



DEAL UNDERWRITING GUIDELINES

*A Detailed Guide for
Analyzing Your Deal!*



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This is a good time to note that there are some deals that may be more difficult to close for various reasons. These are:

- *Short Sales (too many hoops to jump through)*
- *Auctions (must have money quickly, and Due Diligence time is too short)*
- *Deals that are subject to the approval of bankruptcy or divorce court (too risky)*
- *Deals in areas where the population is less than 50,000 (unless the small town is considered a bedroom community of, or reasonable commuting distance to, a larger city)*
- *Deals in severely economically distressed areas (fewer potential end buyers)*
- *Condos (you might not control all the units)*

Now it's time to get down to the details!

EVALUATING PROPERTIES WITH POSITIVE CASH FLOW

GATHERING THE DOCUMENTS YOU NEED

These are the documents you'll need to get the information for filling out your deal sheet.

You will need:

Current and Recent Rent Rolls

Recent Profit and Loss Statements (might be called Income and Expense statements)

Trailing 12 Month Financials (12-month financials at a glance)

Offering Memorandum (Marketing Package)

We use the rent rolls and financial statements to fill out the Unit Mix, Annual Operating Expense Analysis, and Total Income Analysis sections on the deal analysis sheet.

The Offering Memorandum (OM) is valuable for getting a sense of what the property is like. It will likely tell us if the property is All Bills Paid or not, what kind of debt is currently on the property, area demographics and such. There will often be pictures. You can find out how the property is situated physically in the area. It might give information about recent improvements or rehab that is still needed. It might tell you what class of property this is, and what the area class is.

The OM is generally not good for getting the rents to use in the Unit Mix section. Those are Market Rents, and may bear little resemblance to the actual lease rents. More on that later! If the property is currently performing, the OM is not the place to get most of the expense amounts. You need the financial documents for that.

COMPLETING THE ANALYSIS SHEET: A CHECKLIST

We're happy to provide both the paper sheet and the Excel analysis form. If you're submitting a deal analysis on the paper form for our review, please be sure that the information is legible. Include as much helpful information as you can, even if it's in the margins or white space.

For your reference, there are samples of a completed paper analysis sheet and a completed Excel sheet at the end of this document. It's very important to note that the deal analysis sheet is a tool. That's all it is! Each deal is different, and sometimes the deal sheet may seem inadequate. Well, sometimes, it is. That's where the knowledge of what Lance teaches, common sense, and lots of explanations come into play. Let's fill out that deal sheet!

1. ____ If you're sending us the paper form, be sure your name and email address are listed.
2. ____ Enter the property address and name of the property.
3. ____ Enter the asking price, if there is one. If you're using the paper form, circle 'Asking'. If you're suggesting an offer price, include that too, and indicate that it's an offer price.
4. ____ Be sure to enter the **number of units**, and if you're using the paper copy, the per unit amount.
5. ____ Be sure to indicate if this is a **Class A, B, or C** deal. Make a note of the area class, too.
6. ____ Include Owner/broker information.
7. ____ Enter the current mortgage information, especially if it's assumable. If it **MUST** be assumed, note that, too. If it's unknown, that's okay. Skip it.
8. ____ Enter how many units are subsidized, or approved for subsidies.
9. ____ Make sure to note if it's **All Bills Paid (ABP)** or not. This **JUST** applies to the electricity. There are some apartments where only the efficiencies are ABP, or only the units in older buildings, or only the HUD units, for example. When it's mixed like this, just make a notation of 'mixed' or 'some' or something that describes the situation.
10. ____ Enter the unit mix information. It's okay to combine line items with a weighted average of the rent amounts, as long as the total amount approximates the actual amount of the lease rents. More on this later, too!
11. ____ Enter the **annual expenses**. On the paper sheet, you may have to cross out and re-label descriptions or combine items. Some things to pay close attention to are:

TAXES DUE NEXT YEAR : Even if the seller didn't pay his taxes and it's not listed on the financials given to you, it is probably in the Offering Memorandum. This is one of those times when it's okay to use the Pro Forma figure, if you have nothing else.

INSURANCE: Insurance for a Class C property may be in the \$150 to \$300 per unit range in most

places, if you have no figures to go on. Coastal areas may be much more, possibly up to \$500 per unit.

UTILITIES: Most financials break these down, and if they do, you should, too. If you are only given a lump sum for all the utilities, use that.

MANAGEMENT and PAYROLL AND BENEFITS: The Excel sheet has a line for each of these. If you are using the paper form, combine the amounts and enter that in the MANAGEMENT FEES line. We expect the management and payroll amounts together to be around 10% to 12% of the Gross Scheduled Income (GSI).

If Maintenance salaries are listed, include them with REPAIRS AND MAINTENANCE rather than with MANAGEMENT/PAYROLL.

REPAIRS AND MAINTENANCE: We expect these to be about 10% of the GSI. If they are lower, it might be a clue that the property wasn't taken care of and there might be rehab to do. Or, it might just be because the seller performed a lot of maintenance himself. That's important to know because a new owner will likely not be doing the work himself. Another reason it might be low is because the salaries for maintenance personnel may be included with other salaries.

CONTRACT SERVICES: Many financials lump all third-party expenses into this category. It may include pest control, accounting, legal, yard or pool maintenance, trash removal, labor costs for repair, etc. The Excel sheet has a line for it. If you have room, enter it on an unused line on the paper form, or lump it into OTHER. Again, if the financial documents break down the contract services, you should, too, especially if you're using the Excel sheet.

Don't list Capital Expenditures in the expenses. We only want to list items that would be recurring or would be expected expenses for a new owner.

When you've entered all the operating expenses, check your total against their P&L totals.

12. ____ If you're using the paper form, make sure you figure the Total Gross Yearly Rental Income and enter that. Double check it against the Gross Potential Rent (or the appropriate total) on the P&L.
13. ____ Enter Other Income. You want to be conservative here. Enter only the items you would expect to be recurring dependably year after year. Don't enter 1-time expenses.
14. ____ Enter the **economic vacancy**. Also make a note of the **physical vacancy**. If you're using the paper form, make a note of both the economic and physical vacancy percentages, then enter the economic vacancy amount in the amount field. Never use less than 10% for economic vacancy. More on economic vacancy to come!
15. ____ Bring the Total Operating Expenses over from the right side of the page. The Excel sheet does this for you. Important note! If the expenses are less than the national average, you'll need to calculate and enter the appropriate amount on the paper sheet, or enter the appropriate percentage on the Excel sheet and let it calculate the amount.
16. ____ On the paper sheet, subtract the vacancy amount and the Total Operating Expense amount from the GSI and enter the remainder in the Net Operating Income line.

