

Is your portfolio working as hard as it could be?

When our income properties are chugging along, it's easy to miss opportunities to improve the total overall performance. However, the combined effects of rent increases, debt reduction, depreciation and the specific financing terms at acquisition generally conspire to reduce the return on equity after a certain number of years. Without a regular review, you'll miss optimization opportunities.

The accompanying chart illustrates these effects, and the procedure to improve the return on equity of your portfolio. To start, we'll assume a 3-property portfolio acquired 5 years ago for a total of \$9M, 70% LTV, using the then-prevailing cap rates and interest rates. We further assume a 2.5% annual net income growth in the subsequent 5 years.

	Property 1	Property 2	Property 3	Total	
purchase price	\$2,000,000	\$3,000,000	\$4,000,000	\$9,000,000	
original equity	\$600,000	\$900,000	\$1,200,000	\$2,700,000	
original loan	\$1,400,000	\$2,100,000	\$2,800,000	\$6,300,000	
original interest rate	6.80%	7.10%	7.30%		
original cap rate	7.80%	8.00%	8.20%		
original NOI	\$156,000	\$240,000	\$328,000	\$724,000	
original debt service	(\$109,523)	(\$169,352)	(\$230,352)	(\$509,227)	ROE
original CFBT	\$46,477	\$70,648	\$97,648	\$214,773	7.95%

Five years later, evaluating these properties at today's cap rates, and the 13% total income growth, we note many positive effects. The annual income has grown from \$214k to \$310k. Using today's cap rates with that new income, the value grew from \$9M to \$11.6M. In addition, we've paid down the debt by \$360k. Our effective LTV is now only 51%, down from 70%.

	Property 1	Property 2	Property 3	Total	
NOI	\$176,500	\$271,538	\$371,102	\$819,140	
new cap rate	6.80%	7.00%	7.20%		
property value	\$2,595,584	\$3,879,114	\$5,154,193	\$11,628,890	
loan balances	\$1,314,986	\$1,978,861	\$2,643,961	\$5,937,809	
equity	\$1,280,597	\$1,900,252	\$2,510,232	\$5,691,081	
LTV	50.66%	51.01%	51.30%	51.06%	ROE
CFBT	\$66,976	\$102,186	\$140,750	\$309,912	5.45%

The big downside is the reduction in return on equity (ROE) from 7.95% to 5.95%. Our money is not working nearly as hard as it used to. What to do?

It is an easy and straightforward process to refinance the existing debt on the portfolio, and use the cash out to purchase additional property. Using today's typical rates, and keeping a conservative 70% LTV, we can pull out an astonishing \$2.2M in cash.

	Property 1	Property 2	Property 3	Total
new LTV	70%	70%	70%	
new loan	\$1,816,908	\$2,715,380	\$3,607,935	\$8,140,223
new interest rate	6.00%	6.50%	6.70%	
debt service	(\$130,719)	(\$205,957)	(\$279,375)	(\$616,051)
new CFBT	\$45,780	\$65,581	\$91,727	\$203,089
cash out (new loan-payoff)	\$501,922	\$736,518	\$963,974	\$2,202,414

Using that \$2.2M in equity, we add additional property to our portfolio (up to \$7.3M value at 70% LTV) Remember, we started out 5 years ago with a \$9M portfolio! This additional property adds \$568k in NOI. Accounting for the larger debt service from the refinanced original properties, the result is a net increase of \$76k to our portfolio income, an increase of 25%!

New Property

equity	\$2,202,414		new property cap	7.75%	
new LTV	70%		new prop interest rate	6.40%	
purchase price	\$7,341,381		new loan term	30	
loan	\$5,138,967				
debt service	(\$385,734)				
NOI	\$568,957				
CFBT	\$183,223				
total portfolio NOI	\$386,312		Increase of	\$76,399	25%
ROE	6.79%				

Conclusion:

If you have a number of properties in your portfolio which have not been re-evaluated in a few years, this may be an excellent time to do so- cap rates are still near their historical lows, borrowing costs are not much changed (the treasury has dropped but spreads have widened, for a negligible net change.) I would be happy to assist in an evaluation and potential new acquisitions.