BUSI 441 Project 2

Rental Apartment Purchase Business Case

Richard Bryant

3404549

October 15th 2016

**Operating Analysis**

1. Identify Operating Issues

**Legislation/ Code requirements**

The caretakers’ office needs a toilet and a range as per code regulations. The fire doors at the ends of the hallways are being permanently held open when they need to be kept shut to halt the spread of fire as per code requirement. The solid wooden core door at the bottom of the stairwell is not up to code since this will not retard a fire, it will only act as a catalyst. The garage only has one entrance on the north side which is not to code. The tenant of suite 206 has been giving reduced rent as a special treatment for being a friend of the property manager; this is against legislation. Gladys falsely advertises the square footage of some rooms. Gladys also only pays reduced rent of $200 which is a breach of conduct.

Some of Gladys’ actions are negative and cause liability concerns because many of them are unethical.

**Liability Issues**

Sidewalk is dirty and could pose safety issues under the wrong weather conditions. The intercom system is old and it may be hard for tenants to hear who wants in, causing safety concerns. There aren’t any security plates on the main entrance and stairway external locks, creating easy entry to break ins. If the hookups to the absent toilet and range are not properly accounted for this could pose as a safety hazard. The boxes that are piled up in the caretakers could fall on a tenant since it is a public area. Gladys and the company who owns Riverview apartments could become liable for Gladys releasing private information even if by accident and showing the public where cash and work orders are held. The fire doors that are being held open pose a liability threat for the owner and property manager. The stairway is carpeted posing a safety hazard. The light fixtures are directly in the middle of the stairwells, posing a safety concern for tenants moving furniture. The stairwell floor level has a solid core wooden door which causes a fire safety hazard. The valets who park the cars for the benefit of the local restaurant cause a third-party liability issue. The waste container full of the restaurants waste is a liability issue because the restaurant could be putting hazardous materials in there. It is not specified that the heat exchanger is properly guarded, but if it isn’t it should be since it is very hot. The loose floor tiles in the laundry room pose a liability concern. The property manager and owner could be liable for any injury occurring to the neighbors’ child while mowing the lawn on the subject property. There is a boarded window in the storage locker room that is a safety concern to the tenants. The elevator, deemed by the engineer, is in reasonably good condition which is not sufficient enough for the everyday use of the building. There is black mold surrounding the toilet in suite 203, causing safety concerns.

This section addresses all the negative safety concerns that cause a liability. Many of these issues are the result of bad processes and new ones will require higher costs to operate. The current improper maintenance habits will decrease the sustainability of each afflicted building component.

**Environmental**

The laundry room floor tile contains asbestos. Suite 203 has a case of black mold around the base of the toilet.

These negative environmental issues increase liability and sustainability concerns and will not increase the operating costs of the building because they will be just a one-time expense.

**Operations and staffing**

This is an improper amount of staff employed at this rental building because there are obviously jobs like landscaping and cleaning that are not being completed. The property has an improper amount of security personnel because the garage is full of homeless people and there have been multiple reports of mailbox break-ins.

These negative operations processes will increase the buildings operating costs and increase liability concerns if left unaddressed.