17. ____ Skip down and enter the **Rehab Costs** in the DEBT SERVICE ANALYSIS AREA. We use that when we calculate the cap rate.
18. ____ If you're using the paper form, calculate the cap rate this way: NOI divided by (price + rehab amount).
19. ____ The only field required in the DEBT SERVICE ANALYSIS AREA is the rehab. The rest of this section is useful for doing financial modeling, and together with the Cash Flow Analysis section, to ultimately determine if this will be a good deal.
- A good estimate for Closing Costs is 3% of the price. Your mileage may vary.
- If the note **MUST** be assumed, go ahead and enter the loan information.
20. ____ Cash Flow Analysis: This area can help you learn how much cash flow to expect annually. To calculate the Cash on Cash Return (CCR), divide the Yearly Cash Flow by (down payment + closing costs + rehab).
21. ____ Be sure to use the Value Play area to explain anything noteworthy and list the value plays.

That's it! You're done with the deal sheet! Want a little more information and insight? Keep reading!

Why NOT use Market Rents in the Unit Mix?

It's very tempting to use the market rents in the Unit Mix area, but there are (at least) two very good reasons not to do it.

1) Doing so can artificially inflate the economic vacancy.

If the market rent is \$500 and the lease rent is \$480, that's not too big a difference, and you might actually be okay using the market rent amount.

But we've seen some cases where the market rent is listed as \$500 and the lease rent is only \$350. That's a big difference! Now remember that we use the Low Occupancy Maximum Allowable Offer (MAO) formula if the economic vacancy is around 40% or more. If all the units were similar to that one we described ... well, let's do the math.

350 / 500 = .7 That means there's a 30% difference between the market rent and the lease rent. (By the way, this is called the 'Loss to Lease'.)

Can we really call that an economic vacancy when we don't expect to receive that \$500 in the first place? No.

2) Doing so can also artificially lower your expense ratio.

If you use the higher market rents to calculate the GSI, then the total expense amount will be a smaller percentage of the GSI.

Do you want to calculate your expense ratio using a phantom number you know won't be collected in the first place? No again!

We need to know the expenses in relation to the ACTUAL amount we expect to receive in revenue.

HOW TO READ A RENT ROLL

Deciphering a rent roll can sometimes be a challenge. It doesn't help that they come in all different forms and with varying degrees of detail. Sometimes they only list the resident's name and amount of rent. That's not helpful!

We are looking for some specific things in the rent roll.

- We want to know how much rent is expected from the resident: we call this the Lease Rent. Most rent rolls produced by software packages also list the Market Rents. For our purposes right now, we don't care about market rents.
- We want to know the physical vacancy
- We want to see if there are any balances due equal to a month's rent or more. In other words, we want to see what was actually collected. We consider any units with delinquencies (DQ) of a month or more to be economically vacant. (NOTE: This is only one method of figuring the economic vacancy. You might also simply take the Total Balance amount and divide by the Total Lease amount, and get an economic vacancy that way. It's a judgment call.)
- We want to find out if there are any non-revenue units. Are any units being used for an office? For model units? For maintenance or storage? If there are, be sure to include them in the unit mix without a rent amount, so we won't calculate our figures expecting income from them.
- We want to see if any residents have been given a Notice to Vacate (NTV). If there are a lot of them, then perhaps the management is trying to clean up a bad resident base. If there are a lot of delinquencies but no NTV's, it might be an indication of poor management practices. There's a value play for us!
- We want to know if there are any down units. A down unit is a vacant one that needs more than typical turnover to be inhabitable. It might be down simply because it needs a new sink and dishwasher, or it might be down to the studs and needs everything. If you see any down units, be sure to ask the broker to give you the rehab info.
- Always try to get the most recent month-end rent roll. A rent roll produced during the first few days of the month will not be helpful for figuring collections. Many residents simply will not have made their payments yet, but they shouldn't be considered DQ.

SORTING OUT COMMON RENT TERMINOLOGY

Few things can be as confusing as the terminology used when dealing with rent amounts. Not all brokers use them the same way, so it's ~~very hard~~ impossible to give definitive definitions. In an effort to demystify them, here's a guide... that's right some of the time!

1. **ACTUAL RENT (ALSO CALLED THE LEASE RENT)** This one is *golden* and very likely the only place you'll find it is on a current rent roll. This is what we *should* use in the unit mix area of the analysis sheet when calculating the NOI and thus, the cap rate. It's the amount that'll be received if the resident pays as contracted.
2. **SCHEDULED RENT** This might refer to what the rent should have been, but concessions have been given that bring down the actual amount the resident will pay. For example, maybe the month they signed, there was a special that reduced rent by \$25 for 6 months. In this case, the scheduled rent was \$450, but their **actual rent** those months was \$425.
3. **PROJECTED RENT** This might be used to describe what the rents would be after the repair is done on vacant/down units. It could also describe the rents that are used in the calculation of future projections. Often lenders will want to see 5 year financial projections. What is commonly done is to add 3% to the previous year's numbers in the projections.
4. **PROFORMA RENT** This is typically what you'll see in the marketing brochures. It might be synonymous with market rent or projected rent in some cases. It almost always is more than the current actual rents, or even scheduled rents.
5. **STABILIZED RENT** We generally consider a property to be stabilized at around 80 to 85% occupancy. This could be used to describe the rents that might be collected after a property has been rehabbed or repositioned and the clientele is of a better overall quality and quantity. And by quantity, we mean that if the property had to be repositioned, it might mean that there is a considerable drop in tenancy while the undesirables are being evicted. It's hard to get one bad apple out and one good apple in, until you have all the bad apples out.
5. **MARKET RENT** This might be used to describe what the rents are (well, theoretically) at the apartments across the street or down the street. Think about it being what the broker thinks the rents should be in this market in general. Be wary of the listed market rents in an Offering Memorandum. Not all brokers arrive at them the same way, and there seems to be a lot of optimistic speculation used when coming up with these amounts. We've also seen it used to describe what the rent would be to John Doe if he walked into our apartments today, and didn't receive any discounts.

