

Turning Trailer Courts into Communities (Part 3)

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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. In Part 2, we discussed how community values are determined using the income valuation approach, how the NOI, (Net Operating Income) is arrived at, and the basic premise behind the Cap (capitalization) Rates.

In this article, let's use some of the knowledge we've gleaned and look at how we might approach the valuation of a potential acquisition. In keeping with the title of this article, let's look at the type of community many of us are likely to encounter when we first start out, the *Turnaround Challenge*.

We'll use the example given in Part 2 to come up with some ideas about value. NOTE: Most of the following observations apply not only to turn-around properties but to *any* Manufactured Home Community under consideration.

Purchasing a property can be compared to getting married. We start looking and, when we find something we are interested in, we play the "Dating Game" where we investigate and evaluate the candidate (option and due diligence). If all goes well, then we get to the serious negotiations to get engaged (purchase agreement) and eventually, we get married (closing).

The Dating Game--Investigate and evaluate

Using the numbers from the 50 site example given in Part 2, let's set the stage and expand the discussion. Let's say we are out cruising the speed bumps for our next "Lonnie Deal," and we find out that the community is for sale. It's located in an OK area of town, the streets are paved but do not have curbs. Most of the houses are older, and the spaces are 45' x 90'. Each space has it's own meter for natural gas and electric, and the water and sewer is supplied by the city. There are no amenities, and there are several vacant home sites and a few homes that look vacant.

After locating and visiting with the current owners, we find out they have owned it for 20 years, the kids are grown and moved away and, since papa got sick several years back, they just haven't been able to watch over the place like they used to. (No wonder the place looks shabby you think to yourself.)

As you start asking them questions, you ask, "Why are you selling?" They tell you that now just seems like a good time to get out of the business, relax, and maybe do some traveling. Without prompting, they tell you they think it's worth \$400,000. (Wonder who told them that, the barber?) To which we reply, "How'd you get that number?" (After flinching of course.) They change the subject.

As you walk around with them, the condition of most of the homes and home sites indicate many residents have been there for some time. The owner tells you the rents haven't been raised for the last couple of years, and several residents are seriously behind on their rent payments. You are also able to find out the property has a first mortgage on it of about \$100,000 at a small local bank. They say they bought it from the original developer, who built it ten years before they bought it. They don't have much in the way of books or records for you to look at and, though they haven't said anything, it's easy to see they haven't spent much on capital improvements since they've owned the property. They do give you a list of the residents and how much each pays and what the park is currently paying for taxes, insurance, water, sewer and trash, etc. We find out the park has one master meter for water, and each resident pays his or her gas & electric directly.

Crunching the numbers

After leaving, you do a quick analysis as you sit in your car in the Burger King parking lot. Its important to note that when "crunching the numbers" to come up with an offering price, we must always use the current income and expense numbers, as many times the owner or their broker will give us numbers reflecting what the property should, or could, produce. In addition, we usually must add in what we assume will be an average number for vacancy and credit loss, as most owners and brokers neglect to include these numbers. We can get a pretty good idea of what it should be by doing a market survey and reviewing the owner's bank records and comparing what was actually deposited to what could have been deposited. After doing the numbers in our example, here's what we come up with:

Sites	Site Rent	Monthly	X 12 =	
50	\$100	\$5,000.00	\$60,000	Gross Annual Income
		\$500.00	\$6,000	Less Vacancy/ Credit (Actual)
		\$1,750	\$21,000	Less Operating Expenses
		\$2,750	\$33,000	Annual NOI (Net Operating Income)

Determining value and upside potential

In this example, our figuring produces an NOI of \$33,000. Next, using this NOI, I like to figure a value based on three cap rates to get an idea of what the range *could* be. Knowing that many investors would pay a price based on a return as low as 8%, cap the \$33,000 and arrive at a possible value of \$412,500 (\$8,250 per site). (This is close to what the owner is asking!) Since we also know that these investors are usually looking for communities of 200 sites or more in excellent condition, it's safe to say this is not an appropriate cap rate for this property.

Next, figure the value based on 10%, and come up with a possible value of \$330,000 (\$6,600 per site). (You may hear the 10% is a rule of thumb, this is because it's very easy to do the math in your head.) Lastly, figuring a value using 12% you arrive at \$275,000 (\$5,500 per site). You think to yourself that this is where I should start negotiations, and perhaps even subtract from this number the amount we can show is needed for capital improvements.

Valuation at Various CAP Rates

NOI	Cap Rate	Value	\$ per Unit
\$33,000	8.0%	\$412,500	\$8,250
\$33,000	10.0%	\$330,000	\$6,600
\$33,000	12.0%	\$275,000	\$5,500

You decide to wait and see how your conversation goes later with the seller and what kinds of terms you can arrange, before assuming a position on the price. Now, as you finish up the rest of your Whopper®, you grab the phone book from the back seat and start calling around to the other local communities. After visiting with several of them, and then driving over for a visit, you determine that their average rent is \$165, they don't include water, sewer or trash in the rent, and their vacancy rates have been running 5-10% but have started to tighten up the last several months. You then call a few dealers and ask them how sales have been, what kinds of homes are selling, and what the demand is for community spaces. They reply that sales are up, demand is good for community spaces and it's getting harder to find them. Now we run a quick "what if" by raising the rent to \$150, which is still under market, and increasing the expenses to account for what we think will need to be spent on the community in terms of deferred maintenance, and whatever else we plan on doing.

In this example we've figured it's going to be at least \$1,000 per month in additional expenditures to get the property where we want to be over the next 4-5 years.

