



The DANTER REPORT

Special Report

A Periodical of Commercial Real Estate Research

Comparable Market Rent and Setting Appropriate Rent for a Proposed Multifamily Development

The Danter Company’s methodology for determining comparable market rent is unique within the industry in that it is based on a scientific regression analysis of all conventional apartments within a market area, as opposed to analysis of selected comparables.

This special report is intended to help our clients understand these critical differences and why we believe that they help us to prepare the most accurate market feasibility analyses in the industry.

area is critical because all the conclusions are based on detailed analysis of the market area. Incorrect market areas can lead to inaccurate conclusions and potential problems. The Danter Company identifies the Effective Market AreaSM (EMA), defined as the smallest geographical area from which a project can expect to generate 60% to 70% of its support. When we determine an EMA, we look at four key factors: geography, demographic analysis, mobility patterns, and area perceptions:

Comparable market rent—the rent that a unit with a given level of amenities can be expected to achieve based on prevailing market conditions—is one of the most critical components of a market feasibility study.

Geographical factors—rivers, railroads, freeways, hills, and major arteries often define neighborhood boundaries. Such geographical factors, which can play a big part in where people move, are ignored in radial analyses.

Project rents based on a comparable market rent set too high can slow absorption and can affect not only initial absorption, but rent increases expected by the pro forma in later years. Project rents based on comparable market rents set too low lose potential income every month from tenants who would pay more for their units.

Demographic factors—population and household trends, housing and income characteristics, differences in socioeconomic makeup of individual neighborhoods, and growth figures all are analyzed to help identify the EMA. Radial analyses cannot account for these characteristics, and can skew a report by including neighborhoods of vastly differing socioeconomic makeup.

At The Danter Company, we are convinced that the only valid method of determining accurate comparable market rent is the combination of the Effective Market AreaSM, the 100% Data Base, and regression analysis.

Mobility factors—interviews with area real estate professionals, leasing agents and civic officials are combined with our past experience in determining mobility patterns. Mobility patterns are predictable, and while individuals occasionally act counter to prevailing trends, mobility analysis can help pinpoint where the majority of tenants for a particular project are the most likely to come from. Radial analyses cannot make these distinctions.

THE EFFECTIVE MARKET AREA

The first step in determining appropriate comparable market rent is determining the appropriate market area. Setting a proper market

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We usually recommend rents that will make prospective renters perceive a property to be a value in the market. This is of special importance for large properties, which have a constantly high level of replacement absorption
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Area perceptions—we interview area officials and real estate professionals to determine area perceptions. Area perceptions also help determine mobility patterns and the appropriateness of the development for its site.

THE 100% DATA BASE

The next step is a field survey of all conventional apartment communities within the EMA (not just selected comparables). Our research shows that the largest single component of support for an apartment project is tenants already residing in other conventional apartments within the EMA. Typically, an apartment project can expect 45% to 50% of its tenants from other conventional apartments within the EMA. Add support from within the EMA from new household formation, home ownership, or other rental properties, and the total EMA support increases to 60% to 70%, depending on the demographics of the EMA.

The EMA is supportive, rather than competitive. A competitive EMA, including only projects with a similar price or amenity level to the proposed project, only examines a portion of the market at one pricing level.

The 100% Data Base allows us to measure support and the depth of the market at all levels. Our field surveys identify all conventional apartment developments within the EMA. Each project is surveyed to determine not only rents and vacancies, but also amenity level and curbside appeal. The 100% Data Base allows analysis of the existing market conditions experienced by those tenants most likely to move into the proposed project, instead of only comparable properties.

THE REGRESSION ANALYSIS

Once the 100% field survey is complete, it is not enough simply to determine medians for each unit type and call this median “comparable market rent.” Median rent may not reflect rent movement at existing properties. For an article for *Apartment Resources* several years ago, we took an existing metropolitan market area field survey of two-bedroom rents and added 500 upper-end units to the base with-

out changing the rents of other existing units. The median rent increased \$23 *despite the fact that no existing units increased their rents.* Adding only 300 units increased the median rent by \$18. Median rent can be disproportionately influenced by additions to the high or low end of the market, and therefore does not reflect what tenants are actually paying for units of a moderate amenity level. Therefore, we use regression analysis instead of medians, because of its ability to determine market rent *at any amenity level.*

Each 100% Data Base field survey applies a point value for each project’s unit amenities, project amenities, and curbside appeal. These three factors are totaled to determine each project’s Comparability Index. Next, all rents are converted to net rents. Net rent assumes that water, sewer and trash removal services are paid by the owner and that additional utilities (heat, cable television, etc.) are paid by the renter. Making these adjustments allow us to compare all rents on the same scale.