The difference between the market rent and the actual lease amount is called the 'Loss to Lease' or 'Loss to Market'. In the rare cases where the actual lease amount is higher than the market rent, that difference is called the 'Gain to Lease' or 'Gain to Market'.

6. **CURRENT RENT** This could be used to mean actual rent, lease rent, scheduled rent, stabilized rent, or market rent as described above! If your broker uses this term, simply ask if he means actual lease rent.

This brings up another point to be aware of - when the broker tells you the current rent is \$500, remember that many of those existing leases were signed before the \$500 may have been in place. At most complexes, especially larger ones, residents of like units will not all be paying the same rent at any given time. That's why it's so critical to get the rent rolls to see what each resident is paying *now*. And once you examine the rent rolls, compare the amounts received to the P&L's, just to be sure you're on the right track.

The bottom line is, always try to find out the lease rent amounts. You may have to do some digging to find them! That's what is actually expected as income, and that's what you need to evaluate your deal.

SAMPLE PAGE FROM RENT ROLL ILLUSTRATING ECONOMIC VACANCY

SSI410
45042
Select: 12/16/11
285 Apts., 260,608 Sq. Ft.

Rent Roll Report

December 16, 2011

Page: 22
12/2011
12/16/11
10:17

Apt.	ID	Type	Apt. Status Names	R S	Sq.Ft.	Market Rent	Code	Lease Charges	Gross Possible	Actual Potential M/O Date	Lease Expires Term	Sec/Other Deposit	Ending Balance	
01 - 2007	3-2B	VA	LUIS MEYDELIN		1,320	775.00			775.00					
01 - 2008	6	2-1B	OC GLORIA N	C	949	625.00	RENT	625.00	625.00	625.00	08/02/10	01/31/12	200.00	
01 - 2009	8	2-1B	OC LIZETH N WALTER	C	949	625.00	RENT	540.00	540.00	540.00	06/01/11	05/31/12	150.00	
01 - 2010	2-1B	VA	VA Vacancy Loss		949	625.00			625.00					
01 - 2011	3	2-1B	OC ADALID N	C	949	625.00	RENT	495.00	495.00	495.00	06/28/11	05/31/12	0.00	
01 - 2101	2	3-2B	OC ROSALIA E VALARIE J ALIYA	C	1,320	775.00	ASSTM	730.00	730.00	730.00	08/01/11	07/31/12	0.00	
Total:						Market Rent 170,895.00		Lease Rent 134,967.00	Gross Possible 160,010.00	Actual Potential Charges 136,003.17	Security Deposits 36,433.50	Other Deposits 1,350.00	Total Deposits 37,783.50	Ending Balance 14,350.70
<div><div>Income Code:</div><div>Resident Stat.</div><div>Unit Stat.</div><div>Unit Analysis</div></div>														
ASSTM	Emp - Asst Manager	C	Current	NA	On Notice Available	Description	Units	Percent						
CONC	Concession	L	Leased	OC	Occupied	Occupied	245	85.96						
EMPCO	Emp - Courtesy Officer	N	Notice	VA	Vacant Available	Vacant	40	14.04						
HOUSE	Housing	P	Previous	VL	Vacant Leased	Down	0	0.00						
MGR	Emp - Manager	X	Cancel			Total Units	285	100.00						
MTM	Month to Month					Construction	0							
RENT	Rent					Waiting Lists	8							
RREF	Rent Refund					Employee	3							
						Model	0							
						Other Use	0							
						Total Special Use	3	1.05						
<div>** We found another 19 units that were a month or more behind (economically vacant)</div> <div>** 40 physically vacant plus 19 economically vacant = 59 'vacant' units</div> <div>** 59 divided by 285 total units = 21% econ vacancy</div>														

Notice the differences between the Market Rent, Lease Charges, Gross Possible, and Actual Potential Charges in the middle of the page.

SAMPLE PAGE FROM RENT ROLL SHOWING TOTALS

SSI410
45042
Select: 12/16/11
285 Apts., 260,608 Sq. Ft.

Rent Roll Report

December 16, 2011

Page: 24
12/2011
12/16/11
10:17

Apt.	ID	Apt. Type	Status	Names	R S	Sq.Ft.	Market Rent	Code	Lease Charges	Gross Possible	Actual Potential M/O Date	Lease Expires Term	Sec/Other Deposit	Ending Balance		
Grand Total :							<u>Market Rent</u> 170,895.00		<u>Lease Rent</u> 134,967.00	<u>Gross Possible</u> 160,010.00	<u>Actual Potential Charges</u> 136,003.17		<u>Security Deposits</u> 36,433.50	<u>Other Deposits</u> 1,350.00	<u>Total Deposits</u> 37,783.50	<u>Ending Balance</u> 14,350.70
Grand Summary of Actual Charges by Income Code (Current, On-Notice, Transfer Out residents only)																
ASSTM		Emp - Asst Manager				730.00										
CONC		Concession				-453.00										
EMPCO		Emp - Courtesy Officer				540.00										
HOUSE		Housing				1,658.00										
MGR		Emp - Manager				770.00										
MTM		Month to Month Fee				150.00										
RENT		Rent				131,572.00										

LEASE RENT does not include vacant units in this case. Not all rent rolls are alike, though, so you just have to look and figure it out.

GROSS POSSIBLE includes vacant units in this case.

ACTUAL POTENTIAL CHARGES might include additional rent for pets, month-to-month charges, RUBS or trash bill-backs, etc.

MARKET RENT is clearly higher than the Lease Rent amounts or the Gross Possible Rents. If you were to use the Market Rents in the Unit Mix area, you can see how the GSI would be artificially inflated. That affects the expense ratio and the economic vacancy calculations.

HOW TO READ THE PROFIT AND LOSS STATEMENT

If only all financial statements were the same... Alas, they are not. You'll see some that are created from scratch without using any software package or spreadsheet. You'll see some that are several pages long, some that are only several lines long, maybe written on a yellow legal pad. Some are created by the mom and pop owner, some by a manager or management company, some by a bookkeeper, some by a CPA. Even among the ones done by a CPA, you might receive financials done using an accrual basis, or a cash basis – and those don't include all the same things.

You may receive one or more monthly Profit and Loss statements. You may receive one or more 12-month trailing statements. That trailing statement might include the most recent 12 months, but most often you'll receive the previous calendar year 12-month document and then individual documents for the previous months of the current year. You may receive a Profit and Loss Variance report.

