Modeling Multifamily Potential Rental Income

Using Actual Rents versus Applying 100% Market Rents with Loss-to-Lease

Introduction

The Freddie Mac requirement is that the appraiser produce an adequately supported estimate of the as-is market value of the subject property.[1] Modeling rental income at 100% market rents is not the correct method, even with an arbitrary/non-supported estimate of loss-to-lease, since a property typically never achieve market rents for 100% of their units because:

- Leases begin and end over the course of the year, typically with 12-month terms.
- In an increasing or decreasing market, the originally signed leases may or may not represent current market leasing.
- In many markets, the property manager has incentive to renew leases at an amount lower than current market rents to avoid a vacant space and its paint/cleaning expenses if it that tenant vacates.
- Tenants who have renewed over several years might now be leasing at rents materially below current market rents, and no expectation of vacating.

For a Freddie Mac Multifamily appraisal of a property at stabilized operations, the appropriate estimate of Potential Gross Income (PGI) and Effective Gross Income (EGI) is to model the existing rent roll plus any vacate units at market rent, not 100% market rents — this is a reasonable reflection of the as-is operations of the subject property.

If the appraiser believes that a potential buyer or operator would consider something other than continuation of current leasing levels, the report must provide detail of those expectations with adequate support of those assumptions. This methodology is cleaner, easier to explain, and typically represents how property managers and buyers model their annual operational budgets.

Freddie Mac Appraisal Requirements

Section 60.2 of the *Freddie Mac Multifamily Seller/Servicer Guide* (Guide): “Appraisals must estimate the as-is leased fee market value of the Property.”

Then, Section 60.14c of the Guide states:

> *The appraiser must derive the value indicated by the income approach by considering the following economic factors:*
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> 1. *The forecasted gross income must consider historical rents of the Property, current rents of the Property and rents currently obtained from comparable units (similar in amenities, location, size, type, style, and quality) adjusted for market concessions, rent abatements, discounts and the like.*

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[1] Section 60.2 of the *Freddie Mac Multifamily Seller/Servicer Guide* (Guide): “Appraisals must estimate the as-is leased fee market value of the Property.”

The influence and limitations of rent control, rental concessions, historical trends, and other relevant factors must be reviewed and analyzed relative to the forecasted gross income of the Property.

The appraiser must analyze and discuss the difference, if any, between the Property's actual recent contract rents and the appraiser's estimate of the Property's market rents, and their impact on the leased fee value of the Property. If the appraiser's estimate of market rent is dissimilar to the recent leasing at the Property, the appraiser must provide an adequate discussion and explanation of the variance.

So, if the appraiser is using 100% market rents to estimate their potential rental income, they are not in compliance with these sections of the Guide since 100% market rents ignores the financial status of the current rent roll and is not "As-Is", but some hypothetical operational expectation.

Appraisal Background and Methodology

In the Income Approach for a multifamily property at stabilized operations, the appraiser is to model the rents that a potential buyer would expect to receive over the next 12 months[2]. This is inherent in the definition of Market Value that assumes a sale of a property on the date of value.[3] So, for the 12 months after the date of value, a property manager would expect to receive:

- Rents from current tenants subject to lease terms, as shown on the rent roll
- Market rents from currently vacant units

There is a probability that each tenant might either move out or might roll over at the end of its lease term [4]so at lease expiration for current tenants, the tenant can:

- Renew:
    - At market rent, or
    - At their current rent, or
    - At some point between their current rent and market rents, or
    - At a lower rent
- Move out
    - If the tenant moves out, there will be a period of zero rent collected for that unit, **plus**
    - There is a potential additional cost to management for unit clean-up, paint, repairs, carpet cleaning, etc., to get the unit ready for the next tenant

Many property managers and buyers model their annual operational budgets based on the current rent roll plus some consideration of which tenants might move out, which might stay and whether they offer a renewing tenant a new lease at something other than current market rent. Typically, operating budgets are based on realistic expectation of rent collections, not on a scenario of achieving 100% market rents.[5]

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[2] For a stabilized property, the next 12 months of income and expenses are the equivalent of operations into perpetuity.
[3] Guide Section 60.3, "Market Value Definition"
[4] This is the lease renewal rate or the tenant retention rate.
[5] Typically, property managers' compensation is tied to their success at meeting operating budgets, so it is in their interest to provide ownership with a realistic picture of property operations, not a hypothetical attempt to achieve 100% market rents.

If then, the appraiser models the PGR as 100% market rents, they are not modeling the reality of rent collections at that property for the next 12 months and they ignore/overlook the actual income to be received by property management. They are modeling a hypothetical property, not the property that is in front of them.

A rent roll with 100% market rents is typically never achievable for a stabilized multifamily property so if the appraiser develops their income scenario based on 100% market rents, they have incorporated a Hypothetical Condition into their analysis which, by definition, is not an As-Is estimate of market value and is not in compliance with the Guide. Other indications demonstrating the error of applying 100% market rents:

- A multifamily property's rent roll will typically always have older leases that do not reflect market rent but cannot be re-negotiated until expiration
    - Even though these are short-term leases, the appraiser cannot "wish them away", pretend that they do not exist, and then model PGI at market rents. That is an analysis of a hypothetical situation, not the as-is status of the subject property
- If the appraiser models 100% market rents, they also must consider any additional vacancy resulting from increasing rents on existing tenants. Some longer-term tenants who have benefited from less-than-market lease renewals will balk at being asked to pay materially higher rents so there might be additional vacancy and lease-up time when/if these tenants vacate
    - This additional vacancy might require the owner to spend more on marketing and repairs/painting on units that otherwise would have been re-leased to the existing tenant
- A potential increase in property taxes as the local assessor re-evaluates the property's operations at the higher rents
- A greater investment risk (i.e., capitalization rate) to account for the uncertainties of the change from existing rents to a more aggressive leasing plan of 100% market rents

Loss-to-Lease is an Incorrect Methodology

Appraisers use the concept of loss-to-lease to try to account for the phenomenon that the appraiser's estimate of market rent is different than (i.e., higher) the subject property's actual rent roll leases.[6] In this concept, the appraiser believes that the subject could/should/would achieve 100% market rents but, however, this is not a credible assumption for multifamily properties since typically there will always be a differential between the income from totaling the rent roll and the appraiser's 100% market rent.

This methodology or thought process is a hold-over from the appraisal of office, retail or industrial property where the appraiser is trying to tie the subject's rent rolls with multiyear leases to their estimate of current market rent. However, this methodology does not apply to the valuation of multifamily property since an apartment rent roll might have tens or hundreds of tenants with a continual/ongoing flow/rotation of lease commencement and expiration dates.

It is a natural, operational expectation for a multifamily property that it will have ongoing tenant commencement, retention and lease expirations so, as such, the rent roll will never mirror 100% market rents.

[6] The concept of loss-to-lease is only taught briefly in the Income Capitalization course of The Appraisal Institute as "deficit rent". Loss-to-lease is a poor name for this concept and maybe an even better name for this concept that provides more clarity to the phenomenon would be "Rent Roll Differential".

Solution

If the appraiser's PGI already considers the lease terms of the current rent roll (i.e., actual rents instead of 100% market rents), there is no need for any loss-to-lease adjustment. This is the methodology that meets the Guide requirements for an As-Is estimate of market value.