Sites	Site Rent	Monthly	X 12 =	
50	\$150	\$7,500.00	\$90,000	Gross Annual Income
		\$750.00	\$9,000	Less Vacancy/ Credit (Actual)
		\$2,625	\$33,000	Less Operating Expenses
		\$4,125	\$48,000	Annual NOI (Net Operating Income)

Valuation at Various CAP Rates

NOI	Cap Rate	Value	\$ per Unit
\$33,000	8.0%	\$618,750	\$8,250
\$33,000	10.0%	\$495,000	\$6,600
\$33,000	12.0%	\$412,500	\$5,500

Based on your quick run down, you feel there is enough potential here for you to investigate further. This shows that if we buy at \$275,000, raise the rents, and make the improvements we've thought about, we can increase the value of the property to \$412,000, which is an increase of \$137,500! (Or more if we were to sell to someone at a lower cap rate.) Thinking back to our market survey, we remember that most communities are not including water, sewer and trash in the rent, while still charging more that we intend to! Perhaps by installing meters on each house, and charging for the water, sewer and trash instead of increasing the rent over the next few years, we can further increase the cash flow and hence value of this place!

Results of Improving the Cash Flow

Cap Rate	"Original" Indicated Value	"New" Indicated Value	Increase In Value
8.0%	\$412,500	\$618,750	\$206,250
10.0%	\$330,000	\$495,000	\$165,000
12.0%	\$275,000	\$412,500	\$137,500

What happens many times is a buyer can buy a property like this at a *high* CAP rate, improve the property and the cash flow, then sell it at a *lower* cap rate based on the *higher* NOI! As an example, say we bought at the 12% cap in this example for \$275,000, then sold it at an 8% cap rate for \$618,750. That would be a hypothetical profit of \$343,750!!! (Note: It's unusual to get that much of a spread in cap rates, however, it can be done)

Negotiating the Deal

You go back to visit with the owners again, and after some initial discussions regarding their needs now and in the future, you let them know where you are at. You tell them that you are concerned that the community may soon need major improvements to replace the 30 year old infrastructure and that, no offense, but to compete with the other communities, the property needs work (they already know this) to bring it back to the shape you are sure it would be in if things had been different for them. You point out the rough condition of the streets, which will need to be resurfaced, and in some areas cut out and replaced. The individual mailboxes are going to need to be replaced with new UMBS (Centralized boxes). The entire park needs landscaping, and you haven't even started in on the cost of eventually upgrading or replacing the electrical boxes, the water and or the sewer lines.

As all of these items begin to sink into the owner's brain, you point out that the value they were asking is not realistic based on how the property is currently operating, and can show them using their own bank statements. We remind them we are buying *current* cash flow, not opportunity. With these things on the table, you tell them you are interested enough to take a closer look at the property and that you are willing to pay them \$500 (or whatever you can get away with) for a 60-day option to purchase the property, provided it meets with your approval after you have done your research. Knowing your personal situation as regards to cash, and the sellers needs (they do need some cash now, but are receptive to steady monthly payments), you propose that should everything meet your approval, that the transaction be structured as follows:

Sales price: \$275,000 Down payment \$25,000

Existing loan \$100,000 Pmt. \$1,213/mo 8% 10 Years Left

Seller carry \$150,000 Pmt. \$1,000/mo 8% Years 1 & 2, up the Payment to \$1,250/mo 8% Years 3 & 4, then up it again to \$1,500/mo 8% Years 5 - 12

Based on this offer, this is the cash flow for the first two years before you work to improve it:

NOI \$33,000

First mortgage debt service: \$14,560

Proposed seller debt service: \$12,000

Cash flow after debt service \$6,440

Your cash on cash return in this scenario is 25.76 % ($\$6,440 / \$25,000$ down payment)

You discuss with them that since they are willing to be flexible with you on the terms, you are willing to flex some on the price, but that it must be based on the property's current income, as is, and considering what all needs to be done, you feel that \$275,000 is a fair price. You also point out to the seller that they currently are not spending anything on capital improvements and maintenance, and after they pay their mortgage, they are netting about \$1,500 a month. Since you are now going to be doing the doing the work and will need to do some fix up, you would like to net at least \$500 each month, so you will send them \$1,000 until you can get some of the work done. Then you will raise the amount so that within a few years they are getting the same amount they get now, but without any of the work and hassle.

You also point out that since you will be working on the property, you will be improving the collateral for their note. Collateral they know and understand since they've owned it for 20 years.

Let's assume that the sellers agree to the price and terms, but want to be assured that the kids won't be bothered by having to get the place back someday if we default, as they just aren't too interested in it. We suggest one solution is to use an agreement for deed, or real estate contract, and using an escrow service to collect the payments. That way the bank gets paid and they get paid, and we don't get the deed until it's paid it off. They check with their advisor who agrees that this will be ok. We now have the attorney draw up an option and give the seller the \$500 (or whatever we can get away with). Now that the option is signed, we have 60 days to go do our due diligence. Of course we could always skip the option and sign a purchase agreement with enough contingencies in it to make it act just like an option, without the consideration fee.

In Part 4, we'll discuss all the particulars of "due diligence."

Doug Ottersberg, ACM, MHM, is a private investor focusing on affordable housing, primarily Manufactured Housing Communities, renting and financing manufactured homes and land. He serves on the New Mexico Manufactured Housing Association Board of Directors as a Community Representative where he is involved in educating Community members and assisting the Association's lobbying efforts on behalf of the industry. He also volunteers in the local school system as a Mentor teaching financial literacy. Doug and his wife Ana decided that if Real Estate Investing didn't work where they lived that the best thing to do was quit their jobs and move. They have been happily unemployed ever since.

For more information visit:

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