*Avoiding these common mistakes will help relieve the stress of apartment renovation.*

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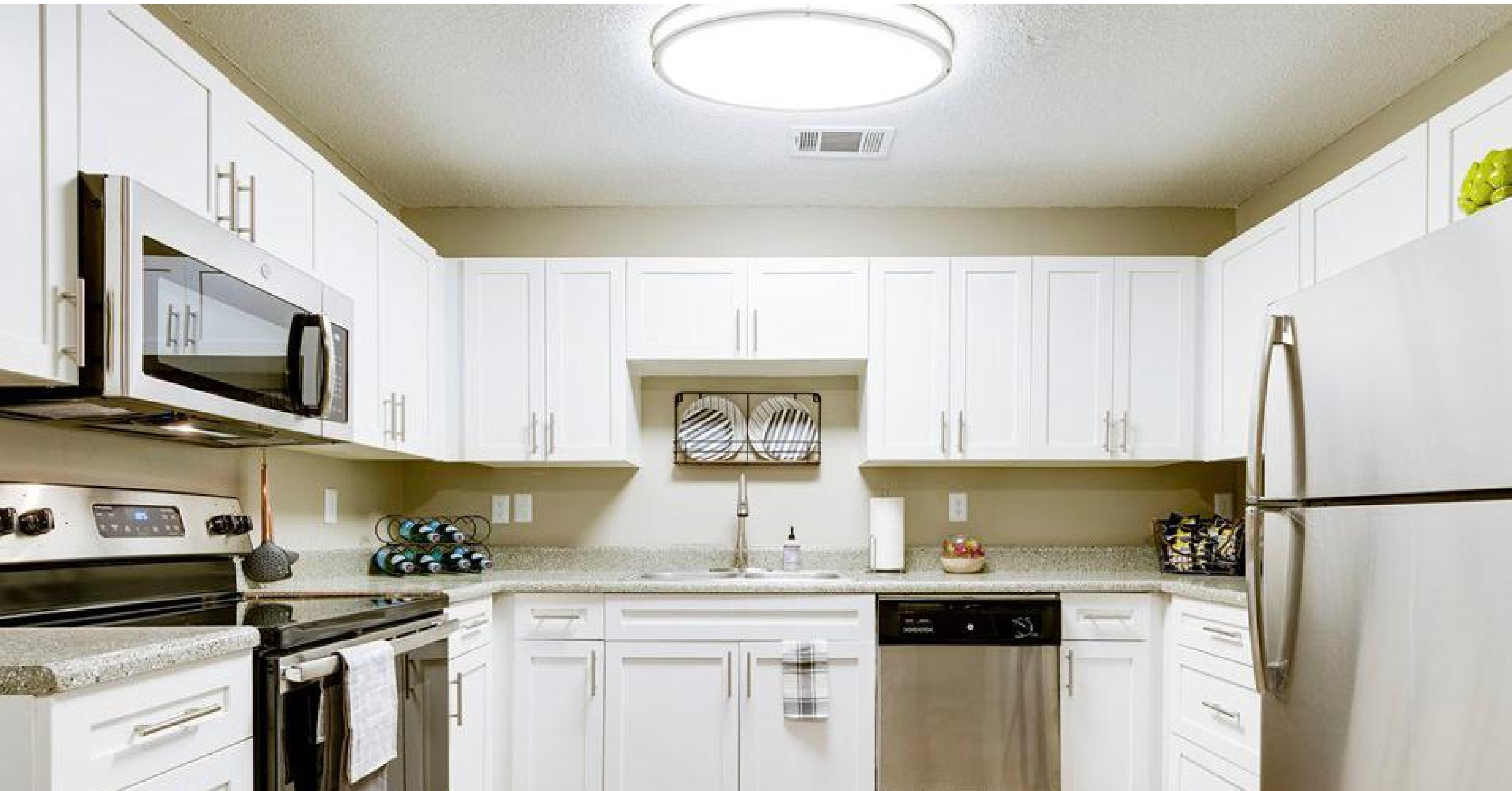


# COMMON APARTMENT RENOVATION MISTAKES

## And how to avoid them.

Value-add investing in apartment communities has been one of the hottest sectors for investors in multifamily housing for the last several years. Investors are buying undervalued assets and making capital improvements to achieve higher rents and increased occupancy, resulting in large increases in the overall value of the property.

While this strategy is being successfully deployed by many firms in the US, it is not without concerns and potential pitfalls. In order to help investors become more successful at value-add investing, we are outlining the most common mistakes made when planning and performing value-add projects.

### INEFFECTIVE DUE DILIGENCE

One of the most significant areas where companies make mistakes begins before they even own the asset. Due diligence time! This is simply the opportunity a prospective buyer has to inspect and validate the condition of the underlying asset, including financials, market surveys, exterior condition assessment, HVAC, roofing inspection, plumbing inspection, electrical inspection, interior unit evaluation, common area inspections and more. The goal is that the potential buyer is very informed as to the overall condition of the asset, and therefore can make effective underwriting assumptions.