**Maintenance**

The outside walkway is cracking, and lifting in spots. Planters are in poor condition. Overgrown bushes are covering some windows and there are mossy and bare patches in the lawn. The exterior paint is 7 years old and fading. Stucco on the exterior of the building is damaged in many areas. Fascia boards are peeling and cracking. Some patios even have moss build up that needs to be repaired. The entry sign is missing letters. There are overgrown plants in the lobby. The caretaker office doesn’t have a toilet nor a range. The caretakers’ office has boxes and garbage piled up. Since the property is in such terrible condition, it is truly surprising that the building has no vacant suites and generally has low vacancy. The corridors have noticeable stains in the carpet. The ceiling is outdated and non-textured and walls are an old light yellow color. The windows are single paned and made out of aluminum; these are outdated designs. Patios are single glazed as well. The main entrance door is aluminum frame and is the older style of singe swing door. The intercom system is outdated and hard to use. The lobby area has an outdated sofa, coffee table with cigarette ashes, and carpet. The caretakers’ office has old yellow shag carpet. The corridors do not have baseboards. The corridors have outdated lighting and frequency of lighting fixtures. The walls are outdated with standard drywall. There is a significant amount of cooking odour and cigarette smell staining the entire interior of the building. Building ventilation is outdated because the fire doors need to be kept open to expel the extra heat. The walls and ceiling in the stairways are a different color than that of the corridors, creating undesirability. There are many marks and gouges in the drywall of the stairways. The lighting in the stairway is dull and outdated. The lighting fixtures in the stairway are directly over the middle of each stairwell which is outdated. The garage is poorly lit and has significant debris laying around, as well as burnt out bulbs. The walls aren’t painted, just bare concrete. The parking surface is uneven and cracking, as well as some concrete curbs; some parts of the parking area need to be paved too. Lighting needs to be installed behind the building. The waste container is overflowing. The concrete floor of the boiler room is black with grime, and is cluttered with garbage. One of the dryers is out of order. The lights in the laundry room are dim, outdated, and one is burnt out. There is asbestos in the floor tile and some of the floor tile is missing and broken in areas. The sink in the laundry room is very dirty. Some lockers are abandoned and full of waste. The storage locker room has a pool table full of garbage as well as some old furniture. There are miscellaneous building components left out on the workbench in the storage locker room. The elevator is not in perfect condition. The elevator interior is outdated, showing wear, and has graffiti in areas. The elevator floor has many gouges from moving tenants. The roof is being used as a storage area for doors and lumber and there is moss growing in these areas as a result. The roof shows evidence of lifting flashing, missing drain covers, leaf and debris build up, and pooling. One common area fan is motor-less and the other is broken. Suite 203 has hot water dripping from the tub taps, rust surrounding the medicine cabinet, and silver backing paint is gone from the mirror. Some of the floor covering is black from moisture. The light diffuser in the medicine cabinet of suite 203 is outdated and shows discoloration. Suite 203 also has an old razor plug receptacle on the wall. The kitchen of suite 203 has a patch of peeling veneer, gouges in the vinyl flooring, and a discolored hood fan. The dining room in suite 203 has discolored carpet and an old light fixture. The exterior of the windows is dirty. The deck has lots of waste covering it. Suite 206 has a bathroom is similarly poor condition as suite 203, except that the sink is the one dripping hot water.

Nearly every item creating a negative effect on the property is riddled with liability issues and will increase the operating costs significantly if the same standards are kept.

**Security**

There isn’t an astragal on the lock to prevent prying it off, nor is there a security plate on the outside of the stairway door. Glady’s should not be showing anyone how she completes deposits, where the cash is kept, or how work orders are tracked. This is a huge security concern because this will promote burglary and the releasing of private information to the public. The building is missing a bunch of safety components or they were not reported on: sprinkler system condition, alarm systems, fire extinguishers, television monitors, motion detectors, radios, and security lighting. It sounds like the garage only has one entrance, from the street level on the north side. The lighting at the back of the building is a security issue. Suite 203 doesn’t have a deadbolt or an eye viewer. All of the doors in the building are the same and so also suffer from this security defect.

These negative security issues create liability in the context of court claims and physical safety. The safety systems that are not properly installed will decrease the sustainability of the building because they are designed to extend the life of the building. These systems will require proper staffing and then will increase operating costs to maintain.

**Marketing**

For rent sign is crooked and without a phone number. The patios need to be monitored more closely to improve curb appeal and ultimately the value of the building and neighboring buildings. The main entrance door is outdated and would improve marketability for new tenants. The entry sign is missing letters and degrades the property’s marketability. The lobby has overgrown plants, old furniture, a cigarette ash tray, and a carpet that is damaged, further degrading the marketability of the lobby for any prospective tenants or visitors. The sign in the caretakers’ office needs to be taken down, and for that matter, this policy is outdated and is currently decreasing the marketability of the property in the market. The marketability is also affected negatively be the cigarette smell and cooking odour of the building interior. Gladys falsely advertises that the larger rooms that are the same layout as suite 213 are 900 square feet when she does not know that actual square footage. All of the exterior repairs that are not completed will remain detractors for the buildings marketability.

Keeping the building at this low standard of marketability is a negative factor on the property and detract from the sustainability of the project through long term revenues. This low standard will also decrease operating costs but at a much higher cost to the owner in the long run.

**Revenue and Expenses**

Parking fees are not being collected. The tenant of suite 206, and the property manager Gladys as well, are paying significantly reduced rent and the building is creating less revenue than it should be.

These are negative factors on the property are keeping operating costs at a higher ratio unnecessarily, and in turn detracting from the buildings sustainability in the long run.

1. Specifying Revenue Opportunities

Enforcing parking fees, increasing rents to the fair market rates for the tenant of suite 206 and Gladys’ suite, keep the building in peak aesthetic condition to be able to increase rents, implement a higher degree of security to drive rents up, improving the maintenance of the building will increase rents and revenue more than the increase of operating costs, adhering to legislation and code regulations will decrease liability and therefore decrease the costs of any future litigation, and the liability concerns discussed above should have proper mitigation strategies as to avoid extremely large court expenses. These are all avenues that will lead to increased revenues for the subject property. Implementing parking fees and fair rent increases are simple strategies that can be actioned immediately for little to no cost. Keeping the building in top condition, creating overall better security and improving the maintenance schedule will have increased operating costs going forward but can be implemented relatively quickly once professionals are hired. Adhering to legislation and code regulations and mitigating all liability concerns will cost the most and take the longest to implement since the building must meet certain requirements. Each of the strategies that are easy or moderately easy to implement will have a high change of success because there are fewer parties involved and they are less complex in nature. Complying with legislation will succeed as long as the correct mindset is kept along this process. Mitigating liability will have the most uncertainty to succeed because we cannot mitigate 100% of the risk, although we can get close.