Just keep it in mind that we are looking for some specific things in the financial documents.

- We want to know how much rent was actually collected. Compare this amount to the rent roll to double check it. Theoretically, it should be the same. You might be amazed how often it isn't. This discrepancy might be due to accounting practices, or the fact that you have last month's rent roll, but financials from 2 months ago. On a few occasions, we've found math errors in their financials. When these things happen, just use logic and common sense to see if it's in the ballpark.
- We want to identify 'Other Income' that we can conservatively and reliably include on our deal sheet.
- On the trailing financials where they show several months side by side, check for trends. For example, if you notice that occupancy increases dramatically in recent months, make sure the new residents went through a normal screening process. Many times, sellers will do whatever they can to get bodies in the units in order to increase the occupancy. Sometimes these units are being filled with undesirable residents, and with very large concessions. This will not only affect the buyer's bottom line, but will cost the buyer to correct the situation.
- We want to find the management fees and the payroll and benefit amounts. Remember, these together should be around 10% to 12% of the GSI.
- Find all the information you need to list the expenses on the deal sheet.
- Check the last lines of the trailing financials to see if any months had a negative cash flow.

SAMPLE PAGES FROM FINANCIAL DOCUMENTS

This example is a Profit and Loss Variance Report. It shows the actual numbers and compares them to the predicted budget amount for the month and the year to date. This example also shows the yearly budgeted amount.

This is a common general format for income and expense statements. They start with the Gross Potential rent amount, then individually list and subtract (or add) the items that affect that amount.

Notice the bad debt write-off of over \$11,000. That lessened the Total Income for that month considerably. But based on the Yearly Budgeted write-off amount, we assume they don't expect to do that on a monthly basis.

Profit and Loss Variance								
Through February 29, 2012								
Account	MTD Actual	Budget	Var.	MTD %	YTD Actual	Budget	Var.	YTD %
400 INCOME								
405 RENTAL INCOME								
410 Gross Potential Rent	72,864.00	75,720	(2,856)	100.000	144,513.00	151,440	(6,927)	100.000
412 Apartment Vacancy	(29,131.56)	(27,000)	(2,032)	(39.981)	(56,033.33)	(52,945)	(3,087)	(36.162)
413 Beginning Delinquent Rents	16,826.76	0	16,827	23.093	30,645.54	0	30,646	21.191
415 Beginning Prepaid Rents	(2,616.64)	0	(2,617)	(3.866)	(5,443.89)	0	(5,444)	(3.754)
419 Staff Units	(555.00)	(555)	0	(0.762)	(555.00)	(1,110)	555	(0.394)
421 Lease Concessions	(795.00)	(1,010)	215	(1.006)	(1,594.94)	(1,945)	350	(1.103)
426 Ending Delinquent Rents	(3,149.50)	(10,000)	6,851	(4.734)	(20,276.26)	(20,000)	(276)	(14.021)
426 Ending Prepaid Rents	4,367.64	0	4,368	6.094	7,164.28	0	7,164	4.958
435 Rental Income Subtotal	57,370.70	37,075	20,296	(78.737)	97,939.60	75,539	22,401	(67.725)
439 OTHER INCOME								
440 Bad Debt - Write Off	(11,563.98)	(2,000)	(9,564)	(15.868)	(11,989.97)	(4,000)	(7,990)	(8.291)
471 Late / NSF Fees	1,220.00	1,000	220	1.674	2,325.00	1,335	990	1.808
473 Forfeited Deposits	100.00	140	(39)	0.136	265.69	280	(14)	0.177
477 Other Income	605.60	270	335	0.630	1,402.24	540	862	1.011
485 Other Income Subtotal	(9,668.27)	(590)	(9,068)	13.255	(7,847.04)	(1,245)	(6,702)	5.495
485 TOTAL INCOME	47,712.43	36,485	11,227	(65.481)	89,992.46	74,294	15,698	(62.230)
500 EXPENSES								
501 GENERAL & ADMINISTRATIVE								
515 Admin Expense / Office Supplies	3,211.04	1,220	(1,991)	4.407	4,971.58	3,689	(1,283)	3.438
525 Postage	125.85	244	119	0.173	347.91	444	98	0.241
530 Legal	210.00	180	(30)	0.298	385.00	360	(25)	0.252
546 Bank Service Charges	0.00	0	0	0.000	42.43	0	(42)	0.029
549 G&A Subtotal	3,546.89	1,644	(1,903)	(4.868)	5,725.92	4,493	(1,234)	(3.990)
550 OPERATING & MAINTENANCE								
551 Pest Control	1,325.00	300	(1,025)	1.818	1,475.00	800	(875)	1.020
554 Plumbing	41.21	50	9	0.067	355.98	280	(77)	0.247
555 Electric Repairs	0.00	55	55	0.000	0.00	110	110	0.000
560 Building Exterior	0.00	0	0	0.000	27.40	0	(27)	0.019
565 Turnover Costs	655.00	1,150	495	0.899	1,330.00	2,530	1,200	0.920
567 Appliance Repairs	502.88	150	(353)	0.890	956.71	300	(657)	0.454
570 Other - Gen Maint.	399.17	0	(399)	0.548	1,283.89	0	(1,284)	0.868
575 Painting	1,674.67	1,750	75	2.286	3,044.67	4,350	705	2.520
585 HVAC Repairs / Maint	29.28	110	81	0.040	261.72	270	8	0.181
592 Landscaping	1,200.00	1,200	0	1.947	2,400.00	2,400	0	1.660
594 Snow Removal	0.00	100	100	0.000	0.00	200	200	0.000
598 O&M Subtotal	5,827.21	4,855	(962)	(7.997)	11,438.27	11,040	(398)	(7.908)

This is page 2 of the same report. Notice the NET INCOME line beside the arrow. They had a positive cash flow of \$8.16.

