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San Felipe Court

A Successful Renovation

By Wayne E. Etter and E.J. Cummins, Jr.

Renovating an income-producing property is an ideal application of asset management techniques. The first step in using these techniques is the development of an asset management plan.

The plan should include a market study, a careful determination of the plan's cost and an analysis of the renovation's impact on the income stream and the property's value. Then, using the data developed in the asset management plan, the decisionmaker must determine if the renovation is justified by the increase in the property's value. This "Instructor's Notebook" demonstrates the application of asset management techniques to the proposed renovation of St. Regis Place, a Houston mixed-use complex.

The property, located in the Galleria-River Oaks area is a 242,909-square-foot, 325-unit apartment complex. In addition, a 54,975-square-foot office-retail development is on the site. The complex was constructed in 1954 and needed substantial repair when renovation was proposed in 1990.

The April 1990 monthly operating statement was typical of the property's performance prior to renovation.

Rental income	
Apartments	\$108,982
Office-retail	26,182
Total	\$135,164
Operating expenses	76,222
Net operating income	\$ 58,942
Annualized net operating income	\$707,304

Based on the actual rent collections and assuming 95 percent of the total space was occupied, the average monthly rental rate for the unrenovated apartments was 47.2 cents per square foot. The average monthly rental rate for the unrenovated office-retail space rate was 50.1 cents per square foot. Capitalizing the annualized net operating income at 10 percent yields an estimated April 1990 market value of \$7,073,040.

Asset Management Plan

The existing office-retail space tenants agreed to remain and pay an increased rental rate after the renovation. However, a comprehensive study of the local apartment market was made to determine if sufficient tenant demand would exist for the renovated apartments. The apartment market area contains multiple employment centers within five to ten minutes driving time of

the site, many retail attractions, hotels and several high-income residential neighborhoods. The location of the complex relative to employment was an important reason for tenants choosing to live there.

Within the market area there had been limited construction of new apartments, some renovation of existing apartments and some existing apartments being operated without renovation. Occupancy rates generally in excess of 95 percent were found for each category, indicating a strong demand for each.

However, monthly rental rates showed marked differences. Depending on the size and type of unit, monthly rents in five newly constructed apartment developments ranged from 85 cents to \$1 per square foot whereas monthly rents in five renovated apartment developments ranged from 75 cents to 90 cents per square foot. Monthly rental rates for apartments in five unrenovated developments ranged from 50 cents to 75 cents per square foot per month.

Thus, within one market area, demand came from three distinct market segments or tenant types. Because of this, the required rental rates for a renovated project seemed achievable in the market area; current tenants would be replaced by other tenants willing to pay higher rents.

To attain these higher rental rates, the property had to be re-positioned in the market. This was to be accomplished in part by renaming the complex—San Felipe Court—and renovating inside and out. External renovation included:

- construction of a new facade;
- re-roofing, pool repair and parking improvements; and
- new security gate and landscaping.

Internal renovation included:

- new floor coverings;
- new appliances;
- new ceiling fans, light fixtures and mini-blinds;
- painting and
- refinishing cabinets and counters.

The estimated cost of these renovations was \$1.75 million. In addition, the office space renovation was estimated to cost \$250,000 for a total of approximately \$2 million. Thus, the essential questions to be answered by the analysis are, first, whether or not the renovation will increase the property's value by more than the

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renovation's cost and, second, whether or not the expected return on the incremental investment is sufficient.

To answer the first question, a *pro forma* December 1993 operating statement was prepared. By then, the renovation's effect on the property's income stream was expected to be complete. A 68.6 cents estimated average monthly rental rate was used to figure the rent collections for the renovated apartments, and a 68.8 cents average monthly rental rate was applied to the renovated office-retail space. These rental rates seemed achievable given the market study findings. A 5 percent vacancy rate was assumed. The *pro forma* statement was as follows:

Apartments	\$ 166,636
Office-retail	37,823
Total	\$ 204,459
Less 5% vacancy	10,223
Effective gross income	\$ 194,236
Operating expenses	110,434
Net operating income	\$ 83,802
Annualized net operating income	\$1,005,624

Capitalizing the annualized net operating income at 10 percent yielded an estimated value of slightly more than \$10 million—a value increase of about \$3 million between April 1990 and December 1993.

Thus, a \$2 million renovation was expected to increase value by \$3 million. Had the value increase been less than the estimated renovation costs, the analysis would have ended at that point.

Of course, the sufficiency of the expected return on incremental investment was another important consideration before proceeding with the renovation. Estimating the return allowed the expected return to be compared with those of other investment opportunities. In this case, the incremental \$2 million investment was planned to take place during a 24-month period with the bulk of renovation to be completed within 12 months. The \$3 million increase in value was assumed to be realized at the end of 42 months to permit the calculation of the internal rate of return. In addition, the change (positive or negative) in monthly net operating income during the 42 months was treated as a positive or negative benefit, as appropriate. The expected return on the incremental investment was approximately 25.8 percent.

