Understanding the APOD
How to Crunch the Numbers on Your Investment Transaction

Commercial Investment Education Alliance

Commercial Success Series 105

Commercial Investment Education Alliance

- Please put your cell phones and other electronic equipment on “silent” mode.
- Questions and Answers are encouraged, but to keep the class moving forward the instructor may defer questions requiring longer answers until a break or the end of the program.

  Please hold your personal or case specific questions until a break or the end of the program.

About CIEA

- The Commercial Investment Education Alliance (CIEA) is a cooperative effort between a group of highly experienced commercial REALTORS®. Its objective is to provide straightforward, high quality commercial real estate education. The classes currently include:

  100 Fundamentals of Commercial-Investment Real Estate

  101 Exploring the Business of Commercial Real Estate

  102 The Mechanics of Valuing Commercial Real Estate

  103 The Techniques of Analyzing Investment Real Estate

  104 Tax Aspects of Investment Real Estate

  105 Understanding the APOD

What You Will Learn

- Through this course we hope that you will learn both the conceptual and the practical analysis methods to initially analyze an investment property, to understand its cash flow, mortgage loan determination, equity needs, and initial important numbers for property valuation and comparison purposes. The use of such analysis helps expedite the presentation and filtering of potential transactions.

What You Will Learn

- Prepare an information needs list for the Owner/Seller or for the listing agent to supply.
- Carefully read and study all information received.
- Make a copy of all information for buyer's agent and buyer, as appropriate, if not otherwise restricted.
- Become the **expert** on this property and this investment opportunity.

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Caution!

- The Factors, Ratios, Concepts and Valuation Methods used to Analyze Commercial and Investment Real Estate are Tools to aid in Decision Making. They are not a substitute for *Critical Thinking.*
- Commercial and Investment Real Estate is complicated and requires a high level of Competency. Make sure you are Qualified to participate before taking on an assignment. Check to see if such activities are covered in your Broker's E & O Policy.

Disclaimer

- This course is for educational purposes and is solely intended to provide an overview of commercial and investment property analysis. CIEA and the presenter do not provide legal, tax, or other professional services and advice. Each transaction and individual circumstance very widely and participants are strongly urged to seek independent legal, tax, and other professional advice.

Annual Property Operating Data (APOD) Worksheet

- What is an APOD?
- Where does it come from?
- Who prepares it?
- When is it used?
- What information do I need to prepare it, and where do I get that information?

Annual Property Operating Data Worksheet

- *What is the APOD?*
- The APOD is a form used to do a basic analysis on a real estate investment transaction so that it is summarized in a simple, organized and consistent format.
- Many forms exist on the Internet or the agent or principal can create their own form.
- We use the form available from CCIM Institute.
- For specialized properties you should customize your own form.

Annual Property Operating Data Worksheet

- *Where does it come from?*

  Agents and investors have developed similar forms over time. CCIM has developed and shares the form it developed. This form is used as our example.

  You can develop your own form if it suits your needs better or is more appropriate for the type of property under analysis.

Annual Property Operating Data Worksheet

- *Who prepares it?*
- The listing agent is most likely the person to prepare such a form as a tool in their analysis of the property.
- A buyer's agent or the buyer may also prepare such a form so that they can compare one property to another in an organized and consistent format.

Annual Property Operating Data Worksheet

- *When is it used?*

The APOD form is prepared by the listing agent in their initial analysis of the property.

The APOD form may also be used by the buyer's agent to study the proposed transaction and to compare to other properties under consideration.

The APOD form may also be used by owners or prospective investors to help analyze a property in an organized format.

Annual Property Operating Data Worksheet

- What information do I need to prepare it, and where do I get that information?

Common Elements of Every Investment

- A Monte Trueism
- Something is going out
- Something is expected to come in
- Passage of time
- Risk of not getting the expected result within the expected time frame.

Filling in the APOD Form

- **Upper Left Corner**
- Find a place to put in the date of your analysis.
- **Property Name:** Name of Property (if any), major tenant name, or street names at intersection for reference.
- **Location:** Street address of property, city
- **Type of Property:** Property Type (Big 4), add class of property A,B,C,D
- **Size of Property**: Land and building size in sq. ft. and number of rental units.
- **Purposes of Analysis:** Put in why you are doing this analysis and what will be the use of this analysis. Also, indicated if this is an actual (last 12 months) or pro forma (next 12 months) analysis.

Filling in the APOD Form

- Add on the form if the interest you are analyzing is a **FEE ESTATE** or a **LEASEHOLD ESTATE**.
- If a **LEASEHOLD ESTATE** indicate if the ground lease is **subordinate** or **unsubordinated** to the mortgage.

