

# HOW TO TELL A GOOD MARKET STUDY FROM A BAD ONE

## BY ANNIE GERARD, CRE



In addition to producing 40 to 60 apartment market studies per year for builders, lenders, investors and cities, we've critiqued or torn apart and redone more than 30 market studies prepared by other analysts in the past few years. Typically, the findings or methodology were called into question by lenders or would-be buyers of a given property or project – all too often for good reason.

Market studies with any of the flaws noted below should be viewed with caution. (Some apply primarily to affordable projects, others to age-restricted projects, and some to projects of any type.)

These kind of errors can mean that market depth is actually much lower (or considerably *higher*) than shown in the market study. Equally bad from the standpoint of project performance, conclusions on supportable rents can be dangerously off. Spending a comparatively small amount upfront on good market research can save hundreds of thousands of dollars down the line, just as settling for poor quality research can be costly.

## PROBLEMS WITH SUPPLY DATA

### 1. Affordable projects used as market rate comparables

In the old days, any study that treated Section 8 "FMR" rents as if they were in fact at market could be written off as the product of someone with little experience. (The "market" in Fair Market Rent was presumably thought to have something to do with what the market would actually bear, as opposed to a figure calculated by the folks at HUD.)

Most analysts now know that Section 8 rents aren't comparable. But studies that rely on the income/rent restricted rents in affordable LIHTC or Bond projects to set market rents are still relatively common – and are also a poor measure of market.

### 2. "Affordable is Affordable"

Tax credit and Bond projects that require tenants to pay the entire designated rent out of pocket are not the same as HUD or USDA/RHS projects that require tenants to pay rent equivalent to 30% of their adjusted gross income (however little that may be). In many HUD projects, for example, most tenants pay between \$100 and \$200 in out-of-pocket rent. That's no test for LIHTC units with rents starting at \$575, for example.

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Similarly, “basic” or “market” rents for RHS projects – which are set according to the monies needed to repay the loan, again with little or nothing to do with the market – also don’t serve as a meaningful test of ability to pay market rents if no one in fact pays them. (And in many RHS projects, no one does.)

### 3. No unit mix on comparables

You can’t weight rents by mix without mix – and if you *don’t* use weighted averages, a rent analysis can be seriously skewed, as this illustration of average (mean) vs. weighted average rents indicates:

<b>WEIGHTED AVERAGE RENTS VS. MEAN (AVERAGE) RENTS</b>	
# Units	Rent
50	\$1,000
950	\$500
1,000	
<b>Average (mean) rent (a)</b>	<b>\$750</b>
<b>Weighted average rent (b)</b>	<b>\$525</b>
(a) $(\$1,000 + \$500)/2$	
(b) $(50*\$1,000)+(950*\$500)/1,000$	
<i>SOURCE: Apt Market Research</i>	

### 4. Using the average of a rent range instead of base rent

Base rents are the lowest rent quoted for a given floor plan, without premiums for views, elevation, fireplaces or other amenities in select units. The highest rent quoted often applies to just a few units. Averaging the range (low + high/2) instead of using the base (low) rent can artificially inflate rents – in this example, by \$36.

<b>WEIGHTED AVERAGE BASE RENTS VS. AVERAGE OF RANGE</b>				
Project	1BR Units (#)	Low Rent (Base)	High Rent	Average of Rent Range
<i>Village Oaks</i>	34	\$600	\$700	\$650
<i>Fairview</i>	56	\$625	\$675	\$650
<i>The Palms</i>	72	\$700	\$775	\$738
<i>Creekview</i>	14	\$650	\$725	\$688
	176			
<b>Weighted average base rent</b>		<b>\$653</b>		
<b>Weighted average of averaged rent for range</b>				<b>\$689</b>
<i>SOURCE: Apt Market Research</i>				

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### **5. No data on bathroom count**

The California Tax Credit Allocation Agency [CTCAC] and California Debt Limit Allocation Committee [CDLAC] now require that comparables be an *exact match* on bathroom count, as well as bedroom count. Other State LIHTC allocating agencies have the same requirement. Not only is using 2BR/2BA comps to assess supportable rents for 2BR/1BA units deceptive, it can cause the entire study to be rejected.

### **6. Comps in a (very, very) different submarket**

We once redid a market study in a barrio neighborhood of east Los Angeles that used “comps” from pricey Marina del Rey. Another egregious example was a study that relied on rents for units in La Quinta (Palm Springs area) to arrive at supportable rents for a project in the remote desert community of Blythe, some 100 miles east. While geographic proximity isn’t everything, variations at the neighborhood/submarket rent level can make a huge difference in whether rents are supportable at a given location.