With San Felipe Court's location and the market area demand for space, the expected 25.8 percent return was considered attractive given the low risk. The asset management plan was adopted, financing was obtained and the renovation began. What were the results?

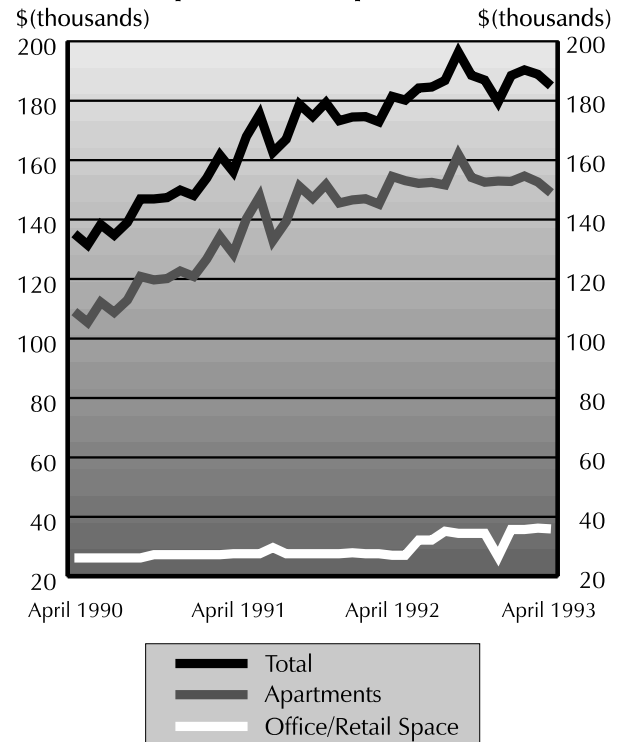
Renovation Results

The renovations began in April 1990 and were largely completed by September 1991, somewhat ahead of schedule. Renovation costs totaled \$1,821,463. The accompanying graphs show an overview of the results achieved by the renovation decision.

Monthly rental collections through April 1993 are shown in Figure 1. The increase in rental collections during the period demonstrates that the asset management plan succeeded. The planned increase in rental rates for the renovated property was achieved because San Felipe Court's location made it a desirable place to live, and the renovation made tenants willing to pay higher rent to live there.

In Figure 2, a three-month moving average of the property's estimated **monthly change in value** is compared to the cumulative amount of renovation expenditure. The property's monthly value was estimated by capitalizing the annualized net operating

Figure 1: San Felipe Court Rent Collections April 1990 to April 1993



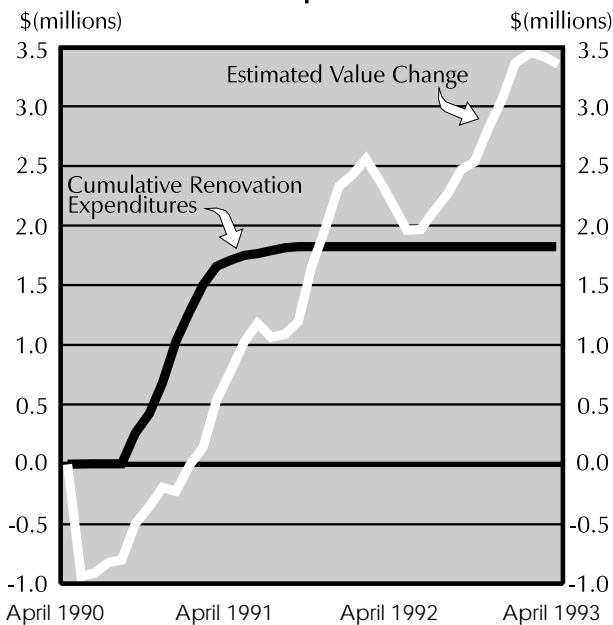
Source: Real Estate Center at Texas A&M University

income. Then, the monthly change in value was estimated by subtracting each month's value from the estimated April 1990 value.

The property's estimated value declined when the renovation began as those units vacated for renovation did not generate rent. As the renovation proceeded, however, rental collections and the property's estimated value began to increase. The goal of a \$3 million value increase was reached in December 1992—one year earlier than planned. Although the renovation and repositioning of San Felipe Court was a success, a renovation can accomplish only limited goals.

In general, overspending will not make an old property competitive with new properties; after renovation, the property will still be an old property. On the other hand,

**Figure 2. Estimated Value Change Compared to Cumulative Renovation Expenditures
San Felipe Court**



Source: Real Estate Center at Texas A&M University

if renovation spending is insufficient, the property's planned repositioning will not be achieved; repositioning the property requires more than performing needed maintenance. Thus, the extent of the renovation must be based on a carefully developed plan for the property.

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