TALES FROM THE TRENCHES
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October, 2010

YOU'VE GOT HOW MANY VACANCIES?

It was an okay building, in an okay part of town. 36 suites, just about the size our investor had targeted in his plan to acquire 200 units. The road to this investment was typical. Like a lot of investors, he started out small.

First he bought a condominium townhouse in a rental pool. Then he bought a couple of houses with secondary suites, one legal and one illegal. Then it was a fourplex and another fourplex. This process took three years. In order to reach 200 units he was going to have to ramp up his purchasing program. He found a realtor and started looking. Concurrently, he talked to his regular mortgage broker who referred him to a commercial lender. They had preliminary conversations with the result that our member knew roughly what amount of money he could borrow.

The hunt for the appropriate building continued until he and his realtor found the 36-suiter that seemed to fit the bill. Negotiations started; offer and counter offer with both sides bargaining hard. Finally, a deal was struck with a four-month closing date. On the day the offer went unconditional, only two of 36 suites were vacant.

Fast forward to the week before closing almost four months later. The lender wanted, as lenders do, an updated, certified rent roll. The seller had provided a rent roll as part of the buyer's diligence. But, the lender said, "that was four months ago, we need to know how many suites are going to be rented on the closing date." The seller provided that certified rent roll, which to our member's surprise and horror showed that vacancies were way, way up. Exactly half, 18 suites, were now vacant.

Apparently, the seller had just let suites stay vacant as tenants moved out. The lender said, "you do understand that your funding is driven by revenue. The fewer suites rented, the smaller your revenue and therefore the smaller your funding." Our member hadn't really understood that part of his mortgage. He thought that he had qualified for a mortgage in a specific amount and that's what he was going to get. Not so. He said to the lender, "I have an excellent property manager in place. Here is our management plan. We will fill up those suites in no time." The lender replied, "Great, we're glad to hear that. As soon as you reduce the vacancy rate, we will fund more of your mortgage."

Well, the scramble was on. With the mortgage reduced by over $1 million, more cash was required. The seller agreed to extend the closing by one month in return for a further $50,000 non-refundable deposit. Our member and his property manager put together an advertising blitz that rented 12 of the 18 empty suites. This raised the amount of mortgage funding, but more cash was still required. Fortunately for our member he had an untapped line of credit and a family that were prepared to give him short-term financial assistance. He closed the deal with the reduced mortgage funding and started the rental process. He quickly discovered just how difficult it is to rent suites at the rental rate you need, in the winter, when the vacancy rate is 7½%. It took another three months before he reduced vacancies to the original 2 vacancies existing when he made his offer.

Lessons Learned

1. Understand that once sold, sellers often quit managing.
2. Ask the lender how they handle vacancies and funding.
3. Improve your diligence with a thorough lease review.
4. Deal with vacancies and other management issues by adding clauses or schedules to your offer to purchase.