

*operate*

# Rehab ROI: Do the Math

*Operators don't always account for a renovation's life span in their investment calculations, at their own peril. By Donald M. Davidoff*

## REHABS PRESENT ONE OF THE MOST CHALLENGING PRICING SITUATIONS

I've found in the apartment industry. There's a tug-of-war between the business desire to allocate capital in a way that provides a measurable return on investment (ROI) and the human desire to preside over a nicer portfolio. I find that a lack of familiarity and comfort with the math behind ROI calculations often gets in the way—and not always just from the jobsite side of the team.

The basic premise of rehabs is straightforward: An operator invests \$X to increase rent \$Y, gaining a return of Z percent. As long as Z percent is higher than the cost of capital, the overall return is positive. Seems simple, right? But I've encountered several issues that cause me to believe that operators aren't always getting what they think they're getting from their rehab investments.

## RENOVATIONS AREN'T FOREVER

I frequently hear something like this from rehabbers: "We're putting \$3,000 into a rehab and need a 10 per-

cent ROI. So as long as we get a \$25-a-month bump in rent, we're good."

Twenty-five dollars times 12 months is \$300 a year, which is a 10 percent return on a \$3,000 rehab cost. What's wrong with that? Nothing—if you're going to get the rent bump in perpetuity. But, of course, we're unlikely to get that—every upgrade has some life span to it, and that life span significantly affects the project's actual ROI.

In other words, renovations have a set amount of time during which they can be considered "fresh" before they need to be done again. This point is often overlooked, however, in evaluations of rehab plans, even though it can have a profound impact on the relationship between what's spent on the rehab and the revenue the expenditure will earn.

Just take a look at the numbers in the charts at left to see the actual ROI, by life span, of the rehab in our \$3,000 example. They show that anything less than a 10-year life span yields a negative return (see Figure 1). Meanwhile, it takes 20 years to yield just a 7.8 percent return.

To bring this realization into a real-world context, the scenarios in Figure 2 use several examples of calculated returns based on renovation numbers covered by the trade press. As you can see, just like the owners in my original example, it's highly unlikely the owners in scenario 4 are going to achieve anything near the returns they're trumpeting. Scenario 2, while not yielding big total dollars, is a home run in rate of return.

An important point to recognize is that the higher the ratio of rent gain to rehab cost, the less the life span affects the return (see Figure 3). Since the initial investment is made back more quickly, a shorter life span generates a value closer to the "return in perpetuity" calculation.

## FAULTY LOGIC: LOWERING THE BASE RENT TO PROTECT ROI

Here's a conversation that may sound familiar:

**Community manager (CM):** "I need to lower my one-bedroom prices."

**Pricing and revenue manager (PRM):** "OK, what, exactly, makes you feel that way?"

**CM:** "I've got a few units that have been sitting vacant for too long."

**PRM:** "Anything those units share in common?"

**CM:** "Yeah, they're the units we're doing the rehab on."

**PRM:** "OK. Then we really need to reduce the upcharge

**FIGURE 1:** ROI OF SAMPLE REHAB, BY LIFE SPAN

Year	1	2	3	4	5	10	15	20	30
ROI	-90.0%	-63.0%	-42.4%	-28.7%	-19.4%	0	5.6%	7.8%	9.3%

Note: Cash flow modeled on annual rents.

**FIGURE 2:** SAMPLE ROIs, BASED ON REHAB COST AND RENT

	Scenario 2	Scenario 3	Scenario 4
Rent differential (annual)	\$900	\$1,800	\$1,200
Rehab cost	\$2,300	\$6,500	\$8,900
Return (if perpetuity)	39.1%	27.7%	13.5%
Return (if 10 years)	37.5%	24.6%	5.8%
Return (if 15 years)	38.8%	26.9%	10.4%
Return (if 20 years)	39.1%	27.5%	12.1%
Return (if 30 years)	39.1%	27.7%	13.2%

**FIGURE 3:** RETURN IN PERPETUITY

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Rent differential (annual)	\$1,464	\$900	\$1,800	\$1,200
Rehab cost	\$14,634	\$2,300	\$6,500	\$8,900
Ratio	10.0%	39.1%	27.7%	13.5%
Difference, 10 years vs. perpetuity	-10.0%	-1.6%	-3.1%	-7.6%

for the renovation, not reduce the price on all units in that unit type.”

**CM:** “Then I won’t get the ROI on the rehab!”

A lot of rehabbers misguidedly evaluate their “return” based on the upcharge for the renovation. But if we reduce the base rent on all units in a unit type because the renovated units aren’t leasing, it’s a double whammy—we aren’t really getting the ROI on the renovation, and we’re actually now leaving money on the table for the unrenovated units.

It’s not easy, but the only way to be sure of a renovation’s return is to put both the renovated and the unrenovated units on the market and compare the average days on market (DOM) for each. If the average DOMs are statistically equivalent, then we know the differential we’re getting is due to the renovation; if the average is lower or higher for the renovated units, we know we’re under- or overcharging what the market will bear and

need to make the appropriate adjustment. If that adjustment causes us to fall below an ROI threshold, we should stop doing the renovations. That’s not an easy decision to make, but it’s the right decision.

#### THE PERILS OF HIDDEN COSTS

The foregoing discussion shows that we need to think beyond the direct costs of upgrades to the upgrades’ “hidden” costs. For example: What’s the increased vacancy loss due to increased turn times to complete the renovations? What’s the cost of the disruption the renovation causes elsewhere on the property? Will we have to be less aggressive on renewals during the construction period?

I see many operators get caught up in the bigger, sexier upgrades—granite counters, wood flooring, and so on. These may be necessary with Class A product, but with Class B, they may not be. When you spend thousands

of dollars, you need serious rent growth to get a decent ROI—can you get that for high-end finishes with B, or even B+, product?

Instead, consider some lower-cost upgrades that often give more bang for their buck because of how noticeable they are. Backsplashes, for example, are at eye level, and most apartments have relatively short wall spaces, which makes backsplashes particularly low cost but high impact. Faucet and handle finishes are much less expensive than brand-new appliances and can really spruce up the look of the bath and kitchen.

The point with all the above is to test and measure your assumptions. Only then will you know what truly yields the best ROI on your rehab. **MFE**

*Donald M. Davidoff is the founder of D<sup>3</sup> Demand Solutions, a technology consulting firm specializing in the multifamily housing industry.*

## Bellwether Enterprise

Capital on a Mission

### Bellwether Enterprise is on a mission.

As a full-service commercial & multifamily mortgage banking company offering a broad spectrum of competitive financing solutions and highly advanced loan servicing, we’re quickly becoming one of the most respected mortgage banking companies in the country. Bellwether Enterprise provides customized funding for all commercial property types, while energizing neighborhoods and bringing development dreams to life. As a subsidiary of Enterprise Community Investment, Inc., we support its mission of creating and preserving affordable housing in thriving communities.



With an unwavering commitment to local expertise and unmatched customer service, Bellwether Enterprise is making an impact beyond the bottom line, for the good of our clients and the communities we serve across the country.

**That’s Capital on a Mission.**