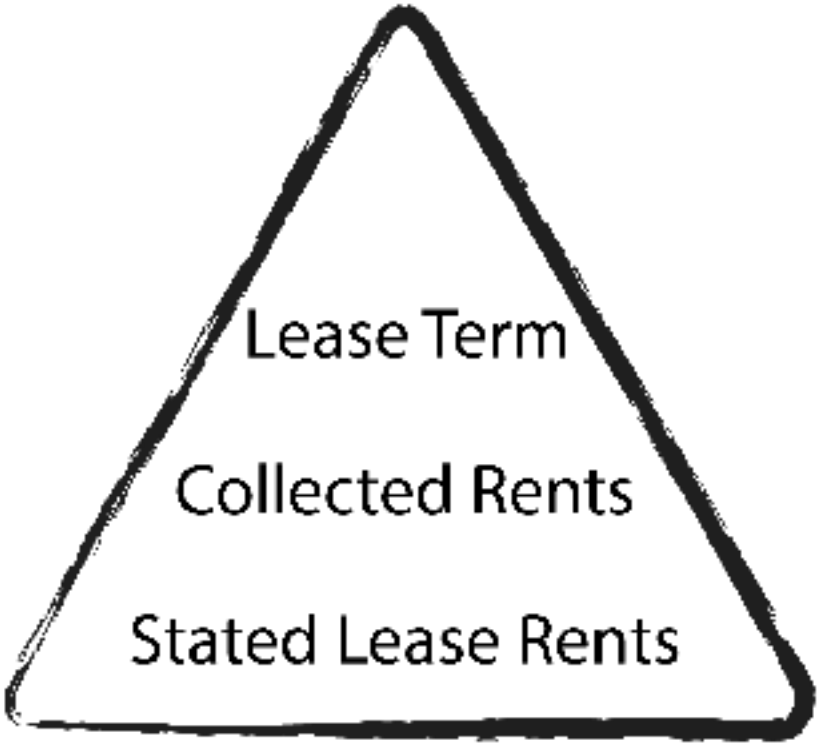
RENT ROLL TRIANGLE

Grade Any Rental Property in Three Easy Steps
Any Rental Property. Anytime. Anywhere.



The Ultimate Rental Property Grading System

A Three-step Do-It-Yourself process to performing Evidence-based Due Diligence of Rental Property Income

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About the Author

This book by John Wilhoit represents an industry standard on how to take rental revenue analysis to the next level. With this simple-to-use tool, you can get to the "first cut" without computing power and hours and hours of analysis. Of course, a serious investor will follow with deep due diligence to validate any initial outputs.

John Wilhoit has a Bachelor of Science in Business Management and a graduate degree in Urban Planning. In this book, John takes you through Rent Roll Triangle systematically. John's approach to rental property analysis is rooted in his 20+ years of experience in asset management and the property management profession.

His perspective is further broadened by experience in the public sector for federal and state agencies and in asset management for a publically-traded real estate investment trust. As an asset manager and owner–operator of apartments, condominiums and townhomes, John has developed his approach by administrating thousands of apartments across the United States from pre-construction through development and lease-up and stabilized operations.

This book is a do-it-yourself version of incredible analytical financial processing power that you can perform on your own with the app, simple pen and paper or a single page spreadsheet. This book will assist investors, owners and managers of rental property in reaching their real estate goals by using Rent Roll Triangle to distinguish strengths and weaknesses at-a-glance allowing more time during due diligence to focus on those areas that impact financial outcomes.

Wouldn't it be great to separate performance of the 90th percentile from the 40th percentile in the first twenty minutes? The ever-true odd thing about this is that in too many instances the price of both deals is about the same!

His blog, Multifamily Insight, provides John's perspective on the world of multifamily acquisitions, management and investing. To subscribe, go to www.multifamilyinsight.net.

John is the author of *How To Read A Rent Roll: A Guide to Understanding Rental Income and Multifamily Insight Volume I, II and III; How to build wealth through buying the right multifamily assets in the right markets*.

You will love John's books and the industry expertise and insight that he shares.

Join the conversation at JohnWilhoit.com for updates, blogs, books and podcast.

Preface

What if you could grade any rental property, anytime, anywhere in three easy steps? How much time would that save you? Like a standardized test, results from applying the concepts found within this book will clearly present rental property income strengths and weaknesses. This is the first step to furthering your knowledge and making improvements to enhance value. Calculating a "snapshot" score using the Rent Roll Triangle formula provides you- the real estate owner, investor, lender, service provider, appraiser, manager- with an immediate starting point with guidance on where to focus your attention to affect improvements in cash flow.

Rent Roll Triangle™ (RRT) emphasizes the powerful interaction between three property specific variables; current rents, or stated rents (from the lease), collected rents (actual collections), and the term of in–place leases (lease term) in predicting strength of income. The outcome produces a grade from 0 to 100%. The higher the percentage, the higher the strength of income.