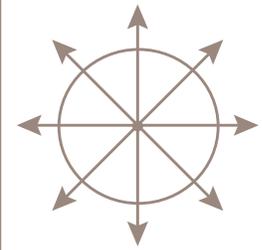
We then create a scatter graph by plotting net rent by Comparability Index for each project. Next, a regression line (weighted by the total number of units in each project) is established showing average comparable market rent (net) for a project at any Comparability Index level. We then establish a comparable market rent from this regression line. Projects below the regression line represent a value in the market at their Comparability Index.

Regression analysis allows us to determine market rent at any amenity level. This is particularly critical because each market sets its own standards based on what renters will pay or what landlords have historically charged. Not every market will reward the same apartment development with the same rents. Regression analysis allows us to identify these differences in standards before development takes place.

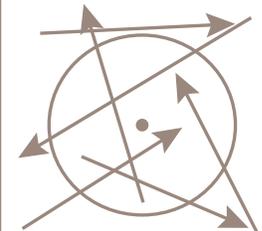
MAKING PROPER ADJUSTMENTS

Often, the regression analysis cannot tell the full story. Therefore, to go from a regression-driven comparable market rent to a recom-

A MOBILITY PRIMER



Radial mobility (above) consists of people moving farther from the central city in the same direction. A family who lives northeast is most likely to move farther northeast.



Lateral mobility (above) consists of mobility not conforming to the radial model. It is less common and housing developments that must depend on lateral mobility for most of their support must market aggressively to counter established radial trends.

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The combination of regression analysis with the Comparability Index allows us to accurately identify comparable market rent at any amenity level, something that selected comparable analysis is unable to do.
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mended rent for the subject property, we refine the process of determining appropriate rent by using additional analysis tools.

That is why we use **step-up/step-down support** analysis in conjunction with regression analysis to set appropriate rents for a proposed development. Our research indicates that there is a limit to rent increases that renters are typically willing to endure. If the new unit represents a value, Tax Credit renters are typically willing to increase their rents up to \$60 and renters at market-rate properties are willing to step up their rents up to \$150 (depending on the Comparability Index and the market). Renters who are paying rents below the proposed rent, yet within step-up range are considered the step-up support base.

Since most support for a rental property typically consists of renters already within the EMA, setting rents at levels with little or no step-up support will slow absorption (initial

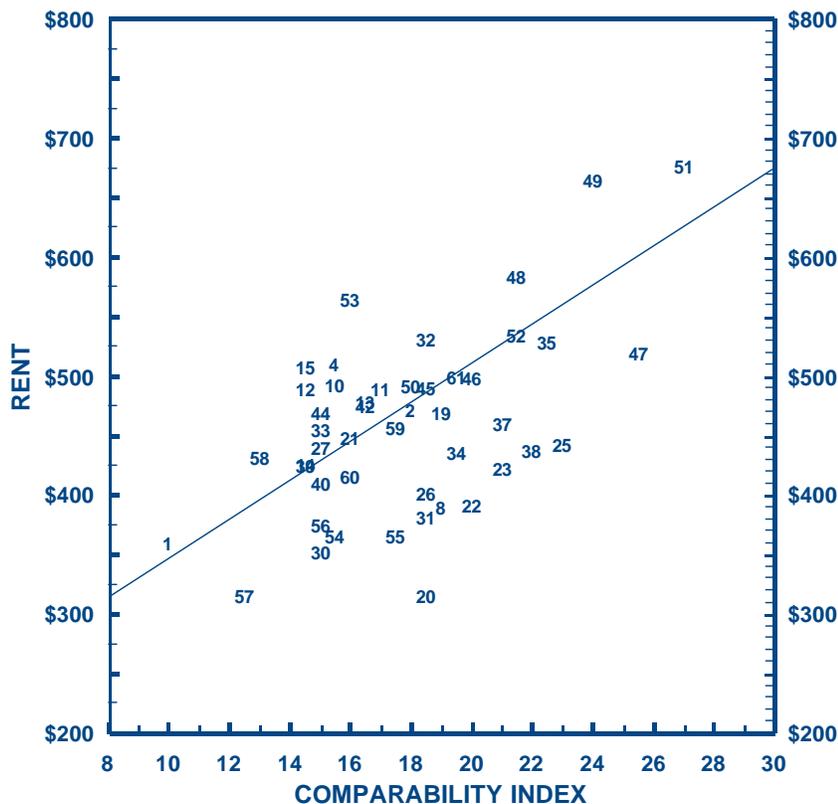
and replacement) considerably. We often recommend setting rents below the comparable market rent in order to maximize the step-up support and increase absorption.

