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EXCLUSIVE

Optimize Hidden Values of Existing MF Properties

By Natalie Dolce | National

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NEWPORT BEACH, CA—"Optimizing value in almost any type of investment requires a systematic approach to both acquiring the asset and then determining the best way to realize the value without compromising the asset's long-term worth." That is according to **Alexander Philips**, CEO and CIO of **TwinRock Partners**.

According to Philips, this is especially true with real estate that has so many moving parts and dimensions. So how do you know when an asset will perform as anticipated and generate the desired returns? Find out in the exclusive column below where Philips takes a closer look at that question and discusses his firm's methodology to first determine whether a property will make a good investment based on certain criteria, and then formulate a course of action to ensure the property will perform as projected.

The views expressed below are the author's own.

SEEKING UNDERVALUED ASSETS

To achieve our investment goals, we are really focused on acquiring and rehabilitating multi-family properties in markets that, based on our research and local contacts, we find especially attractive. Right now these are primarily in Oklahoma markets as well as Milwaukee, Reno, Colorado Springs, and Northwest Arkansas.

These markets are on our radar screen because they are both qualitatively and quantitatively benefiting from the economic recovery—perhaps more than others—with an expanding business base, growing employment, and, due to the largely inactive real estate industry over the past several years, have a lack of for-sale and rental housing. Although we don't live in these areas, we make it our business to know them as thoroughly as our own backyards.

When we look for acquisition candidates, we have specific criteria based on our experience in the investment arena. In addition to local economic conditions, we ask:

- Is the property located within a market area served by retail , schools, parks and other community services as well as convenient job centers?
- Is the asset's acquisition basis impacted by current market or other transitory conditions such as its asset class being temporarily depressed or maybe the property itself is out of favor?
- What is the property's condition and does it have potential for future improvements and value creation beyond its current market status?
- Can the property be rehabilitated or repositioned with reasonable capital improvements to enhance its physical (i.e. esthetic) characteristics or change the use to create new value?
- Is the acquisition price just too good to pass by?

A DEEP ANALYSIS

Whether one is investing, acquiring, developing, renovating, or, most challenging of all, purchasing a property for re-use such as transforming an office building into an apartment or condo building, the purchaser needs to know every aspect of the property as well as the market in which it is located. This is where boots on the ground—whether your own or a local broker or colleague—become critical in making an accurate assessment.

As always, the devil is in the details and our methodology requires us to dig deep into the structure's physical condition as well as the status of current ownership, operating expenses, occupancy rate and history, access to transportation, and competing properties.

Due diligence also includes a thorough property inspection report, lease and file audit, along with professional market research. We leave no stone unturned and take into serious consideration any significant negative factors such as crime on the property. An important part of our vetting process is to review police reports as well as interviews with the local police department, security firms in the area, and local property managers. Crime can be a deal killer.

Each factor, if not properly analyzed in the context of a property's operating performance and intrinsic value, can chip away at the ability to attain the projected Net Operating Income or, in some cases, undermine it altogether. That said, one of the first considerations we take into account in our pro forma analysis, besides the acquisition cost, is whether the property can be upgraded to serve a higher profile market attracting a higher income renter. A 20% increase in rents can make a dramatic difference to the NOI.

When assessing the upside potential of a property, every factor is considered:

- Does the property have good bones and can it benefit from a facelift?
- What renovations/capital improvements will have the most significant impact, item by item?
- What improvements will support an increase in rental income in the least amount of time, such as upgrading selective community amenities and individual units?
- What are the operating costs and are they reasonable for the property? Can they be reduced without compromising quality?
- What is the added value of upgrading and expanding resident services such as concierge?
- What opportunities are there for ancillary income such as telecom, laundry service and vending machines?

CREATING VALUE

In some instances, there may be a unique opportunity to add significant value that goes beyond our own projections when all the investment stars are in alignment. A case in point is our purchase in 2014 of the Coppermill Apartments, a 544-unit apartment complex built in 1978 on 24 acres in Tulsa, OK. Repositioned and now marketed as YaleTowne, it consists of 32 two-story buildings and an office/clubhouse.

Although an older property, it has four key attributes that we found attractive and difficult to replicate: great location in a major urban area, nearby retail and other services, proximity to job centers, and the opportunity for upgrades to create a more upscale rental property and enhanced value.

The site has excellent visibility on a high traffic arterial street in the center of a growing municipal area with a robust economy that has added more than 2,700 jobs to local payrolls in the last 12 months. According to the Bureau of Labor Statistics, the Tulsa Metropolitan Area unemployment rate was 4.3% in May compared to 5.4% a year ago. Dozens of companies added jobs or announced upcoming positions such as Capital One, Hewlett Packard, NORDAM Group, Helmerich & Payne Inc., and Lufthansa Technik Component Services.

