# CREATING VALUE IN UNDERPERFORMING MULTI-FAMILY APARTMENT COMPLEXES

*A strategic plan that cuts operating costs, improves management efficiency and responds to market needs is the first priority.*

**by Stephen A. Stoner**

The Bush Administration's much anticipated bailout of the savings and loan industry finally has arrived in the form of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). FIRREA created the Resolution Trust Corporation (RTC), which is responsible for managing and financing the resolution of failed thrifts. Included in RTC's charter is the orderly disposition of an estimated $200 billion to $500 billion of income-producing real estate owned (REO) property—i.e., property that has been foreclosed by the failed thrift institutions. The creation of this disposition mechanism, combined with the panoply of REO property on the books of healthy or marginally performing savings and loan institutions, creates business opportunities for real estate investors who are skilled in managing troubled property. For those investors lucky enough to negotiate a deal with the government or a thrift, the challenge is merely beginning. The real test of their skills will come when they attempt to create a profitable investment.

Development of a strategic plan for creating asset value should be the first order of business for a prospective owner of an underperforming, multi-family apartment complex. Note the use of the word "prospective." Planning is most effective when it occurs prior to the closing of a deal; good planning by a prospective owner ensures that the team acquiring the property knows exactly what to expect and how to proceed once it takes possession. Specific points to evaluate during the planning process include:

- Improved management efficiency
- Operating cost reductions
- Capital improvements and maintenance schedules
- Amending leasing policies
- Market repositioning
- Partial asset shutdown

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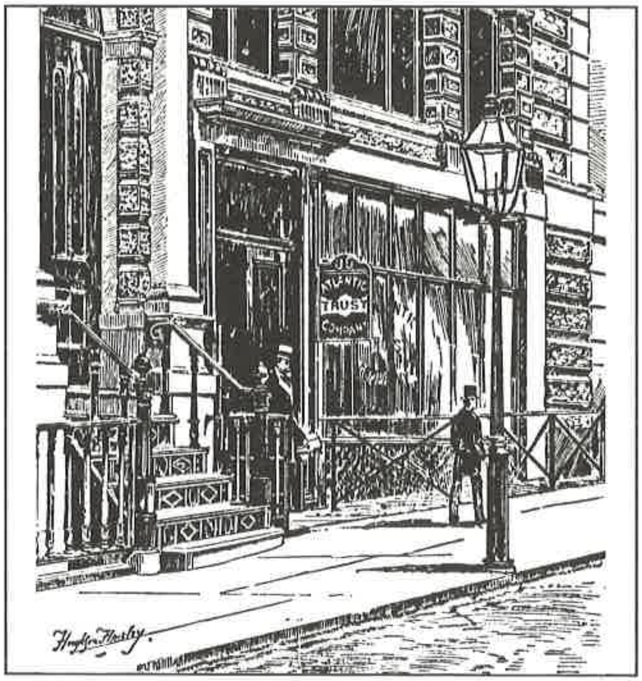

## Improved Management Efficiency

One of the first areas to consider is the performance of the existing property management team and the steps that need to be taken to streamline management efficiency and reduce costs without suffering a noticeable decrease in tenant services.

Automating the financial and accounting functions is a good place to start. Automation means more than just cranking out monthly operating statements on a personal computer. It means automatically generating and mailing rent invoices to tenants near the end of each month so payments can be sent directly to a bank for deposit in a lockbox account. It also involves automatic receipt of daily account statements from the bank so the property manager can follow up on delinquencies. In addition, automation of certain regularly occuring payments (loan payments, insurance contracts, etc.) may be instituted.

A good financial software package should include budgeting and cash management applications and the capability of creating monthly operating statements on a timely basis. If scrutinized properly, these statements enable the property manager to identify and solve potential operating or maintenance problems quickly and in a cost-effective manner. Automating the generation of monthly operating statements can be a cost saving in itself. The upfront costs of a computer system usually are offset by the savings achieved by reducing manual processing time.

Significant savings also can be achieved by moving the property manager and rental agents of a small- or medium-sized apartment complex off-site. A move to a central management office allows the unit that was being used as an office to be rented, and it allows agents and managers to allocate a portion of their time to other projects without eroding services to tenants of the complex. Prospective tenants can call the central office for an appointment to see vacant units, and current tenants can inform the off-site office of problems by telephone. Maintenance requests can be made via an answering machine set up in an on-site maintenance shed that is checked on a regular basis by maintenance personnel.

Creating standard operating procedures for the maintenance crew of the apartment complex can eliminate the need for and the cost of an on-site maintenance supervisor. Schedules for regular tasks, such as lawn mowing or pool cleaning, can be established as can responses to routine but unpredictable requests by tenants for repairs (leaky faucets or broken windows, etc.). Nonroutine or costly maintenance decisions that require supervisory input can be forwarded to a supervisor at the management office.

### Operating Cost Reductions

Establishing a budget is the easiest and most obvious method of controlling operating expenses. The budget should be based on historical operations and include input from an experienced manager on how to alter existing procedures to save money without affecting services by, for example, sourcing all maintenance and insurance contracts, increasing deductibles on insurance or requiring tenants to pay for utilities.