Profit and Loss Variance								
Through February 29, 2012								
Account	MTD Actual	Budget	Var.	MTD %	YTD Actual	Budget	Var.	YTD %
599 PAYROLL								
000 Salaries - Management	4,343.19	3,735	(607)	5.991	8,090.78	7,472	(1,209)	6.003
010 Salaries - Supervisor	4,512.49	3,825	(686)	6.193	4,512.49	7,252	2,740	3.120
020 Salaries - Maint Staff	2,911.29	2,307	(604)	3.094	5,931.65	4,014	(4,316)	6.170
035 Other - Payroll	3,459.00	5,289	1,819	4.792	6,078.33	10,575	3,900	4.018
645 Payroll Subtotal	14,936.63	14,958	21	(20.499)	28,803.25	29,915	1,113	(18.917)
650 ADVERTISING								
051 Advertising	1,975.99	1,754	(210)	2.799	5,176.66	5,276	2,101	2.197
675 MANAGEMENT FEES								
076 Management Fees	3,000.00	3,000	0	4.117	6,000.00	6,000	0	4.145
699 UTILITIES								
700 Electricity	2,429.95	3,535	1,105	3.335	4,854.91	7,070	2,216	3.357
710 Water / Sewer	4,305.38	5,300	994	5.910	10,631.74	10,000	(32)	7.352
720 Natural Gas	69.68	75	5	6.096	142.17	150	6	0.098
740 Trash Removal	1,559.62	1,000	(559)	2.552	1,659.52	2,000	140	1.266
749 Utilities Subtotal	8,865.51	9,810	1,244	(11.893)	17,458.34	19,820	2,332	(12.093)
750 TAXES & INSURANCE								
755 Property Taxes	0.00	3,500	3,500	0.000	52,256.81	55,757	3,500	35.138
780 Taxes & Insurance Subtotal	0.00	3,500	3,500	0.000	52,256.81	55,757	3,500	(36.136)
790 Total Expenses	37,950.23	39,641	1,691	(62.084)	124,886.27	132,394	7,416	(86.380)
795 NET OPERATING INCOME	9,762.20	(3,156)	12,918	(13.395)	(34,898.51)	(59,010)	23,114	24.130
799 CAPITAL IMPROVEMENT EXPENSE								
900 Building Exterior	2,946.00	6,000	3,052	3.834	8,733.95	12,500	2,766	6.731
935 Fencing	0.00	6,500	6,500	0.000	0.00	6,500	6,500	0.000
900 Carpets / Floors	2,564.96	2,550	85	3.520	7,019.38	4,600	(2,518)	4.853
910 Appliances / HVAC	3,237.37	980	(2,257)	4.443	3,237.37	2,520	(717)	2.239
920 Windows / Doors	253.72	280	26	6.348	253.72	560	306	0.175
930 Roofs	1,950.00	0	(1,950)	1.441	1,050.00	0	(1,050)	0.726
975 Capital Expense Subtotal	9,754.04	16,410	8,656	(13.357)	21,293.42	26,580	5,287	(14.724)
989 NET INCOME	8.16	(19,866)	19,874	(0.011)	(56,189.23)	(84,590)	28,401	38.855
								(51,494)

Look at the VACANCY line highlighted in orange. The vacancy has gone down remarkably during the year. It appears they spent 2011 repositioning the property.

██████████ Apartments 2011 Income - Expense

12

On this page, notice that the utilities for May and June are far less than the other months. This doesn't appear to be a seasonal fluctuation, or the difference would be more gradual and spread over more months. This is a question for the broker.

Also notice that the ON SITE PAYROLL and PROPERTY MANAGEMENT FEE were included in the category of GENERAL & ADMIN. When you submit your spreadsheet and paperwork, don't leave it 'lumped' in this category. If you're using the paper form, add these together and list them on the Management Fees line. The Excel spreadsheet has line items for each one individually.

Always check the NET OPERATING INCOME line, usually at the end. Notice in this example that there was a negative NOI in March, then two months later in May, there is a substantial increase. This is surely related in part to the low expenses in May and June, but it would be a good idea to see if you can figure out the reason, and confirm it with the broker.

7299	UTILITIES													
7302	Water	3,318	7,155	8,301	1,790	0	1,998	3,420	5,411	2,000	6,498	3,822	2,958	46,705
7304	Wastewater	3,253	5,364	6,501	4,280	0	5,213	2,723	3,336	4,699	1,075	0	2,420	38,913
7306	Utility Billing	761	455	220	0	0	0	0	0	0	0	0	998	2,434
7310	Electricity	7,551	17,381	18,026	6,641	4,110	4,130	10,284	14,800	7,522	0	12,949	12,531	118,798
7320	Gas	4,416	0	0	6,629	2,755	0	6,282	3,542	0	3,419	1,434	3,452	33,928
7330	Trash Removal	1,254	1,254	0	0	0	0	0	0	1,224	0	0	1,321	4,982
7340	Cable TV	2,820	3,807	37	7,009	1,043	1,904	2,000	2,039	2,000	836	3,444	482	27,223
7350	Telephone & Pagers	346	381	0	100	0	0	0	0	0	0	0	0	627
7399	TOTAL UTILITIES	25,220	36,696	35,129	28,490	7,909	13,225	24,739	29,228	17,444	11,628	21,649	24,063	270,778
7399	AD & PROMOTION													
7410	Advertising	103	126	178	448	357	331	301	0	0	0	0	0	1,844
7420	Promotions	0	120	0	0	545	123	0	0	0	212	0	0	999
7430	Signs	0	0	0	0	0	0	0	0	0	0	0	0	0
7440	Referral Fees	0	0	0	0	0	0	0	0	0	0	0	0	0
7499	TOTAL AD & PROMOTION	103	246	178	448	901	454	301	0	0	212	0	0	2,843
7499	GENERAL & ADMINISTRATIVE													
7500	Office Supplies	921	693	0	218	459	272	227	211	115	54	563	141	4,613
7510	Professional Services	33	33	0	61	0	0	0	0	0	0	0	0	127
7511	Legal / Accounting	37	410	0	0	0	0	0	0	0	1,000	450	0	1,897
7512	Credit / Background Reports	200	(96)	0	0	215	0	0	0	0	0	0	0	320
7513	Dues / Professional Assn. Exp.	2,540	304	0	0	0	0	0	0	0	563	0	0	3,406
7515	Copy & Duplication	0	0	95	87	227	0	0	0	0	0	0	0	409
7520	Bank Fees	0	0	0	217	63	77	55	0	132	73	126	161	904
7530	On Site Payroll	25,039	25,220	20,126	13,930	15,067	35,279	14,105	16,001	15,410	15,794	16,223	16,790	208,879
7560	Property Management Fee	3,071	2,926	4,024	3,599	2,490	2,490	2,490	4,007	3,553	3,477	2,111	2,111	26,432
7570	Travel	0	0	0	436	0	0	0	0	0	0	0	0	436
7579	TOTAL GEN & ADMIN	29,870	27,891	24,259	24,547	18,522	18,118	16,967	20,299	17,209	19,961	20,623	18,956	256,922
7580	TAXES & INSURANCE													
7600	Property Taxes	7,500	7,500	7,543	7,543	7,543	7,543	7,543	7,543	7,869	7,907	7,543	7,513	91,089
7610	Insurance	3,192	3,192	6,110	5,820	2,840	2,840	2,840	2,840	2,840	0	8,064	3,127	43,703
7699	TOTAL TAXES & INSURANCE	10,692	10,692	13,653	13,362	10,383	10,382	10,382	10,382	10,709	7,907	15,607	10,640	134,792
7699	MISCELLANEOUS													
7700	Miscellaneous	174	231	0	0	(5)	10	(34)	0	0	0	0	0	376
7719	TOTAL MISCELLANEOUS	174	231	0	0	(5)	10	(34)	0	0	(36)	0	0	340
7720	TOTAL OPERATING EXPENSES	75,360	85,250	88,747	83,225	43,401	44,961	36,854	61,583	36,699	45,530	65,813	57,088	764,305
7729	NET OPERATING INCOME	3,942	4,188	(8,929)	8,860	80,972	44,298	39,612	40,415	41,074	60,182	41,933	49,070	381,888

