Weigh options for value-add investment projects

The Denver multifamily market has remained a target for developers despite the pandemic. The local investment market strengthened at the end of 2020 with property sales in the fourth quarter outpacing sales from the first nine months combined. Prices rose and cap rates compressed, and 2020 ended with a whopping 22,304 units under construction, according to NorthMarq's fourth-quarter report. To maximize return on investment and stay competitive, developers must make calculated decisions on value-add renovations vs. simple make-ready turns to ensure occupancy rates meet or exceed what has been outlined in their pro forma.

■ **How to identify potential for a value-add renovation.** It is no secret that cap rates for Class B or C value-add investment properties are more attractive than those of Class A assets. Strategic renovations of Class B and C assets justify rent increases sought after by investors and draw potential demand from tenants who are seeking higher-quality housing without paying Class A rents. While revamping each unit, upgrading common areas and improving the property exteriors enhance the appeal of the property to target renters, drive increases in rents and mitigate vacancy rates, investors also must consider the condition of less visual aspects of the property, such as structural, mechanical, electrical and plumbing, and incorporate any necessary upgrades into their pro forma to ensure they meet their target ROI.

"We don't just look for properties based on their class, we look for the ones that are in the best condition and have the most potential," said Dennis Gonzales, regional manager of capital projects for Monarch Investment & Management Group.

"When we were deciding on whether or not to acquire a property with the intent to renovate, we kept in mind that seven to 10 years is the magic number of when things start to get old and need to be renovated," said Travis Myers, asset manager for 2525 Capital. "We asked ourselves, can we put about 10-15K into a unit and increase that rent by 16 to 20%? If the answer was yes, then we'd move forward."

Market assessment is crucial as well. "We assess the potential within the specific market and where we think rents will grow, and how close the asset is to the growth pattern within the city," said Eric Ray, regional director for Grand Peaks. "If we think we're going to get a better return by buying a Class B asset to get into that market and holding it long term because rents are going to increase just with the growth in the market, we will. If we think that by doing a renovation to increase capital to an A, then pushing the rent, we will do that instead."

■ **The importance of local market trends.** Baseline expectations vary dramatically from market to market. Tenants in one market might focus more heavily on in-unit features such as high-end appliances or quartz or granite countertops while expectations in another market may revolve around luxurious outdoor spaces featuring state-of-the-art pools and grills and elegant landscaping. Defining the scope of value-add renovations is dictated by what is trending in the specific market and it is critical to stay

Leslie Kinson
Strategy development manager, Global Construction

competitive with the new lease-ups both in ROI as well as resident experience. Often investors will rely heavily on operators to provide insight into specific market trends during pro forma development.

Operators should be seen as partners and be involved as much as possible. They tend to know the market well and can provide a lot of guidance about what will work. They can review the market and help recognize if a renovation is needed, what type of renovation and to what extent in order to move the needle to position that building in the market to be competitive and then present this to ownership, according to a director of facilities for a Denver-based real estate investment trust.

Specific trends in the Denver market identified through these interviews for in-unit value-add renovations include:

- Upgrades to LED lighting;
- Crown molding and baseboard additions;
- Upgrades to light, vinyl plank flooring in the common areas and plush carpet in the bedrooms;
- Open floor plans with a half wall in the kitchen to break up the rooms;
- Luxury bathrooms with curved shower curtain rods and oval tubs;
- Hard-surface countertops such as granite or quartz;
- New stainless steel appliances;
- New electrical and plumbing fixtures;
- All white or a white/grey combo paint scheme with black hardware finishes;
- Increased natural light through enlarged or additional windows; and
- Balconies.

"The ideal goal is to be timeless with your in-unit renovations while still appealing to your target demographic," said Ray.

Specific trends in the Denver market in value-add renovations for interior and exterior common areas identified include:

- Dog parks, dog washes and pet relief areas;
- Outdoor grill areas;
- Outdoor fireplaces;
- Indoor common area conversions into communal workspaces;
- Resort-style pools and hot tubs equipped to be open year-round;
- Upgraded package delivery/holding areas/systems; and
- Accessible parking.