### **7. Too few comps**

Beware a market study with just a handful of comps, unless there’s a compelling reason for it (e.g., no existing apartment stock – although THAT might make you nervous, too). A valid price curve needs sufficient data points to support the pricing conclusions. We survey a minimum of five and typically 8 to 10 comps.

### **8. Too many comps**

Market studies that include every type of project, of every construction era, catering to every target market – the “kitchen sink” approach to supply analysis – can be problematic, too. Apartments catering to college students, for example, where “bundling” of households is common, doesn’t prove a good test of the rents 65+ households will pay.

### **9. Disregarding Section 8 “float”**

Market rate projects with more than 50% Section 8 tenants should be treated with care. Street (quoted) rents tend to inflate if no one actually pays them: if most/all tenants have Section 8 vouchers or certificates, most/all pay considerably less than the street rent.

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### **10. Mixing “apples and oranges”**

This can take several forms, with the most common, and potentially most misleading, having to do with differences in 1) utilities and 2) lease term.

- **No consideration of cost value for utilities**  
Passing through the cost of various utilities to tenants started years ago, and in many markets there’s now little consistency in who pays for what. Water and trash – the two most common pass-throughs – can easily carry dollar values of \$50 or more. Failing to consider the value for utilities included in the rent can really muddy the picture of how the rents at one project compare to another project with different utility provision.
- **Ignoring effects of lease term on rent**  
In some submarkets, there can be big differences in the quoted rent depending on length of lease term (i.e., rents for 3-month leases are \$100 higher than six- or 12-month leases). If rents are quoted differently for six-month, 12-month or month-to-month lease terms, the data should reflect it.

### **PROBLEMS WITH ASSESSING DEMAND**

Potential pitfalls in forecasting depth of market (“demand”) typically relate to undercounting the percentage of renters in the targeted income band and/or failing to properly set the threshold/minimum occupancy requirement. We’ve seen an increasing number of market studies that use a much bigger (or different) geographic area for demand purposes than the geographic area used for purposes of evaluating supply. (That, of course, makes it pretty simple to show that the market is pent-up.) Less commonly, demand calculations are flawed by relying on the wrong age threshold and/or counting population as opposed to households, both of which significantly inflate demand.

#### **1. Incorrect qualification ratios**

Generally speaking, minimum income requirements should be set using qualification standards practiced in the local market (e.g., 40% for affordable family and 50% income-to-rent for seniors) rather than 33%, if applicable. But many State agencies set their own requirements (e.g., 40% for senior projects, as opposed to the 50% qualification ratio that’s actually applied at most senior apartment projects). Beware any market study (like one we once redid) that uses zero as the minimum income for residency.

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### **2. Understating rental tenure**

Rental tenure (% of renters) is directly correlated with income: the lower the household income, the higher the likelihood to rent. To avoid undercounting depth of market, rental tenure should be determined for the targeted income band, rather than simply plugging in the rental tenure for all income ranges.

### **3. SENIOR: Age 55+ rather than 65+ cut-off**

It's rare to see senior apartment demand calculated using data on those 55+ ("because the project will have a 55+ age limit") – but if this occurs, disregard all findings. Since the core market for senior apartments is indisputably those 65+, using the [much larger] 55+ household base greatly inflates the demand.

### **4. Using population instead of households**

Similarly, demand numbers need to reflect **households**, not **population**, in order not to overcount. A married couple (2 persons, 1 household) will rent one unit, not two.

### **5. Geography Mismatch on Demand and Supply**

To assess market saturation, the geographic area used to calculate demand must be the same geographic area used to assess supply. If demand is calculated for Kings County, the comps shouldn't be located in Fresno County. If demand is calculated for Santa Barbara County, all affordable projects of that type in Santa Barbara County should be tallied – not just those in the small Santa Barbara County community of Santa Maria.

### **6. Generic turnover**

Since turnover varies enormously, *local* turnover rates in surveyed apartment projects should be compiled as evidence of "movership." Census data on turnover is misleading: it reflects all stock turnover, not just rental housing, thereby undercounting for turnover in the rental market. Insist that analysts track down accurate external turnover data, including evictions, for the rental projects they survey. (It's useful to query leasing agents to make sure internal turnover is quoted separately, too, i.e., tenants moving from unit A to unit B.)