WHY IS REHAB SO IMPORTANT TO US?

We take into account the rehab when calculating both the **cap rate** and the **MAO amount** (when the vacancy is more than about 40%). To find the true cap rate on a property that is currently income producing, we divide the NOI by (asking price **plus** rehab amount) to get the cap rate. Brokers NEVER do this, and it's one reason why the cap rates they claim as 'actual' are often much better than they really are when you take the rehab into consideration.

Read more about the MAO formula below.

UNDERSTANDING 'ALL BILLS PAID' – WHY WE HAVE TO KNOW!

One thing we must know is whether or not it's All Bills Paid (ABP). The term 'All Bills Paid' is a little misleading. We're really only talking about the electric bill. The reason it's so important has to do with the expense ratio.

The national averages for expense ratios are 45% where the tenants pay the electric bill, and 55% where it's all bills paid (where the owner **pays the electric bill**). So if our actual expenses are less than 45%, we throw out the actual amount and calculate what 45% of the GSI would be, and use that amount as the expenses on the left side of the sheet. What we're trying to do is figure out what the expenses would be for a new owner. It would be added risk if we used an expense ratio less than the average.

We use 55% if it's all bills paid, because the owner's expenses are higher if he has to pay the electric bills, and the extra 10% is about the average cost of the added expenses.

(Note: if the property is in the Houston area, we add another 5%. So if it's not ABP in Houston, we would use at least a 50% ratio. If it is ABP in Houston, we would use 60%. In other coastal areas where insurance may be excessively high, consider increasing the amount there, too.)

USING THE MAO FORMULA FOR LOW OCCUPANCY DEALS

We use the MAO formula when the economic vacancy is more than around 40%. In that circumstance, the cap rate method isn't helpful because the results are unrealistic – the numbers are incomplete. The MAO method is a carryover from the single family residence world of rehabbing distressed properties. It works for apartments, too!

Here's the formula:

MAO = (70% * ARV) - Rehab Cost

Where ARV = proforma NOI / market cap

So, let's assume we have a Dallas property at 50% vacancy in an area where the current market cap is around 9%. It needs \$75,000 worth of rehab. It's not All Bills Paid.

Let's say we've used the existing rents and put them in the unit mix section of the analysis sheet representing all the units. Let's also say the expenses are skewed because it's self managed and the expenses are not all available. In that case, we'll use 45% for our expenses. **(Remember, if it were an All Bills Paid property, we would use 55%. And if it's a Houston area property, we'd add another 5% to those, making it 50% for non-ABP and 60% for ABP.)** Let's assume we've done the math regarding the unit mix rents, vacancy, and expenses, and we come out with an **NOI of \$150,000**.

Let's use the formula:

MAO = (70% * ARV) minus Rehab Cost

Where ARV = proforma NOI / market cap

We first need to figure out the After Repair Value (ARV). So, we'll take our NOI of \$150,000 and divide it by the area market cap of 9%. That gives us \$1,666,667 as our ARV.

Now we need to figure out the maximum amount we'll offer.

MAO = (70% * \$1,666,667) – rehab

MAO = 1,166,667 - \$75,000

MAO = \$1,091,667

Since this is the MAXIMUM amount we'll offer, we would begin by offering less than this amount, giving us room to negotiate when they make a counter offer.

Let's recap:

When the economic VACANCY is about 40% or more:

1. The cap rate no longer applies, so we use the MAO formula
2. MAO assumes 10% vacancy
3. MAO assumes average expenses of 45% or 55% (for ABP), plus 5% more for Houston
4. Using 10% vacancy and 45% (or 55% or 60%) expenses, you get the pro forma NOI
5. Use MAO formula to calculate the **maximum** amount you would offer

OTHER QUESTIONS TO BE ANSWERED

The data on the deal analysis form is only part of the information we need to evaluate a deal. There are some very important questions we need to have answered by the broker or seller.

In addition to the information we've already discussed on the deal sheet, find out these things:

- Why are they selling? This will give us a clue about how motivated the seller is. (This only applies to privately owned deals. If it's an REO, we *know* why they're selling.)
- What's the area market cap rate?
- What class of area is this in? If they say it's a Class C or D, you might go to spotcrime.com and check the address for reported crimes.
- What is the nature of the rehab that needs to be done?
- Is there a Call-for-Offer date we need to know about?
- Have there been recent improvements? How much and what were they?
- If there's an assumable loan, when does it mature or balloon?
- If the seller has lots of equity in it, or if it's free and clear, is he willing to do any financing?
- If there's anything noteworthy about the area, include that. For example, it is next door to a major university and the residents are primarily students? Or, is it near a major employer that is expanding? Are these the only apartments in the area?
- Is there a Resident Utility Billing System (RUBS) in place to charge any utilities back to the resident?
- If there are subsidized units, is there any available information such as when the subsidy contract expires or if/when/how it is renewable?