"A lot of times you start with the exterior work because it's easier to sell the interior dream," said Bryan Fasulo, area vice president for Haven Residential. "It's easier to have someone walk in and say to them, 'Hey, there's going to be this beautiful apartment, look how beautiful it is here!' Than to say, 'Hey, come look at this beautiful apartment inside this box of thpppppt!'"

■ **Can you ever over improve?** With some Denver apartments now offering extravagant upgrades such as movie theaters, golf simulators, electric vehicle charging ports, room service and more, investors must decide when enough is enough or risk potential tenants who are not willing to pay the premium rents required for such lavish upgrades.

It becomes a game of dollars and cents. The expectation is not to have a new shiny penny, but rather to create a good, comfortable atmosphere that's well maintained, according to the Denver-based REIT's director of facilities.

In most cases, the long-term strategy for each specific property will dictate the extent of the renovations. Investors rely heavily on local market surveys and research on the competition paired with knowledge gleaned by their operators to make the best decisions.

■ **Value-add renovations vs. make-ready unit turns.** When acquiring a property, investors are not always looking to engage in value-add renovations. Especially when acquiring Class A assets (and sometimes Class B), it makes sense to do some quick fixes or moderate renovations and fill the units immediately.

"We have core investors who are looking for that A or B to hold for the next 10 years," said Fasulo. "We have investors who do the new development, so we look at that. And, we have value investors as well who want to buy the B and C's and bring them back to life."

Often it is the age of the property that dictates whether or not to do a value-add renovation. Properties 15 to 20 years old are more often than not receiving full value-add renovations, while newer properties can get away with much less and remain competitive. Another contributing factor is the vacancy rate. Every day without a tenant paying rent is a day without money coming in, and opting for a development model that dictates renovating a property while occupied is not uncommon.

These types of renovations happen in a few different ways. Sometimes, unit renovations can take place unit by unit after a tenant moves out and before the unit is rented to a new tenant.

Myers gives a few different examples: "If you're trying to put your asset on the market within the next 18-24 months and you're already starting your renovation project and you haven't hit 50% or 60% of your unit renovations, then you're renovating everything that comes available." Or, "If you're in year one of the five-year renovation and you know you're not putting the property on the market for seven years, but you have these renovations planned, then you look at how destroyed the individual unit is when a tenant moves out and renovate single units based on their condition."

Other times developers may choose to renovate one floor of a property at a time, maintaining occupancy in the units on the other floors.

Fasulo gives another example: "From time to time we will renovate only a certain number because the previous owner only did 20% of the planned renovations. The new owner then comes in and decides to do the other 80%, but leaves the original ones alone because they're good enough."

■ **Tackle in-house or contract out?** Value-add renovations most often are included in the pro forma since the decision to renovate is driven by the projected ROI.

A careful examination of market rents for similar renovated properties is essential to make sure there is enough upside to warrant the cost

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Full unit renovations add value to multifamily properties

and lost income during renovation. The gap between market rents for renovated units and the in-place rents must justify the expense. If the net operating income increases enough post-renovation that the value of the property at a market cap rate is significantly higher, and represents a nice return on invested equity, then the project makes sense. If the upside in rents does not create enough value, then the project does not make sense, according to the vice president of acquisitions for a Denver-based REIT.

If a value-add renovation is deemed necessary, there are a few ways an investor can contract out the work that needs to be done. Many developers and operators have construction management divisions that oversee the project. This division either executes the work with its in-house construction team or contracts it out to another general contractor.

"We have in-house construction management departments for larger projects – huge renovations, roofing, painting, things like that – who will then, in turn, find a GC to manage the job," Fasulo said.

For moderate renovations, the work is either tackled in-house by the property management company or contracted out to a general contractor. The more basic tasks such as painting, replacing faucets or light fixtures, and switching out batteries and filters most often are handled by the property manager's maintenance department. Larger and more complex tasks such as replacing flooring or countertops or rewiring electrical are most often contracted out.

"The liability is real. If you have the electrical done wrong or the plumbing stuff done wrong, that can be a costly mistake," said Myers.

■ **Final notes.** With CBRE forecasting increased multifamily investments in 2021, Denver's highly attractive market remains on a long-term expansion trajectory. It's no wonder that the high ROI for carefully calculated value-add renovations in the multifamily market continues to attract investors from across the country and abroad. ▲

leslie@globalconstructionco.com