
NOI	600,000		
cap rate		7.50% NOI/PP	
<u>Loan</u>			
LTV		75%	
loan amount	6,000,000		
equity	2,000,000		
interest rate		6.50%	
amortization		25	
debt service	(486,149)		
<u>Cash flow</u>			
NOI	600,000		
debt service	(486,149)		
cash flow	113,851		
COC		5.69% cashflow/equity	

<u>Sales at Y5</u>			
proforma rents	1,250		
proforma Revenue	1,500,000		
proforma Expenses	750,000	50%	
proforma NOI	750,000		
market cap rate	7.50%		
sales price	10,000,000	NOI/cap rate	
profit	2,000,000		
cash flow	569,254	5 years	
total profit	2,569,254		
return on investment		128% profit/equity	
average annual return		26% ROI/5	

Let's look at a model

Morgan Glen

Underwriting – Rule of Thumb #1

- 1% rule
 - Rent/unit is 1% of price/unit
 - \$2.0M 20 unit property
 - \$100,000/unit
 - \$1,000 rents
- Indication of cash flow potential
- Some deals that don't meet the 1% rule may still work
 - Huge upside potential
 - Markets with low expenses

Underwriting – Rule of Thumb #2

- Expense ratio
 - 50% of revenue
 - Quick way to estimate NOI
 - Some markets have higher and lower expenses (tax, insurance)
 - Very low rents or high rents can affect the expense ratio
 - Class of building can also have an effect on expenses
 - Rough estimate, but is useful for that systematic approach

End of Day 2