

Turning Trailer Courts into Communities (Part 2)

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In Part 1, we talked about some of the things that make manufactured home communities ideal investments and the different types of communities we're liable to run into. Now let's look at placing a value on them.

Show me the cash flow!

As with any income property, the primary thing that determines a manufactured home community's value is its cash flow, or lack thereof. We want to be able to be driving by a potential acquisition and by getting some basic information and doing some quick, easy calculations, determine if we'd like to take a closer look.

Without getting too technical just yet, think of an income producing property like a CD for sale down at your friendly bank. For example, let's say we go to the bank and pay \$10,000 to "invest" in a CD. The bank is really giving us a deal and will pay us a whopping 5 % if we act fast and lock in the rate for 12 months, so we go ahead and do the deal. Now at the end of the 12 months, the bank pays us \$500. How did the bank know what to pay us? They multiplied the amount invested, (\$10,000) by the interest rate, (5% or .05) and came up with \$500.

What if we needed to generate \$500 this year and knew the bank would pay 5 %, could we figure out how much we'd need to put in the bank to generate the \$500? Sure we could. We just use the inverse of multiplication, division. (See you did learn something useful in school!) In this case we would divide the desired income, \$500 by the rate of 5% and we'd get \$10,000.

If we look at the math involved, we could say the same thing algebraically by remembering our old buddy I R V, Where

I = Income

R = Rate of return

V = Value of the investment

Let's apply an income property to the CD example above. First, we would substitute V for the CD, I for the \$500 and R for the 5%. Thus we could say that an income property that produced \$500 of I was basically worth \$10,000 of V at an R of 5%. Pick some numbers yourself and play around with them. Practice solving for each variable, write it out on a pad of paper as you do it using the formulas above, to help you visualize the relationships between the numbers. Pay attention to what happens to V when you raise R, or lower I. In this example if we needed a 10 % return, the value of the \$500 cash flow would drop from \$10,000 to \$5,000. If we lowered R to 3%, the value of the \$500 cash flow raises to \$16,667!

Of course there are many things we need to take into consideration besides cash flow when valuing an income property, many of which will help us determine what the R in IRV should be, but for now let's just focus on the basic cash flow equation. Now that we understand IRV, it's time to learn about IRV's friend NOI, which stands for Net Operating Income. This is the "I" we are interested in determining to plug into IRV. It's the amount of cash flow a property produces before any debt service is paid. As you probably guessed, there's a formula to get to NOI as well:

$$\text{Gross Income} - \text{Vacancy} - \text{Expenses} = \text{Net Operating Income (NOI)}$$

Here's an example using a 50 site community:

Sites	Site Rent	Monthly Income	X 12 =	
50	\$100	\$5,000	\$60,000	Gross Annual Income
		\$500	\$6,000	Less Vacancy @ 10 %
		\$1,750	\$21,000	Less Operating Expenses @ 35% of Gross Income
		\$2,750	\$33,000	Annual NOI (Net Operating Income)

Lets take a closer look at each line of this formula.

Gross Annual Income

This is the part that can get tricky when valuing smaller communities. Many times the owner will have added additional revenue sources over the years such as rental mobile homes, mini-storage, laundry, etc. To value the income produced by the community, only use the current (never projected) site rent when determining the gross income. If you must also purchase the other assets, value them separately and add them to the value of the community itself.

Many owners and RE Agents use all income sources when figuring the Gross, which can severely distort the value of the property. Let's look at a rental mobile home for example. In our area we can buy a nice used 2 bedroom 1 bath and get it ready to rent for \$8,500 or less. It will rent for \$550 per month, giving us a gross of \$6,600. For illustration purposes, say that our NOI was \$5,000 and that we were looking for a 10% yield from these investments. Using IRV to find out the value suggested by the cash flow, we divide \$5,000 by 10% and get \$50,000! For an \$8,500 mobile home! Can you see how you'd be making a BIG mistake if you purchased a community, which included the income from a bunch of rental units? HELLO?

Another area to look out for is such items as late fees, etc. Do not include these in your calculations, those are not constant. You are buying the community for the revenue produced by the sites, so use that income only as your starting point and add in any thing else you may have to purchase such as homes, etc. on a case by case basis.

Vacancy

Even if the property is 100% occupied, prudence dictates that we should expect not to receive 100% of the income every year. Depending on the strength of the local market, we should always subtract 3 to 10% of the Gross Possible Annual income to give our numbers a margin of safety. If you are looking at a property that has high vacancy, I suggest adding 3-10% to whatever the actual number is and using that. Say it's 50%, I'd probably use 60% when doing my calculations. This will lower the NOI to give you an accurate picture of what's happening today, and since we are paying for income, if a space is vacant, we aren't interested in paying too much for it. This comes into play later as we formulate our offer.

Expenses

This area is very subjective, though it is usually safe when doing your initial rough calculations to figure that a normally operating manufactured home land lease community will have expenses running in the 30-40% range. This will be determined by such things as the types of amenities, landscaping, size and location of community, type of utilities, construction, employees, and many other variables. The only way to accurately tell is to review several years of invoices, bank statements and even tax returns. When in doubt, it's safer to err on the high side.

Net Operating Income

This is what all the fuss is about! Basically, our goal is to purchase the property based on it's current NOI. This is where we take a hard look at the income and expenses to see what we can do different than the present owners to raise the NOI. Where's the upside? How can we put something together that will work for both parties?

What's this thing called a CAP rate?

CAP rate stands for Capitalization rate. It's the same as the R in IRV, but said a little bit differently. What is R (return) anyway? It means different things to different investors, but basically it's a measure of how hard your capital is working for you, and just one of the ways we can use to evaluate alternative investment opportunities. This is where we start to think about risk versus reward.

Normally, we want to be compensated commensurate with the amount of work and effort involved with a project. Is this a property we are going to have to put a lot of time, money and talent into? If so we should expect a higher rate of return. Maybe it's a trophy property with no problems. Are we willing to accept a lower return in exchange for little or no hassle and low or no risk?

How then does one go about determining a CAP rate? It's instructive to understand how our credit markets work, however that is beyond the scope of this article. In many cases, investors look at their options for putting their money to work and, as we said earlier, they will need a way to compare alternatives. The answer boils down to what we have a choice of putting our capital to work in and how hard we expect it to work. By doing some investigation, we can find out what kinds of rates other investors are expecting for different types and grades of properties. By looking to see what one of those trophy properties is selling for, we can start to see the low range of returns where we might be working. In areas of high desirability, such as the sun belts, some of these properties sell in the range of 7-9 % cap rates. This means a property with an NOI of say \$100,000 would fetch \$1,111,000 at a 9% cap and \$1,428,571 at a 7% cap. Remember the inverse relationship between R & V? Higher Rates of return mean lower values.

Keeping in our niche of smaller communities, we probably won't be looking at the trophy properties out there, so how do we determine a Cap rate for the property we are looking at? My rule of thumb is to start out at 10% and see if the property makes sense at that number. This \$100,000 NOI is worth \$1,000,000 at 10%. We need to "run the numbers," based on what we expect to see and then play around to see what make sense to us. Even though the cash flow may be the same, a property that requires a lot of work should be worth less than one that needs little or nothing. For example, what if you found a community with the same \$100,000 NOI as before, but it was 30% vacant, and required new sewer pipes, new roads and new residents? You look at it and decide that you won't work for anything less than 20% return on your investment. At that point, the \$100,000 NOI might be worth \$500,000 to you.

Next time, we'll pull it all together and look at several different examples and approaches to valuing these types of investments.

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