



Loss-to-Lease for Multifamily Properties

- Loss-to-lease in a multifamily property is the difference between 100% market rents and the actual leasing of the subject.
 - There is not an industry standard way of accounting for or analyzing loss-to-lease but there needs to be a mechanism for adjusting the appraiser’s 100% market rent scenario to a more realistic estimate of potential gross income (PGI) for the subsequent twelve-month proforma.
 - 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 loss-to-lease and no need for any loss-to-lease adjustment.
 - A value that assumes 100% market rents in a multifamily property without considering the impact of the actual leases and rent roll is not an “As-Is” estimate of market value and would be subject to a Hypothetical Condition.
- An adjustment for loss-to-lease accounts for the phenomenon that a property will never be achieving 100% market rents; that there will always be a differential between the income from totaling the rent roll and the appraiser’s 100% market rent PGI scenario
 - Each tenant’s lease began at different times; some tenants moved in in the past twelve months, and some tenants have longer residency at the property
 - Also, there is a probability that each tenant might either move out or might roll over at the end of its lease term
 - This is the lease renewal rate or the tenant retention rate.
 - In many properties, property management might offer a renewal tenant a rent increase lower than an increase to full market rent as an incentive for the tenant to stay because:
 - The property manager does not have to backfill
 - The property manager does not lose rents due to vacancy
 - The property manager does not have to paint and/or clean the carpets and/or do other repairs.
- Loss-to-lease is a poor name for this concept. Maybe a better name would be “Rent Roll Differential” or something like that.
- Some appraisers apply the loss-to-lease adjustment as a one-time deduction after the bottom line in both the Sales Comparison Approach and in the Income Approach, and this is not correct methodology.
 - This is similar to how they might handle a one-time capital expense for driveway repair or something like that. This is probably an incorrect method since this is not a one-time phenomenon because rents for existing tenants will probably always lag behind market rent levels.
 - The better place to recognize that actual leasing is at levels below market rents might be in the calculation of Effective Gross Income, much like concessions or vacancy

Techniques to Account for Loss-to-Lease

- **Method #1:** Simple potential rent calculation, *with no need to calculate/estimate loss-to-lease*

The appraiser should use the actual rent roll terms, and model vacant units at market rent

Calculation of Potential Rents without a Loss-to-Lease Calculation			
Unit / Model Type		Current Monthly Rent	Annualized
X # of occupied units	x	Rent roll rent for this month	* 12
Y # of vacant units:			
Model A: # of units		Market rents for Model A	
Model B: # of units	x	Market rents for Model B	* 12
<i>Repeat for each model</i>			
Total Prospective Rent =			Σ: of above

- **Method #2:** Complex, *but there is not a need for a loss-to-lease calculation, either*

The appraiser could use the actual rent roll terms, and model vacant units at market rent

- Model each tenant's prospective monthly rents for the next twelve months, as above
- Account for the effect on potential rent given the probability of lease renewal vs. move out
 - Model move-out tenants at market rent
 - Model retained tenants at either a percentage increase over current rent or at market rents, depending on the results of the appraiser's local research
- This can be a time-consuming process for large properties unless the procedure can be automated
 - This can be modeled in an Excel spreadsheet using the current rent roll, plus some additional calculations
 - ARGUS software can handle these calculations, but that requires input of actual lease terms for all the tenants
- It would produce a more accurate representation of proforma rental income, especially if the tenant turnover probability can be developed from market data

- **Method #3:** Apply a *market-derived* loss-to-lease factor to the appraiser's 100% market rent scenario
 - The development of this factor would be produced through analysis of rent rolls in the subject's market to determine market-wide averages
 - This data accumulation can be developed from the appraiser's previous work product and should be automated
 - Compare the total of the units at market rents vs. the total of the units at contract rents plus vacant units modeled at market rents
 - The differential would be the loss-to-lease factor
 - Multiple observations would create adequate support for a sub-market or market-wide adjustment factor
 - Note: This does simple calculation not account for the probability of lease renewals at something other than market rents, but a more complex model can be developed if necessary

Example:

Loss to Lease Analysis: Percentage Adjustment Calculation (sample)			
Income		Monthly Rent	Annual Rent
45	Occupied units at rent roll amounts	\$74,370	\$892,440
<u>2</u>	Vacant units at market rents	<u>\$3,390</u>	<u>\$40,680</u>
47	Total units at contract rent	\$77,760	\$933,120
47	Total units at market rent	\$85,000	<u>\$1,020,000</u>
Indicated Loss-to-Lease:			8.5%

This 8.5% differential would be aggregated across multiple observations in the submarket to develop a market-wide loss-to-lease adjustment factor.