Kiplinger also ranked Tulsa No. 5 on its list of the “Top 10 Most Affordable Big Cities in the U.S.” The city was singled out for its low cost of living, which is nearly 12% below the national average, and a per-capita income that is 11.6% higher than the U.S. norm. With these locational, economic and affordability advantages, the former Coppermill property was from our investment perspective a smart acquisitions with a lot upside potential.

After completing our due diligence, we concluded that returns generated by this property would best be achieved with a strategic renovation that would allow us to take advantage of Tulsa’s long-term demand for more upscale rental properties in light of the region’s present and future economic and job growth.

To this end, we retained a new on-site management team with new ideas that designed and implemented a program to renovate and rebrand the property with the goal of generating a higher leasing velocity and gradually increasing rental rates. With this mission clearly understood and embraced by all parties, the property has performed beyond our expectations with 95% occupancy and rents that are well above our pro forma.

TAX ADVANTAGES ADD TO VALUE

Real estate investments also provide opportunities for use of tax incentives such as depreciation that can add to the ROI and long term value of an asset, according to Gabriel Torre, a Tax Partner with Newport Beach, CA – based CPA firm, Squar Milner.

For passive investors such as those who invest in TwinRock funds, depreciation associated with real estate assets can shelter cash flow, resulting in tax deferred income. However, if that isn’t the case – most likely due to higher cash flow resulting from lower leverage -- there are ways to accelerate the depreciation benefits. Accelerated depreciation refers to any one of several methods by which an individual or entity can, for income tax purposes, depreciate a fixed asset such as an apartment building in such a way that the amount of depreciation taken is higher during the early years of an asset’s life in exchange for increased taxable income in later years.

One way to achieve accelerated depreciation benefits in real estate assets is through cost-segregation studies. A cost segregation study identifies and reclassifies personal property assets that are eligible for shorter depreciable lives for income tax purposes, which reduces current income tax obligations. If an investor were to purchase an existing apartment building that is not in need of improvements, a cost segregation study could break out the personal property components and, by doing so, accelerate depreciation benefits.

Personal property components eligible for cost segregation generally include items that may be affixed to the building but do not relate directly to the overall operation and maintenance of the building. These could include a building’s non-structural elements such as furnishings and fixtures, and exterior land improvements. The primary goal of a cost segregation study is to identify all construction-related costs that can be depreciated over a shorter tax life (typically 5, 7 and 15 years) than the depreciation of the building itself , which is 27.5 years for residential real property. Energy efficiency additions such as solar panels and/or more sustainable construction materials can also produce tax credits that flow to investors.

Torre points out that depreciation can be bolstered further when it comes to value-added/rehab properties through bonus depreciation, which means that more than 50% of the taxable basis can be written off through depreciation in the first year. While bonus depreciation is most frequently used for new properties, in the case of rehab properties such as those acquired by TwinRock, shorter lived assets that are added as part of a facelift (not major structural renovations) may be eligible for bonus depreciation.

Whether through tax advantages or beneficial market conditions, our goal is to upgrade and enhance properties such as the former Coppermill Apartments to, as quickly as possible, address the underlying issues that hinder a property’s optimum performance, tap into its intrinsic value, and take full advantage of increasing demand in the marketplace for multi-family opportunities. Our goal at the transformed Coppermill Apartments was fully realized. Now as YaleTowne Apartments, with the community’s 95% occupancy and an average rent increase of 40%, we are confident that the asset’s performance will continue to improve into the foreseeable future, adding a quality apartment property to the local rental marketplace and providing an attractive return to our investors.

About Our Columnist

Natalie Dolce, national executive editor of GlobeSt.com, is responsible for working with editorial staff, freelancers and senior management to help plan the overarching vision that encompasses GlobeSt.com, including short-term and long-term goals for the website, how content integrates through the company's other product lines and the overall quality of content. Previously she served as editor of the West Coast region for GlobeSt.com and *Real Estate Forum*, and was responsible for coverage of news and information pertaining to that vital real estate region. Prior to moving out to the Southern California office, Natalie was Northeast bureau chief, covering New York City for GlobeSt. Dolce's background includes a stint at *InStyle Magazine*, and as managing editor with *New York Press*, an alternative weekly New York City paper. In her career, she has also covered a variety of beats for *M* magazine, *Arthur Frommer's Budget Travel*, FashionLedge.com, *Co-Ed* magazine and the *Daily Orange* newspaper. Dolce has also freelanced for a number of publications, including MSNBC.com and *Museums New York* magazine.

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