**Budget Analysis**

1. Evaluating the Operating Income Statements

From reviewing the two-year operating income I’ve noticed many items that are too low.

It is important to note that there have been little to no evidence of expenses that are too high, only items that could have more capital invested in them. First of all, the total suite rent for the current year is higher at $321,840, not $316,000. The current management fees are low at $16,818. Expenses that should be added and that are missing in this category are a higher degree of staffing in terms of security and accounting. Although these expenses will increase costs, it is advisable to include proper training processes, this could include training tenants rather than hiring more expensive out of house labour. Similarly, wages and benefits are low at $45,320. This section is directly related to the last section and will increase from the added labour, but may not increase as much if in house labour is used. In terms of advertising, a missed cost would be controlling risk; if we make sure that we are marketing properly we avoid vacancy costs in the future. Another missing cost is repair controls and proper processes for purchase orders. This cost is important for proper documentation and filing for legal purposes. Correct procurement budgeting is a missed cost from this report and is important to keep purchasing costs to a minimum in the long run. The current intercom expense is low as well at $174, this item needs proper repair or replacement and this cost will not cover it. Elevator maintenance is low at $1,935, the elevator is in need of proper routine maintenance scheduling to be kept in perfect condition. Suite cleaning is very low at $1,286; this cost should be much larger since nearly all the suites and lobby are missing regular maintenance. Carpet cleaning, $852, lighting and cleaning supplies, $798, roof R&M, $345, exterior R&M, $3,915, common area R&M, $1,777, Parking, walks, and driveways, $3,031, Landscaping, $2,444, plumbing R&M, $1,392, suite R&M, $11,325, and painting/plastering/tiling suites, $3,903, are all low costs that should be increased to account for the proper amount of wear and degradation described in the report. All of these costs will be lower if handled early rather than late. Pest control is another missed cost that will increase suite cleaning expenses. Fire service is at $582, this is acceptable but a missed cost is fire prevention. This cost will decrease the chance of extreme costs in the long run from fire damage. The last missed cost is the mortgage payment on the investment property’s loan.

1. Budgeting Repairs and Capital Improvements

To keep the building up to code regulations and complying with legislation, the building will need to account for costs close to $6,000 annually, and an upfront cost of $11,000 to remediate any current issues. The issues that are caused by Gladys’ actions are accounted for in the liability section and will not be considered here. The issues in each section in part 1(a) that are surrounded by significant liability concerns, cannot be forecasted with strong accuracy because these costs could change drastically at any time. Some of these problems, if realized and are a small claims court action, can range from $2,000 to $25,000 in damages. If the issues that involve third party liability are realized, the bill may reach upwards of $50,000 to $1,000,000 in damages. Environmental problems will cost close to $5,000 to remediate, and will cost $3,000 annually thereafter to mitigate against in the future. Operations and staffing issues will cost between $20,000 and $30,000 annually, depending on if we hire in house or out of house labour. Every maintenance problem discussed above, whether it is incurable or curable in nature, the total cost to remediate all of these, including contingency, will be nearly $150,000. All of these issues have some degree of liability surrounding them but this cost has already been accounted for in the section above. The security problems that are maintenance natured will only increase costs by close to $6,000 because they will be a single expense and they will have a relatively long economic life. The security problems that are surrounded by liability, such as Gladys’ actions, are discussed above and not needed to be mentioned again here. Security problems that involve possible damages like burglary should be accounted for in the form of a contingency of $3,000 annually. These problems may completely be mitigated by proper insurance protocol. In total, all marketing problems discussed will cost approximately $4,500 annually, this isn’t including the marketing costs relating to maintenance above. Marketing costs that are also liability problems are accounted for in the liability section above as well. The total of $4,500, will effectively be lower in the long run because proper marketing will increase rents and improve the overall condition of the investment; this cost may even turn into a positive revenue stream. All cost problems associated with revenue and expenses mentioned above are easily implemented and will not cost anything to rectify.

The problems that have been identified above are all cost beneficial, either in the short or long run. Of this investment property, these costs will all be pursued to an marginally effective degree because the investment will become increasingly viable in doing so.