Introduction

A real estate asset manager, a scientist and a zoologist walk into a bar. The asset manager (that would be me) knows real estate operations and metrics, the scientist knows mathematics and statistics, the zoologist studies patterns in wildlife, many of which are applicable to how investment criteria are formed. The asset manager doodles on the back of a napkin a premise for measuring income elasticity in rental income. The scientist takes the crude math and creates a calculation. The zoologist forms an opinion about how the formula will affect various species (different property types). Rent Roll Triangle (RRT) is born. It's good to have a team!

Discovering the strengths and weaknesses in asset operations with RRT guides you to focus on those areas of operations that most impact revenue and therefore most impact value. Real estate investing is all about compartmentalizing risk. The better you are at this the better your investment decisions. Few people invest their money without a presumed yield in mind. The Rent Roll Triangle™ (RRT) assists in compartmentalizing strengths and weaknesses in rental revenue and identifying areas of concern pre-acquisition. It is an evidence based approach.

The three property specific variables that make up the triangle are:

- Stated Lease Rent (SLR – stated rents per in–force leases)
- Collected Rent (CR – actual collections)
- Lease Term (LT – percent of lease term fulfilled)

Part I – Rent Roll Triangle (Abridged)

What is the Rent Roll Triangle?

Rent Roll Triangle (RRT) is a calculation. RRT is a grading system to determine strength of income based on interactive variables. As an evidence based approach, RRT is inherently about rental revenue. RRT excludes factors related to the age of a property, its condition or location. RRT is a starting point to identify further actions necessary to remedy gaps in revenue between Gross Potential Rent, Stated Lease Rent and Collected Rent.

For the professional real estate investor, for companies with fully staffed due diligence departments and for the full-time investment advisors with server based financial algorithms at their fingertips, the prior paragraph doesn't mean much. Sure, they can add RRT as another layer to they're fully built investment decision-making systems. RRT will have significantly greater impact for investors outside of the realm of those mentioned above.

RRT can be calculated with pen and paper in the five-dollar calculator. It will assist the doctor looking to purchase the Medical office building. It will be of great benefit to the young couple looking to acquire their first commercial real estate asset. It will help the small investor (on deals under $10,000,000) to secure an independent thought process outside of the document box with 500 pages of information with no conclusions about financial validity, rationale or usefulness within those pages.

In Frank Gallinelli's book *What Every Investor Needs to Know About Cash Flow*, you will find a multitude of calculations that are tried and true. What is represented with RRT is just a slightly different view through the prism of real estate investment analysis and due diligence. It doesn't bend the numbers nor attempt to take you astray. It simply asking you to seek and find relevant rental income information and apply it to the property as an apples to apples and oranges to oranges comparison of operational outcomes. Is this a difficult task? It does require earnest research. It does require validating the numbers used the calculation. Tying off the numbers in this way should add a small amount of additional comfort in the due diligence process deployed by both full-time professionals, individuals and family purchasing rental property assets.

Analogous to "Iron Triangle," a term used by political scientists to describe the strong ties between Congress, Bureaucracy, and Interest Groups in the United States in matters of policy, the RRT emphasizes the powerful interaction of gross potential rents, current, or stated rents (from the lease), collected rents (collections), and the term of in–place leases (lease terms) in predicting strength of income. The outcome produces a grade – 0 to 100%. The higher the grade, the higher the strength of income.

Before starting a road trip, the first step is to know where you are on the map. The Rent Roll Triangle™ (RRT) furnishes pinpoint accuracy as to where a rental property is in terms of financial performance and identifies very quickly the areas of concern. With this information, you can focus your attention on remedies that will have the greatest impact on strengthening the financial performance of the asset.

Rent Roll Triangle (RRT) represents a type of sensitivity analysis that anyone can use to assess rental property income. Yes, it's great to have super-computer processing power to grind data into packets the size of sand, yet for everyday use, most people want a solution they can scratch on a single piece of paper or pound out in minutes on a single spreadsheet. RRT offers that solution.

RRT identifies strengths and weakness in rental property revenue. Once known, you can implement fixes to remedy problems and push positive financial outputs. It is not enough to know the areas of concern and leave them untouched. Is an un-cashed check money? Not until it clears, right? The same holds true with RRT; find the money, get the money, put it in the bank. Where is the money? It's in the leases.

A lease and the lease term represent the legal right to collect rental revenue of a certain amount for a certain length of time. Each lease reflects an anticipated amount of income for a set amount of time in exchange for the property owner providing the property in a usable condition to meet the uses described in the lease. The value of any income-producing asset stands in large part on the value attributed to the leases. The money is in the leases.

In commercial real estate, analysts devote a significant amount of time to "sensitivity analysis". This is code for attempting to determine what will happen next…next month, next quarter and next year. Another form of sensitivity analysis is to determine cause and effect. If A occurs what happens to B?