Filling in the APOD Form

- Upper left corner (continued)
- **Assessed/Appraised Values** (note 2 columns)
- **Estimated Land Value**
- **Estimated Improvement Value**
- **Estimated Personal Property Value** (if any)
- **Total(s)**
- **Adjusted Basis as of indicated dates**

Filling in the APOD Form

- **Main Analysis Section**
- Headings – Six Columns

  ALL FIGURES ARE ANNUAL

  $/SF OR $/Unit

  % of GOI (Gross Operating Income – line 5)

  Blank – for expense figures in $ (lines 7 -28)

  Blank – for income and summary expense figures in $ (lines 1-6 and 29-35)

  Comments/Footnotes (lines 1-35)

Filling in the APOD Form

- **Line 1** – **POTENTIAL RENTAL INCOME (PRI/GSI)**

  Here you would put in the base rental income and other income from leases and projected rent on any vacant space as if the property were to be 100% occupied.

  You need to **READ THE LEASES** to understand the rent increases, term, and any expense sharing or reimbursement arrangements.

  Factors to consider are the quantity ($), quality (risk) and durability (tenant financial strength) of the income stream.

Filling in the APOD Form

- Be alert to the income categories of contract rent, economic rent, excess rent, and percentage rent.
- You need to study the market to determine current market rents, trends, concessions and allowances.

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Filling in the APOD Form

- **Line 2 – <u>Less</u>: Vacancy & Credit Losses**

  This for the vacancy and credit losses on the property. Typical range may be 3% to 20% depending on the property type, location and stage in real estate market cycle.

  You need to research the market, talk to appraisers, owners, managers, tenants, and study the owner's time to "turn the unit" to put it back in space inventory.

Filling in the APOD Form

- **Line 3 EFFECTIVE RENTAL INCOME (ERI/EGI)**

  This is the Potential Rental Income <u>less</u> the Vacancy and Credit Loss Allowance. This is the amount of money you expect to receive in hand over the projection period.

Filling in the APOD Form

- **Line 4 Plus: Other Income (Collectable)**
- Examples are: Parking, Laundry, Storage, RV/Boat Parking, Pay Phones, Vending Machines

Other:____________________________________

____

____

____

Filling in the APOD Form

- **Line 5 GROSS OPERATING INCOME**
- This line is the EFFECTIVE RENTAL INCOME

  plus Other Income.

  This represents the full income from the property.
- **Line 6 OPERATING EXPENSES:**
- This is a header line to start listing operating expenses

Filling in the APOD Form

- **OPERATING EXPENSES**
- Operating Expenses can be classified as either **Fixed Expenses** or **Variable Expenses** (subject to fluctuation based on the occupancy of the building.
- **Lines 7, 8, 9.** Fixed Expenses would be defined as Real Estate Taxes (line 7) Personal Property Taxes, if any (line 8), and Property Insurance (line 9)

Filling in the APOD Form

- **Variable Expenses** would include operating expenses and repairs, reserves for operational replacements, and other charges.
- **Lines 10-28** -Variable expenses need to fit in between line 10 and line 28 on the form.
- **Lines 10-13** deal with property management expenses.
- **Line 14** Repairs and Maintenance
- **Lines 15-18** are for Utilities and other expenses.
- **Lines 19-21** are for certain administrative expenses

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Filling in the APOD Form

- **Line 22** Supplies can be for office supplies or supplies used in the operation and maintenance of the property.
- **Line 23** is header for Miscellaneous Contract Services. These are typically for Janitorial, Landscape Maintenance, Steam Cleaning, Parking Lot Sweeping, Day Porter, Pool Cleaning, etc.
- **Lines 24-28** Other:___________________________

Filling in the APOD Form

- **Line 29 TOTAL OPERATING EXPENSES**
- This is the total of all expenses reflected between line 6 and line 28 on the form.
- **Non Operating Expenses are listed on lines 31-34** of the form. Examples are annual debt service, participation payments to the lender, if any, leasing commissions, funded capital improvement reserves, actual capital improvements, depreciation, income tax (depending on ownership structure), special corporation costs, legal, real estate commissions, expenditures not essential or pertinent to the operation of the property.

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Filling in the APOD Form

- **Line 30 NET OPERATING INCOME**.
- This is the GROSS OPERATING INCOME <u>less</u> the TOTAL OPERATING EXPENSES. The NET OPERATING INCOME (NOI) is the critical number for determining other factors in the transaction.
- It also separates those expenses as **“above the line”** or **“below the line”**.

Filling in the APOD Form

- Once we have the NET OPERATING INCOME (I), we can then estimate or determine the property value through the **Income Approach to Value**. We need to determine a market **Capitalization Rate** from our research of the market. Once we have that rate, we can the divide the NOI by the Capitalization Rate (r) to get our estimate of the property Value (v) or price. I/r.v

  (Upper right corner of form) Add other "basis costs" of acquisition.