1. Budgeting Revenue Alternatives

Enforcing parking fees will increase revenues by $7,380 annually. This is dependent on a revenue of $15 a month for each of the 41 units. We will implement this strategy since there isn’t a cost associated with implementing it. Increasing rents to the fair market rates for the tenant of suite 206 and Gladys’ suite will increase revenue by $5,940 annually. This will be enforced because the costs to implement are nil. Keeping the building in peak aesthetic condition to be able to increase rents will increase revenues by approximately $19,680 or $29,520, assuming a monthly rent increase of $40 or $60 per unit. This revenue will offset the costs implementing by at least $ 8,000 annually. This is a significant jump in revenue and we will be making sure to utilize it immediately. Implementing a higher degree of security to drive rents up will increase revenues by $3,000 annually because turnover and vacancy will be reduced in the process, therefore we have decided to enforce this as well. Although the cost of hiring this increased security will not be offset by the revenue stream, this process will most likely not be implemented until the increased revenues outweigh the costs. Improving the maintenance of the building will increase rents and revenue more than the increase of operating costs because there will be less problems, decreasing turnover further. The increase will be near $20,000 annually, and the cost will be about $150,000 upfront and $5,000 annually afterward. This strategy will be implemented since it will increase our revenue in the long run significantly. Adhering to legislation and code regulations will decrease liability and therefore decrease the costs of any future litigation, this will increase revenue by approximately $6,000 annually in avoiding these costs, so we will implement this process. Liability concerns mitigated will increase revenue by the capital saved from any of these claims being realized. These liability issues can create costs ranging significantly form $2,000, to $1,000,000. We will always implement mitigation strategies because they will reduce costs the most out of any procedure mentioned above.

**Finalizing the Operating and Capital Budget**

1. Operating Budget: Revenue and Expenses

We used an assumed inflation rate of 2% over the 10-year holding period. Vacancy is estimated at a 1% rate. It is also assumed that all operating expense are increasing at a near mirrored rate of 2% per annum. Damages and other recoveries are estimated at 2% per annum, and increasing along with inflation at 2% per annum. As outlined in our budget notes, limiting conditions are: laundry income is $8 monthly per unit and phone charges for the resident manager are $70 per month, cable costs are $28 monthly per unit. Many of the added insignificant annual revenues are included in the operating budget, these can be seen when looking at what has been added in the first column of the budget.

1. Capital Budget Summary

A capital investment of $166,000 will be need in the fist year to achieve the desired NOI for the rest of the holding period. $150,000 of this amount is in need of financing. NOI will be negative in the first year but will turn positive for the remainder of the term. This maintenance capital expenditure will be fully recouped within the 10-year holding period, in fact it will be made back in the first 4 years. The sale price of the subject property will increase by more than it was offset by this main large scale improvement.

1. Cash Flow Budget

The cash inflows in the first year are pertaining to legislation and code regulations, $11,000, environmental issues, $5,000, and maintenance issues, $150,000. The cash inflow needed to offset the maintenance issues realized in the first year will need to be financed over the holding period. The rest of the capital expenditures in the first year can be paid for without financing. In the second year, an inflow will be needed to setup a contingency for any claims that may arise from the previous property manager; $20,000. This capital expenditure will not need to be financed either.

**Conclusion**

As a result of this report, my recommendations to my investor group is to buy the property, with the correct amount of financing outlined in the budget. The positive cash flows remaining after all expenses and debt service tell us that the property will be a good investment opportunity and the investor group will incur a larger return than was first expected over the holding period. The entire section dedicated to the significant deferred maintenance in this property, capital expenditure being $150,000, will warrant a significant reduction in the purchase price. The discount in this scenario will be near $90,000. The additional cash needed to finance the property is $166,000, and the monthly payment will increase for the first two years upfront, but over the holding period the ongoing expenses will be fully recouped. Financing will increase the cash flow of the investment by more than the capital expenditures that the group will need to service. All of the extra repairs and operating expenses suggested above will be fully recouped, especially with the addition of appreciation.

**Executive Summary**

The operating analysis uncovered all the potential problems with the property. There were many revenue opportunities that we identified to increase profitability. The cost of the problems identified turned out to be higher than expected, but offsetting this were the revenues were increased through identifying revenue alternatives. The net operating income statement gave us a positive stream of cash flows. Capital expenditures were identified and accounted for by reducing the purchase price in our negotiation. Cash flow budgeting confirmed our NOI statement to be a positive stream of cash flows, even after the capital expenditure were accounted for and included in the financing.

There are many problems that need addressing, including: legislation and code requirements, liability, maintenance, security, marketing, environmental, operations and staffing, and revenue and expenses.

The timeframe for implementation is as soon as closing can be arranged, this is contingent on the investor group being in agreement with my report.

The anticipated results are a profitable investment as long as the budgeting and capital expenditure schedule is followed. The positive stream of cash flows was created where there wasn’t one before and will be a good addition to our portfolio.