The main thing here is to learn anything about the property that will help you understand the overall picture.

Is Subsidized Housing Good or Bad?

This little question will generate lots of opinions industry-wide.

There are some owners who will tell you they prefer not to allow any subsidized units in their properties. Their experience has been that when some residents are getting their home for next to nothing out of their own pockets, they tend not to respect the property. Vandalism and damage go way up.

Then there are others who will tell you that they love subsidized units because once the subsidy starts, they receive the rent money like clockwork and rarely have to worry about delinquencies.

Our experience is that it boils down to the resident screening process done by the manager. If you have an inadequate process in place to screen out undesirable applicants, you will have undesirable results.

If on the other hand you have some excellent screening processes in place, you may be very happy with the results.

One added happy fact is that very often, the approved subsidy amount is more than the other lease rents for the same type unit.

SAMPLE PAPER ANALYSIS SHEET FOR A PERFORMING PROPERTY

FAX COVER SHEET

To: First Cornerstone Group, LLC
Attn: Deal Analysis
Fax: 713-476-0296
Ph: 713-476-0102

From: Jane Doe
Fax:: _____
Phone: _____
email: Jane.Doe@gmail.com

MASON APTS **Apartment Deal Submittal Form** offer: 7,000,000

Property Address 123 Della St, Dallas Asking/Offer Price 7,950,000

Class A B C (circle one) class B area

Owner _____ # Units 228 \$/Unit 35,053

Current 1st Mort ? Rate _____ % Payment \$ _____ Assumable Y N

Current 2nd Mort _____ Rate _____ % Payment \$ _____ Assumable Y N

broker doesn't know current note, but owner has had apts for many years

Unit Mix
of Subsidized Rent Units (Sec. 8 or other): 22

Annual Operating Expense Analysis
All Bills Paid? Yes No (circle one)

No of Units	Beds	Baths	Cur Rent	Mthly Rent
8	eff	1	350	2,800
95	1	1	454	43,130
30	1	1	515	15,450
44	2	1	600	26,400
19	2	2	645	12,255

Total Income Analysis

Total Monthly Rental Income (\$/mo.)	<u>123,885</u>
Total Gross Yearly Rental Income (x 12)	<u>1,486,620</u>
Other Income - laundry (\$ / yr) <u>Rubs, Edes (+)</u>	<u>56,050</u>
Total Gross Scheduled Income (\$ / yr)	<u>1,542,670</u>
Vacancy (10%) <u>7% phys, 14% ec. (-)</u>	<u>215,974</u>
Total Operating Expenses (\$/yr) <u>45% (-)</u>	<u>694,202</u>
Net Operating Income (\$ / yr)	<u>632,494</u>
Cap Rate (%) <u>ON OFFER PRICE</u>	<u>9.7%</u>

Real Estate Taxes (for next year) 143,000

Insurance (incl liability) 45,600

Water and Sewer RUBS 76,066

Flood Insurance _____

Trash Removal _____

Electric common areas 94,759

Gas owner pays 34,000

Oil contract svc. 22,540

Legal POOL + GROUNDS 7,000

Management Fees + Payroll 164,471

Repairs and Maintenance (10%) 34,200

Other (Security?) ADMIN 14,665

Total Operating Expenses (\$/yr) 636,301

Total Operating Expenses / Total Gross Sched Income (%) 41.7%

Debt Service Analysis Soft turns, exterior paint, landscape

Down Payment \$ _____ Closing Costs _____ Rehab Costs 42,000

1st Mortgage Rate _____ % Balance \$ _____ Terms _____ yrs Payment _____ (\$ / mo)

2nd Mortgage Rate _____ % Balance \$ _____ Terms _____ yrs Payment _____ (\$ / mo)

** owner might accept even lower offer because he seems to be motivated*

Total Annual Debt Service X 12 _____ (\$ / yr)

Cash Flow Analysis

Net Operating Income	_____ (\$/yr)
Total Annual Debt Service	_____ (\$/yr)
Cash Flow	= _____ (\$/yr)

Cash on Cash Return (%)

Actual expenses < 45%, so I used 45% to get NOI.

Value Plays

owner selling due to bad health he might do small carry-back.

broker says market cap is hard to judge because of no sales in area.

- in crease rents, get better mgmt.