If potential buyers do not perform a thorough due dilligence, the underwriting assumptions can be badly inaccurate. For example, if the underlying financials do not allow for the necessary renovation budgets then the potential investment returns will be reduced, thus making the asset less valuable to your investment partners. If you fail to modify the purchase price to achieve your investment goals, you are faced with simply walking away vs making a poor investment decision.

The goal here is to be thorough. Do not short-change the due diligence process. It's not easy, and it's not cheap, but a thorough and accurate due diligence inspection is the foundation of a successful property repositioning investment. Anything less is a gamble to be avoided.

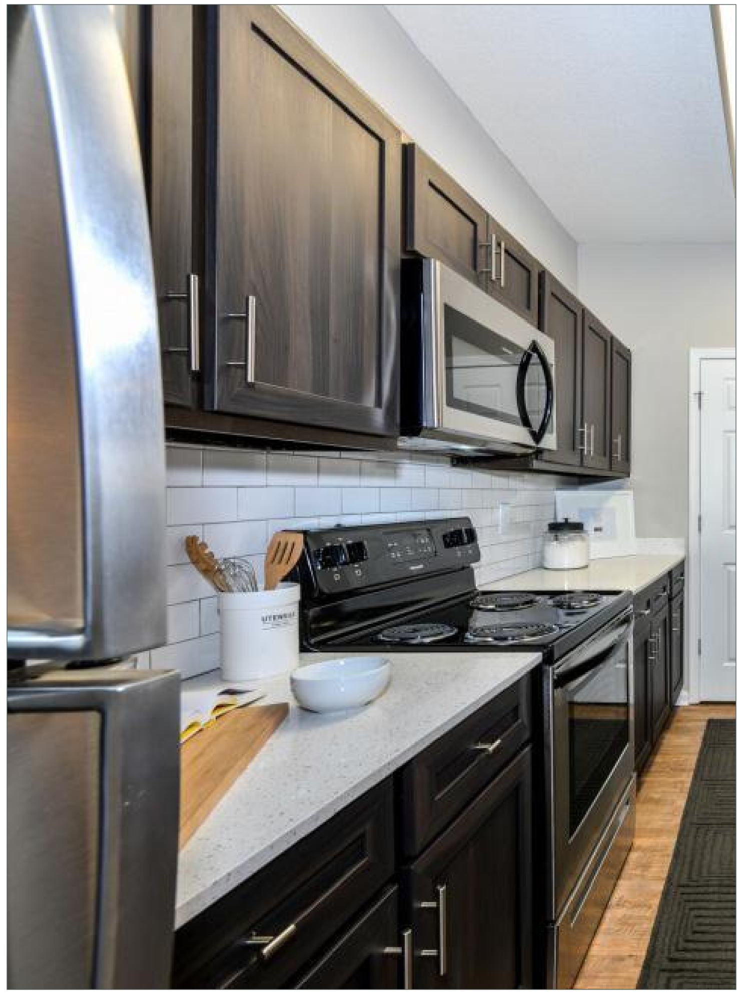
## IGNORING HISTORICAL RESULTS WHEN BUDGETING

Many asset-owner groups in multi-family have centered on value-add investing as their primary investment strategy. Most of these groups have formed solid due-diligence teams that use repeatable processes designed to minimize investment risk and maximize returns.

However, this is not always the case. One major error that gets repeated often from project to project is the failure to use historical value-add renovation costs and results when creating the underwriting for new projects.

This error is most common in interior unit renovations. Typical unit interior renovations are made up of many of the following, depending on the budget, timeline and renovation goals:

1. New flooring throughout the unit.
2. New electrical fixtures/switches/lighting.
3. Add/replace ceiling fans.
4. New plumbing fixtures.
5. Upgraded countertops.
6. Refacing cabinet door/drawer fronts.
7. Add kitchen backsplash.
8. Replace old baseboards.
9. Add crown molding to impact areas.
10. Replace all interior doors/door hardware.
11. Reglaze or retile shower/bathtubs.
12. Replace appliances.
13. Replace blinds.
14. Address any HVAC concerns.
15. Add framed mirrors.



In my previous work life on the general contractor side of the multi-family business, we saw far too often how clients ignored the lessons of the past when looking at the next investment opportunity. For example, if a client had previously purchased a value-add asset in a similar area, why not budget the next renovation based on their actual history of how much each scope element really cost last time.

It was common to see a scope budgeted for $7,000 per unit that really cost $10,000. Many times the individuals building the renovation budget don't really know how much it costs to perform the various activities in their scope in that particular market. Looking back at the example above, if the property was 250 units @ $7,000/unit, that is a budget of $1.75M. If each unit cost $3,000 more than budgeted, then the reality is that only 175 units could get renovated for the $1.75M original budget. In this example the asset was acquired with the goal of a full 250-unit renovation. Proformas were written to investors based on the financial results this renovation would create. Now the owner would be faced with decisions on cutting scopes, bringing work in-house, or reducing the number of units it could renovate.