RRT is your road map providing clear outcomes about where an asset stands in real time. It is not, however, a substitute for contemporary forms of financial analysis; it does not take the place of reviewing financials, service and utility invoices or property tax returns. Performing the RRT calculation for each asset in your portfolio generates specific data points as a springboard to next steps: no running in the dark with scissors or guessing where to find financial weaknesses.

Most income property is acquired for long-term ownership; five-years, ten-years, twenty-years, etc. Thus, while it is important to know the current income, it is equally if not more important to understand the viability of the asset and its income stream going forward.

Rent Roll Triangle™ (RRT) is a simple calculation to measure the stability of rental income based on gross potential rent, stated lease rents, collections and lease term.

The higher the percentage the closer the asset is to operating at its maximum financial potential. Rent Roll Triangle™ (RRT) is a measure of rental income stability. It captures the relationship between stated lease rents (SLR), collected rents (CR), and the lease term (LT), measuring performance on a percentage scale from zero to one hundred with one hundred being perfected financial output-maximum revenue.

Although there are four variables, I refer to this as a triangle because three of the measures are property specific. Gross Potential Rent (GPR) is a market–wide measure. GPR is that carrot that keeps the horse moving forward. Seldom does it remain constant as you and competitors in your marketplace attempt to push rents up. Granted, it is a two-edged sword as economic paradigms shift and changes

to the competitive marketplace can place downward pressure on GPR.

The outcome from RRT is the current percentage of maximum rental income the asset can generate as compared to Gross Potential Rent considering the term of the lease.

Rent Roll Triangle™ (RRT) solves the problem of estimating relative stability of income for a rental property. Further scholarly research of RRT, I anticipate, will point to a greater understanding of the relationship between the variables.

With respect to rental income, RRT immediately points to actionable areas of concern.

Components of the Rent Roll Triangle (RRT) are: gross potential rents (GPR), stated lease rents (SLR rent per the terms of in–force lease), collected rents (CR) and term of tenancy (lease term or LT). The individual elements of RRT represent the four variables within the equation. A significant change in any one variable changes the outcome of the calculation and conveys to ownership and management where to focus time and attention to remedy. Big gap between GPR and SL? Find out why and remedy. Big gap between SL and CR? Review credit quality. Short LT? Why and for how long- what is the cause. Find out why and remedy. RRT assist in finding solutions faster by knowing where to look.

RRT localizes rent income problems allowing operators to address the area of concern in real time.

Reaching the number generated by RRT will create more questions. These questions provide further insight about the stability, or quality, of rental income from the application of RRT to rental property. RRT is simply one more method of viewing an income–producing asset. Relying on any single number to determine value is shortsighted. Use caution against overreliance on any one measure including RRT.

The upfront work is in obtaining actual data for use in the equation. As they say, garbage in, garbage out, so the numbers collected for solving RRT must be accurate.

With respect to rental income, RRT points to actionable areas of concern. RRT localizes rental income problems allowing you to identify issues in real time. How? By interlocking the four variables and highlighting the disparities between them. For example:

- By identifying a significant gap between Gross Potential Rent (GPR) and stated lease rents (SLR). If SLR is far below GPR one question to ask is if this differential is market–wide or property specific? If market–wide, then this knowledge allows you to form competitive concessions to compete more effectively.
- If SLR (actual rents per the lease) are well below GPR, then the issue might be simple mismanagement. Perhaps current management or ownership doesn't care. Perhaps rents are low because the property cannot effectively compete due to its current physical

condition.

- Assuming collections (Collected Rent) are an issue, you know this is directly linked to resident underwriting.
- Identification of leases where residents are departing prior to their lease term expiring. This problem could relate to resident screening or how management handles maintenance. The problem could be that management has dozens of unanswered maintenance calls. Or, the issue could be a wildly competitive market with neighboring properties cannibalizing each other just to capture any incremental occupancy increases.

On the revenue side, narrowing the discussion to factors that most affect rental income allows you to cut to the problem area early in your review and see what's under the hood. Will the patient respond to treatment? Do you have the right team to administer treatment given your yield requirements and expertise? Do you want to perform this treatment or move on to another property with greater profit potential?

RRT is a starting point to identify further actions necessary to remedy gaps in revenue between GPR, SLR and CR. RRT does not consider physical property attributes, age, deferred maintenance, traffic counts or new competition entering the marketplace. While these are of consideration by the serious investor, the calculation is void of any representation about such. At the same time, a lower score versus a higher score will invariably tie back into the condition of the asset and its apparent competition within the market are where the asset competes.

Many assets will be shooting towards attaining a higher RRT score from a current operational stanza that will benefit from professional property management and implementing actions that drive revenue. For assets with scores nearing 100% the RRT representation is that the asset is near maximum revenue potential <u>as the asset is presently operated</u>. Changes to operational strategy, which in turn changes GPR, requires a new RRT calculation taking into consideration the new operational persona. A warehouse turned nightclub, a parking lot turned weekend market, a regional mall shuttering its food court for five specialty hi-end restaurants and bars… have all reset GPR for the asset.