Filling in the APOD Form

- Review Methods of Valuation
- Gross Rent Multiplier
- Cost Approach to Value
- Market Approach to Value
- Income Approach
- Residual Approach to Value – Land, Building, Both

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Filling in the APOD Form

- Negative Factors to Consider – Actual or potential factors:
- Physical Obsolescence
- Functional Obsolescence
- Economic Obsolescence

Filling in the APOD Form

- CAPITALIZATION RATE – Any rate used for the conversion of income into value.
- Factors to consider –two components

    Safe Rate

    Risk Premium

    Risk of Transaction

    Non-liquidity of real estate investment

    Management intensive

    Interest rate on debt

    Yield on equity capital and recapture rate

    Value of reversion

Filling in the APOD Form

- **CAPITAL STRUCTURE** To purchase the property it takes money – capital. Capital comes in basically two forms **DEBT** or **EQUITY**, which each can be multi-tiered initially or subsequently in the transaction. Most purchasers seek to borrow the maximum amount available from a lender and then put in the smallest amount of their own money as Equity to fill any financing gap in the capital structure.

Filling in the APOD Form

- In the top right corner of the form, fill in the value or price line based upon your analysis, add in say a two per cent allowance for Acquisition Costs and say another two per cent allowance for Loan Fees/Costs. That then reflects the estimated **BASIS** in the property for total capital needs at closing.
- Next we have to determine the Mortgage Loan amount.

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Filling in the APOD Form

- Determining the Loan Amount - Once we have the value, the loan amount can be determined one of two ways or the lower amount of the two ways.
- Using a **LOAN TO VALUE RATIO (LTV)**, the value or price is multiplied by this ratio and the resulting number is approximately the potential loan amount that may be available.
- LTV also known as the **ADVANCE RATE**.

Filling in the APOD Form

- A second method of determining the Loan Amount is by using the **DEBT SERVICE COVERAGE RATIO.** In this case the NET OPERATING INCOME figure on Line 30 is divided by a number of 1 or something greater than one, such as 1.2, 1.25 etc., and may go up to 1.5 or even higher. This factor creates a spread of dollars between the NOI on the property, and the funds for the lender's estimated debt service payments. This is a lender's safety cushion.

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Filling in the APOD Form

- The resulting number is the amount of funds available for debt service payments on the mortgage.
- The next step is to find the Mortgage Loan Constant from a financial calculator or Constant Table (interest rate and amortization term). You then divide the payment amount by the Loan Constant and that will tell you the potential loan amount. This is similar to the capitalization process to determine value.

Filling in the APOD Form

- With the loan amount, we place that amount on the Less Mortgages line. After calculating the difference, that give us the number to fill in the Equals Initial Investment for the Owner's Equity needs. This does not take into account any additional monies that may be needed for deferred maintenance, repairs, leasing commissions, etc. that will be performed or incurred before or after the closing date.

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Filling in the APOD Form

- Determining the **CASH on CASH Return**.
- We can determine the CASH on CASH return by taking the CASH FLOW BEFORE TAXES (Line 35) and dividing it by the Initial Investment Amount. That will give a Cash per cent return on the Initial Investment Cash. You can indicate this return on the comment line for Line 35.

Complexity of a Ground Lease

- A Ground Lease expresses the relationship between the land owner (Ground Lessor – fee interest) and the tenant (Ground Lessee – leasehold interest).
- Ground leases are typically long term, may have several options, and are typically absolute net to the parties, meaning the Ground Lessor has no expenses for the property in any way.

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Complexity of a Ground Lease

- If in reading the Ground Lease it is subordinate to the mortgage, then the rent expense is **below the line** and the rent is not considered as an Operating Expense.
- If the Ground Lease is not subordinate to the mortgage (unsubordinated), then the rent expense is an Operating Expense of the property, therefore **above the line**. Treated as a Fixed Expense.
- This impacts the amount of the potential mortgage .

Benefits of Performing the APOD Analysis

- To perform the Analysis, you needed to obtain important property information from the Owner/Seller, or Sellers Agent, if you represent the Buyer.
- By having this information, you can better determine the suitability of the property to sell or to buy given the numbers and supporting documents that are presented to you.

Benefits of Performing the APOD Analysis

- With this information you can present the first three numerical reference points that buyer agents and buyers are looking for in an investment transaction.
- The first number is the **Gross Rent Multiplier**, which is the Value / Price divided by the Potential Rental Income (Line 1). This can be use a brief valuation method or a number used for initial comparison purposes.

Benefits of Performing the APOD Analysis

- The second number is the **Capitalization Rate**. Based upon your market research a Capitalization Rate was determined and used in this analysis to convert income to value.
- The third number is the **Cash on Cash Return**.
- Such numbers can be appropriately used in MLS listings or in the listing agent's marketing materials for the property, or buyer's analysis of one or more properties.

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