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Better Measurement of Apartment Vacancy and Collection Losses

If asked most appraisers would state that an appropriate allowance for vacancy and collection losses in a multifamily apartment community is 5% or perhaps 1O%. In general they would say that their perception of this deduction from gross income is based on conversations with local apartment owners and managers. The purpose of this article is to provide the appraisal community with an alternative measurement procedure for vacancy and collection losses that more accurately gauges the loss in income in the local marketplace.

Historically appraisers have relied on surveys, either in person or by phone, to ascertain the vacancy levels of competing multifamily apartment communities for use in their income approach analyses. The primary technique for researching vacancy levels within the subject's market area generally entails asking questions to whoever answers the telephone at competing apartment communities. The questions central to the survey are, how many units do you have vacant now, and have you had vacant in the past month and over the past year? Unfortunately, in many in-stances these surveys are unreliable and do not address all the concerns that an appraiser must consider.

In the typical valuation scenario for a multi-tenant apartment community, an appraiser must:

- Estimate market rates by a survey of competing properties
- Compare the market rates to the subject's asking rates
- Estimate vacancy and collection losses
- Subtract vacancy and collection losses to yield effective gross income *(EGI)*

This is the analytical framework which most, if not all, appraisal shops follow in valuing multifamily residential apartment projects. It does, however, exaggerate the *EGI* of the subject, resulting in a higher indication of market value.

The piece of the analytical puzzle that overstates the *EGI* is that the appraiser does not recognize that the subject property is not receiving market rents for all of its units. Typically only the newest tenants are paying market rents. Tenants who have been in

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residence for more than a year may have had their leases renewed at an amount less than the current market rate. Others may be holding over on a month-to-month basis at a flat rent with a larger risk of vacancy due to the short-term nature of their tenancy. In addition, there may be tenants who are withholding rental payments and on the verge of being evicted; these conditions must also be considered in vacancy and collection losses.

The person-to-person surveys that most appraisers perform do not reflect the lower-than-market rents of holdovers or renewed tenants or rents owed but will never be received, nor do they reflect the added risk of short-term tenancies. Each of these items of rent loss affects a property's value. The *EGI* is overstated, yielding higher market value estimates.

REVISED ANALYTICAL PROCEDURE

A more accurate measurement of vacancy and collection losses can be derived comparing potential gross income *(PGI)* from market rates against the subject's actual collected income. This analysis can be easily performed using information that the appraiser may already have in-house, namely, the data files of apartment projects already completed.

For each comparable, the appraiser should compare the *PGI* as measured by market rents applied to the property's unit mix with the actual collected income reported on year-end income and expense statements. The percentage difference is the actual vacancy and collection loss (also referred to as "rent loss") for that comparable property. Compiling several observations from the appraiser's database should be sufficient to demonstrate a trend that could be applied to the subject's *PGI*. (This is much like compiling capitalization rates derived from comparable sales, or construction cost comparables derived from data on recently built properties.) That, then, would more accurately reflect the *EGI* for the subject property.

The calculation is stated as:

Actual vacancy and collection loss (also known as rent loss) = *PGI* −actual rental collections! *PGI*

This calculation can also be performed on the HP-12C as:

Input	Keystroke
·(\$) *PGI*	Enter
(\$) Actual rental collections	~%

The display will be the percentage of actual vacancy and collection loss (rent loss).

EXAMPLE

The data in table 1, gathered from actual observations, demonstrates these relationships and compares the vacancy and collection losses.

It is interesting to note the relationship between the reported vacancy from a verbal survey and the calculations. This incongruity is due, in part, to the misconception in the apartment-leasing community that a signed lease constitutes a fully occupied unit producing market rent payments. To the rental agent, this scenario is not a vacancy. But the appraiser considers this condition a factor that reduces *PGI* since a signed lease does not mean that the tenant is currently paying market-level rent.

After compiling a chart of vacancy and collection loss comparables, the appraiser should correlate the results from this analysis to the subject's circumstances. This is easily accomplished by calculating the same ratio for the subject (see table 2), then comparing the calculated ratio to the comparables' results (table 1).

TABLE 1   Comparison of PBI With Collected Income to Measure Vacancy and Collection Losses for Comparable Properties

Property	Number of Units	Reported Vacancy[1]	Potential Gross Income	Actual Rental Collections	Actual Vacancy and Collection Loss
1	285	0.0%	\$1,811,200	\$1,554,228	14.2%
2	242	0.0%	\$1,467,400	\$1,335,200	9.0%
3	176	10.0%	\$1,176,400	\$1,084,222	7.8%
4	78	5.0%	\$573,800	\$513,000	10.6%
5	276	5.0%	\$2,195,000	\$1,806,106	17,7%
6	56	2.0%	\$345,120	\$312,922	93%
	Average:	3.7%			Average: 11.4%

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[1] Reported vacancy is taken from telephone or in-person interviews with property managers or onsite leasing agents.

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Table 2   Vacancy and Collection Losses for Subject Property

Number of Units	Reported Vacancy	Potential Gross Income	Actual Rental Collections	Actual Vacancy and Collection Loss
201	0.0% - 1.0%	$1,575,000	$1,411,500	10.4%

Applying the analyses described to the appraisal of the subject, it can be concluded that the subject's past performance is in line with market observations, and that 10% is a reasonable indicator of vacancy and collection loss (rent loss) for the subject.

It should be noted that the property manager for the subject was interviewed over the telephone to ascertain its reported vacancy levels in the same survey as the comparables noted in table 1. A 0%-1% vacancy rate was reported. Comparing this reported vacancy with the actual vacancy and collection loss of 10.4% shows that the interview system of estimating vacancy and collection losses inadequately addresses an appraiser's analytical needs. This is further support that a better measurement system is needed for the appraisal of these types of properties.

It is important for an appraiser to consider all sources of income in valuing a property, and it is just as important that he or she consider all deductions to income. Apparently, the appraisal community has been overstating the *EGI* in valuing apartment communities since estimates of vacancy and collection have not fully considered all reasons for a lowered rental stream. The analytical procedure described here should be a better way to estimate vacancy and collection losses for multifamily apartment appraisals.