Each cost item in the budget also should be evaluated carefully to identify areas of potential savings. For example, consider an apartment complex that caters to college students by providing a shuttle service back and forth to campus. Monthly expenses for the shuttle service, which include loan payments, gas, maintenance, wages and insurance, average $7,500 per month or $90,000 per year. The complex is located on an existing university bus route which provides more frequent trips to and from the campus and longer hours of operation. The cost of an unlimited bus pass for enrolled students is $150 per semester and $275 for one full year. If the owner of the complex eliminates the shuttle service and instead buys each of the 250 tenants a year-round university bus pass, he will spend only $68,750, saving $21,250 annually, and the tenants will get better service to boot.

A commonly overlooked potential cost-saving measure is to protest real estate taxes. If the property's last assessment occurred at a time of higher profitability, then it may be carrying an inflated market value. In addition, a tax protest for a property in a depressed market often can generate a significant saving. Professional firms specializing in tax protests generally are quite successful and inexpensive; they are compensated based upon only a percentage of the savings.

### Capital Improvements And Maintenance Schedules

A capital budget should be established to prioritize capital improvement needs. An important consideration, especially in the development of a capital budget for recently acquired property, is an assessment of deferred maintenance. A common error made by investors in underperforming properties is to over-improve their complexes, thus driving up operating costs. In many cases, the existing tenant mix will not support the rents that are required to pay for upscale improvements or amenities. For example, all college students need is a sturdy apartment near campus at a reasonable price. Giving them more is asking for an avalanche of maintenance and repair expenses and the associated problems of maintaining profitability when students move to lower cost housing complexes elsewhere.

Once deferred maintenance and other capital improvement needs are identified, evaluated and costed, a schedule of work can be established. In an underperforming apartment complex, it makes little sense to perform work on occupied units unless the tenants are threatening to move out. Management time and funds are much more effectively spent on upgrading unoccupied apartments. Once occupancy stabilizes, a schedule for long-term capital improvements can be put into place.

A regular maintenance program is the most effective method of controlling capital improvement costs. Scheduling and monitoring routine maintenance and checkups are as important as management and financial control tools.

### Amending Leasing Policies

Leasing policies can be used as a mechanism to subtly alter the tenant mix in an underperforming apartment complex and generate greater profits. Each individual apartment complex and market has an optimal mix of leasing policies concerning base rent, terms, pets, children, credit standards, etc., which maximize the value of the complex. Changing even one of these variables can alter the profitability of the complex. For example, if rents are raised, vacancy rates may increase. However, in some situations the increase in vacancy rates can be offset by the higher gross rents that are generated and the lower delinquency rates that are associated with more affluent tenants. The property manager must be in touch with the needs of his tenants and the characteristics of his market to be able to create the most profitable bundle of leasing policies. He needs to evaluate such leasing policies as tenant credit checks and screening procedures, discounts for signing or renewing leases, security deposit amounts, parents' cosigning requirements and procedures for dealing with delinquent rents.

### Market Repositioning

The primary idea behind market repositioning is to understand the market segment represented by existing tenants and determine whether current tenants provide the optimal mix. A comprehensive market study is the key to understanding the market and the tenant mix. The market study is done in several phases. First is the data-gathering stage during which information is gathered on the demographic and socioeconomic trends, competitors, existing and projected pools of prospective tenants, market size and other isolated factors. Based on the results of the data-gathering phase, conclusions can be made regarding the supply of and the demand for housing in the market, and these conclusions can be utilized to identify underserved population segments.

If the determination is made that marketing the complex to a particular population segment could increase the bottom line, then a more detailed study of the situation should be made. This more comprehensive study involves an analysis of the life-style needs of the target population and a calculation of the capital expenditures required to create the proper environment to meet those needs. An important financial consideration in this analysis is the cost of maintaining a different level of service to the tenants. If, after this analysis, a shift in the market position still appears to be profitable, a program of implementation can be developed.

As a hypothetical example, consider an apartment complex located in Lafayette, Indiana, that has traditionally appealed to Purdue University students. Lafayette is the site of a Subaru-Isuzu plant that will open in 1990 and will create over 5,000 new jobs. A savvy apartment complex owner may find it profitable to remarket the complex to employees of the plant who can probably afford higher rents, cause less wear and tear on the facilities and have less turnover.

### Partial Asset Shutdown

The final discussion topic is reserved only for the most desperately under-performing properties. If all else fails, it may be most effective to close down part of an under-performing complex, preferably a nonattached building, to eliminate all of the variable and a good portion of the fixed costs associated with the closed-up area and allow the owner to invest management efforts and funds on the remaining units. The closed-down portion of the complex provides a good source of spare parts for making capital improvements and meeting maintenance requirements of other units, and, if the market ever turns around, the closed-off portion of the building can always be refurbished and reopened.

### Conclusion

There is no blueprint for creating value in underperforming, multi-family apartment complexes. It takes selective acquisition, creative problem-solving, the willingness to defer current returns, adequate capital reserves and a skilled property management team. Investors who plan carefully and are willing to sweat for their return should be excited about the opportunities that are available in today's real estate market.