Large properties (200 units or more) also require special adjustment of the regression-driven comparable market rent. Because of the high traffic volume required to replace turnover, these projects must be perceived as offering a greater value within the market than smaller projects. As a result, large projects must offer greater discounts from the regression-driven comparable market rent.

A recent analysis we conducted of the Columbus metro area illustrates this dramatically. Two-bedroom units in projects with 200 to 299 units achieved an average of \$21.64 less than projects with 100 to 199 units *at the same Comparability Index*. Projects with 300 or more units achieved \$52.13 less than those with 100 to 199 units.

HOW REGRESSION ANALYSIS WORKS

DISTRIBUTION OF TWO-BEDROOM UNITS BY NET RENT AND COMPARABILITY INDEX



The regression analysis is a key tool used to determine market rent for a project at any amenity level. First, all the projects in the area (the 100% Data Base) are surveyed to determine rent and amenities. Each project is then rated based on its level of amenities, or Amenity Index. The Amenity Index has three components: unit amenities, project amenities, and curbside appeal (aesthetic amenities).

All rents are converted to net rents, and each project is plotted on a scatter graph, with rents on the y axis and Amenity Index along the x axis. From this scatter graph, a regression line is determined.

This regression line indicates the average rent in the market for any project at any amenity level.

In the regression chart shown, for example, projects 1, 2, 21, 52 and 61 are achieving rents at the market-driven level. Projects 32, 48, 49, 51 and 53 are achieving rents well above the market-driven average. Projects 20, 30, 54, 55, and 57 have rents well below the market-driven average.

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| <p>SELECTED COMPARABLES VS. THE DANTER METHOD</p> <p>The table at right compares Danter Company methodology for determining comparable market rent with the selected comparables methodology.</p> | <p>Danter Company Methodology</p> | <p>Selected Comparables</p> |
| | Developed by The Danter Company specifically for market feasibility study. | Really an appraisal methodology. Well-suited for determining value, but not for determining comparable market rent or support potential. |
| | Identifies market status at all pricing and amenity levels, allowing analysis of potential support and competition. | Identifies market conditions at only one market level, so it only analyzes potential competition. |
| | Analyses limited to market area directly affecting subject site. | Often uses comparables outside of market area which may draw from a different tenant base. This can skew the analysis. |
| | Not subject to sampling errors given 100% Data Base. | Poor selection of comparables can lead to sampling errors. Properties performing better or worse than the market can skew the results. |
| Examines project in context of the entire market. | Often compares new product with modern design to older product that is functionally obsolete . | |

SPECIAL TAX CREDIT ISSUES

Accurate comparable market rent is particularly critical for Low Income Housing Tax Credit (LIHTC or Tax Credit) developments because Tax Credit rents are not determined based on prevailing market conditions. Rather, the Tax Credit program establishes maximum rents based on the area’s median household income as determined by HUD. In addition, Tax Credit rents can be adjusted annually based on changes in the area’s median household income.

Therefore, once a project is operational there may be little or no connection between allowable rents and comparable market rent. A project can raise rents every year if the area median household income increases, regardless of whether an increase is market-justified. In most markets, median income increases faster than rents. If income increases 4% per year and rent increases only 2%, then each year the project loses 2% against competitive value by taking the maximum rent increase. It only takes a couple of years of rent increases that outpace the market before a project is in trouble, becoming less of a value in the market and suffering from increased turnover and vacancies.

Remaining a value is critical for Tax Credit projects because tenant income limitations narrow the prospective tenant base. In addition, our research indicates that “cheaper prices/rents” is the most important reason for moving given by survey respondents who are income-qualified for Tax Credit units.

Because Tax Credit tenants are extremely price-driven, they are more likely to move to cheaper lodgings, even to a project of lesser quality when their rents cease to be a value. The combination of a limited tenant base and the ability of potential tenants to find quality lodgings in the market at a cheaper rent could be devastating to a poorly managed Tax Credit project. Therefore, initial pricing and future rent increases for Tax Credit units should only be entered into after thorough research into the state of the market.

SOME CONCLUSIONS

Maximizing a property’s performance begins with solid market-based information. A regression analysis based on a full 100% Data Base field survey, especially in conjunction with step-up support analysis, provides the best opportunity to set rents that will maximize performance.

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Regression analysis sometimes cannot tell the whole story of a market. That’s why we use it in conjunction with other analysis tools such as step-up support analysis, which identifies the number of potential renters who can increase their rent a reasonable amount in order to afford units at the subject property
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