Many of these issues can have been avoided by utilizing real past results and putting that knowledge to work up front, thus delivering the desired investment return.

## CHOOSING THE CHEAPEST GENERAL CONTRACTOR

Everyone has probably heard the old adage that you can get things GOOD, FAST and CHEAP, but you can only pick two! This is very true in the world of hiring a multi-family focused general contractor partner for your upcoming renovations.

Many property owners publish a desired scope, put that scope out to bid, and compare the results in order to make a decision on who should be awarded the project. But the reality is that this decision has a number of moving parts to it, and PRICE is just one of them.

A few other points to consider when selecting a GC partner:

1. How long has the GC been in business in that market?
2. Recent client referrals, and project tours.
3. Did they actually bid what your scope entailed?
4. Do you have previous history with the GC that suggests they tend to underbid up front to win the project, or they tend to hold their initial quote?
5. What is the GC's current project workload and how will that impact your schedule and desired quality result?
6. Does your GC bring clever, money saving ideas on how to save you money while delivering the desired result? Do they have success in value engineering to reduce costs?
7. Are they an innovative user of technology to monitor job progress, costing and sourcing?
8. Do they have dedicated on-site Project Managers, or do they rely on their subcontractors to manage the project for them?
9. Are they financially stable and capable of performing the work?
10. What previous experience do they have in performing the type of work you need done?
11. During the project walk was the GC engaged and asking questions to understand the vision of the project correctly, or did they just tag along?

The bottom line is this when you select a GC partner: their bid is only one facet of what makes a great partner. Quite frequently the highest bid represents the best value. That GC has taken the time to ensure the bid is complete and the work can be performed without the need for change orders that make lower bids look not so attractive anymore.

Almost everyone who has hired a GC in the multi-family space has experienced the pain associated with just buying the lowest bid. Schedule delays, change orders for items that should be included, quality issues, lack of project oversight, and on and on.

Solid advice suggests that hiring the GC that provides the best combination of VALUE, PROJECT MANAGEMENT, and QUALITY is much better than hiring the GC who has the best PRICE.

## RENOVATION SCHEDULES

One of the keys to a successful renovation is understanding how long it will take, and effectively communicating this to your residents. Property renovations are invasive and often their success is based on communicating well, showing residents what the results will be, walking them through a renovated unit, demonstrating new paint colors for the exterior, getting new landscaping done quickly to improve the pop, etc.

Since many value-add renovations include a combination of exterior, clubhouse, amenity and unit upgrades, there are multiple vendors working alongside each other at the same time, possibly in the same area of the property. This can negatively impact scheduling.

Successful renovations are a combination of effective project management by the owner, factual timing estimates from the contractors, and solid project planning up front to avoid unforeseen delays.

Most common renovation delays are caused by:

1. Poor planning by the property owner.
2. Lack of upfront project management by the general contractor.
3. Missing/delayed materials.
4. Weather.
5. Poorly written scope/expectations.

In interior renovations, the biggest culprit of scheduling issues is the material supply chain. If a GC has 2 weeks to complete a unit renovation, and you have pre-leased the unit and have a move-in date established, the materials that are needed to complete the renovation should be on-site days prior to the renovation starting. Once the material supply falls behind, it becomes harder and harder to catch up, and this could impact move-ins and resident satisfaction, not to mention the NOI impact to the property bottom line.

The best course of action is to make sure the renovation plans and expectations are set out clearly from the beginning. Whether it's the selections you are making for an interior renovation, the paint color and scheme, the roofing material choice, the design of the new arbor, etc. The clearer the expectations, the better and more on schedule your renovation will be.

## LOSING FOCUS ON ROI OF UNIT RENOVATIONS

When investing capital into a value-add property, one of the key drivers to the investment is the ability to gain the anticipated return on investment (ROI) described in the proforma. While there are many factors that determine how much money a property investment makes, a main contributing factor is the ability to turn invested capital into increased income.

This is especially true when it comes to interior unit upgrades. Every dollar spent to upgrade a unit interior should come with some sort of expected return.

For example, your community chooses to reface the cabinet doors/drawers with new ones. Average cost to do this might range from $600-850 depending on the size of the unit. Performing this activity in a unit might enable the property to increase rents $75-125/month depending on the property. This ROI is quick, meaning the upgrade pays for itself in less than a year.

By monitoring some of the key metrics at the property, it will be easy to tell if the leasing velocity of the old units slows down as the velocity of the new units picks up. When we see this happen, we know our upgrade is welcomed and people will pay for that unit vs the old one.

Many times however, properties launch into unit upgrades with an aggressive schedule in order to get as many done as quickly as possible. The upside is that the inconvenience to the community is lower, but if you are not tracking the lease rate closely and the older units are actually in more demand, there could be a negative impact on occupancy at the community. Losing sight of the absorption of renovated units can be a big negative income driver.

**The mistakes described in this article are some of the most common and impactful in apartment renovation. I hope these comments will help keep you safe and able to dodge these pitfalls. I wish you great success with your next renovation.**