Apartment Deal Form - Blank Rev. 1

SAMPLE ELECTRONIC SHEET FOR THE SAME PERFORMING PROPERTY

Apartment Analysis Form				ENTER DATA IN YELLOW FIELDS		USE WHOLE DOLLAR AMOUNTS		
Property Address		Mason Apts, 123 Della St, Dallas		Offer Price	\$ 7,000,000	Offer + rehab	\$ 7,000,000	
Prop Class A/B/C		B-, C+	Area class	B	Asking Price	\$ 7,950,000	Asking + rehab	\$ 7,950,000
Owner/contact		broker - John Smith, ACME apts		# Units	228			
Contact Phone		555-123-4567		\$/Unit offer	\$ 30,702	offer + rehab	\$ 30,702	
				\$/Unit asking	\$ 34,868	asking + rehab	\$ 34,868	
Mortgages								
Current 1st	\$ -	Rate		Payment	\$ -	Assumable Y/N		
Current 2nd	\$ -	Rate		Payment	\$ -	Assumable Y/N		
Unit Mix				Annual Operating Expense Analysis				
Subsidized Units 22				All Bills Paid? no				
No of Units	Beds	Baths	Curr Rent/mo	TTL Month rent	Taxes Due next year	\$ 143,000	9.27%	
8	efficiencies	1	\$350	\$2,800	Insurance	\$ 45,600	2.96%	
75	1	1	\$448	\$33,600	Water & Sewer	\$ 76,066	4.93%	
20	1	1	\$475	\$9,500	Flood Insurance	\$ -		
15	1	1	\$510	\$7,650	Trash Removal	\$ -		
15	1	1	\$520	\$7,800	Electric	\$ 94,759	6.14%	
44	2	1	\$600	\$26,400	Gas	\$ 34,000	2.20%	
19	2	2	\$645	\$12,255	Oil	\$ -		
30	3	2	\$795	\$23,850	Legal & Acct, license & permit	\$ -		
2	storage & model	2	\$0	\$0	Management Fees	\$ 43,471	2.82%	
0	0	0	\$0	\$0	Onsite Payroll & benefits	\$ 121,000	7.85%	
Total Units	228		Total Rent	\$123,855	Repairs & Maintenance	\$ 34,200	2.22%	
*** never use less than 10% for vacancy; use true economic vacancy if known					Supplies & Miscellaneous	\$ -		
Total Income Analysis					Pest Control	\$ -		
Total Monthly Income (\$/mo)			\$123,855	Telephone	\$ -			
Total Gross Yearly Income (GYI)			\$1,486,260	Advertising/marketing	\$ -			
Other Income			\$56,050	Pool Maintenance/landscaping	\$ 7,000	0.45%		
Total Gross Scheduled Income (GSI)			\$1,542,310	General Admin	\$ 14,665	0.95%		
Vacancy % ***	14.00%	7% phys	\$ 215,923	\$1,326,387	Other Contract Services	\$ 22,540	1.46%	
Op Expenses	45.00%		\$ 694,040	\$632,347	Security	\$ -		
Net Operating Income			\$632,347	Other	\$ -			
Cap Rate Asking Price			N/A for low occupancy deals	7.95%	Other	\$ -		
Cap Rate Offer Price			N/A for low occupancy deals	9.03%	Total operating Expenses	\$ 636,301		
Cap Rate on Offer + Rehab			N/A for low occupancy deals	9.03%	Total Expenses / GSI	41.26%		
Debt Service Analysis								
Down Payment	\$ 2,100,000	Closing Costs	\$ 210,000	rehab needed/deferred maint	\$0			
1st Mortgage	\$ 1,900,000	Rate	6.00%	Term yrs	30	Payment	\$ (11,391)	
2nd Mortgage	\$ 3,000,000	Rate	4.00%	Term yrs	30	Payment	\$ (14,322)	
Total	\$ 4,900,000					"PMT(rate/12, Term*12, Am0"		
						Total	\$ (25,714) (\$ / Mo)	
Estimated DSCR	2.05					Total Annual Debt Service	\$ (308,567) (\$ / Yr)	
Cash Flow Analysis				Value Plays/ notes				
Net Operating Income			\$ 632,347 (\$ / Yr)	RUBS for water, owner selling because of bad health - he's owned it for 20 years, might consider a carry-back.				
Total Debt Service			\$ 308,567 (\$ / Yr)	rehab includes soft turns for 2 vacant units and some exterior minor repair and paint. Also needs some landscaping.				
Cash Flow			\$ 323,780 (\$ / Yr)	broker says area market cap is hard to figure due to not many apt sales or other commercials sales in the area				
Cash on Cash Return (CCR):			14.02%	some rents could be increased, get better mgmt				
Market cap			7.75%	MV/ARV = NOI / market cap				
MARKET VALUE based on market cap			\$ 8,159,317					
Use MAO for low occ deals, where economic vac = >40%								
MAO/door			\$ 25,051	MAO			\$ 5,711,522	
MAO = maximum allowable offer				MAO = (70% * ARV) - Rehab Cost				
*** for MAO calculations, always use 10% vacancy on line 32								

SAMPLE PAPER ANALYSIS SHEET FOR MAO DEAL

FAX COVER SHEET

To: First Cornerstone Group, LLC
 Attn: Deal Analysis
 Fax: 713-476-0296
 Ph: 713-476-0102

From: Jane Doe
 Fax: _____
 Phone: _____
 email: Jane.doe@gmail.com

MAO

Merryvale apts Apartment Deal Submittal Form					2,225,400
Property Address <u>11 Oak St, Houston</u>				Asking/Offer Price _____	
Class A B <u>C</u> (circle one) <u>C area</u>					
Owner _____				# Units <u>144</u> \$/Unit <u>15,454</u>	
Current 1st Mort _____	Rate _____	% Payment \$ _____	Assumable	Y	N
Current 2nd Mort _____	IRate _____	% Payment \$ _____	Assumable	Y	N
Unit Mix			Annual Operating Expense Analysis		
# of Subsidized Rent Units (Sec. 8 or other): _____			All Bills Paid? Yes <u>No</u> (circle one)		
No of Units	Beds	Baths	Cur Rent	Mthly Rent	
<u>56</u>	<u>1</u>	<u>1</u>	<u>480</u>	<u>26,880</u>	Real Estate Taxes (for next year)
<u>66</u>	<u>2</u>	<u>1</u>	<u>540</u>	<u>35,640</u>	Insurance (incl liability)
<u>22</u>	<u>2</u>	<u>1.5</u>	<u>565</u>	<u>12,430</u>	Water and Sewer
					Flood Insurance
					Trash Removal
					Electric
Total Income Analysis					Gas
Total Monthly Rental Income (\$/mo.)				<u>74,950</u>	Oil
Total Gross Yearly Rental Income (x 12)				<u>899,400</u>	Legal
Other Income – laundry (\$ / yr) (+)					Management Fees
Total Gross Scheduled Income (\$ / yr)				<u>899,400</u>	Repairs and Maintenance (10%)
Vacancy (10%) <u>(35% phys)</u> (-)				<u>89,940</u>	Other (Security ?)
Total Operating Expenses (\$/yr) <u>50%</u> (-)				<u>449,700</u>	Total Operating Expenses (\$/yr)
Net Operating Income (\$ / yr)				<u>359,760</u>	Total Operating Expenses / Total Gross Sched Income (%)
Cap Rate (%) <u>N/A</u>					<u>50%</u>
Debt Service Analysis					
Down Payment \$ _____		Closing Costs _____		Rehab Costs <u>150,000</u>	
1st Mortgage	Rate _____ %	Balance \$ _____	Terms _____ yrs	Payment _____ (\$ / mo)	
2nd Mortgage	Rate _____ %	Balance \$ _____	Terms _____ yrs	Payment _____ (\$ / mo)	
<u>MARKET CAP is 9%</u>				Total (+)	_____ (\$ / mo)
<u>ARV = 359,760 ÷ 9% = \$3,997,333</u>				Total Annual Debt Service X 12	_____ (\$ / yr)
Cash Flow Analysis			Value Plays MAO		
Net Operating Income _____ (\$/yr)			<u>MAO = (.6 x 3,997,333) - rehab</u>		
Total Annual Debt Service - _____ (\$/yr)			<u>MAO = 2,398,400 - 150,000</u>		
Cash Flow = _____ (\$/yr)			<u>MAO = 2,248,400</u>		
Cash on Cash Return (%) _____					