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Modeling the J Curve for Multi-Family Investment – Part 1

The investment cycle, from acquisition to value add initiatives to disposition is commonly referred to as the J Curve, as the cash flow dips in the initial 2-3 years during the renovation period, then improvement accelerates as the property is positioned for a road show to potential bidders. The trough of the cycle will reflect a higher vacancy rate, lower rental prices, higher concessions, and most importantly, renovation costs, while the acceleration will include improving vacancy, increasing rental prices and a drop off of the renovation costs.

Unlike a conventional investment in a value property, where cap rates are high, and the investor receives fat checks on a routine basis, redressing and repositioning a Class B, or C to Class A property requires much capital, operational finesse, and negotiation skills. The core function in the due diligence, leading up to the firm offer, is modeling the cash flow and determining the concluding IRR from the investment. We have constructed a simple financial model, to provide a sample illustration of the J Curve in action.

Most of the line items are the same, except the cost of renovation must be included to calculate the IRR. Numerous assumptions must be incorporated, such as the market's reception to the renovation, on a dollar for dollar basis. If we invested $10,000 into a property, how much more could we reap at the time of closing? How much more rent could we charge with the upgrades? How much lost revenue will we realize during the construction period? Will the contractors fully deliver on their quotes and promises?

One issue we came across was whether we could continue to depreciate an asset, which has been fully depreciated by the previous owner. Let's assume a building was constructed 100 years ago and the previous held unto the building for 50 years. We could safely assume the owner took full advantage of lower taxable income by fully depreciating the building, where the carrying book value is now zero. However, at the time we assume ownership of the building, we purchased it for $1.25 MM. Then could we, as the new owner, anticipating 25 years of use for the building, depreciate the $1.25 MM for 25 years? If yes, then we can pay out less taxes in cash.

Before 1986, many investors would realize losses for taxable income and use the NOL carry forwards on their other income, which has now been amended so that tax shelter is only applicable to other forms of passive income. The sales price minus the book value or purchase cost minus the depreciated value, is taxed at 25%. The actual gain realized, or sales price minus the historic, non-depreciated value, minus the 25% taxable gain value, is taxed at 15%.

Purchase	1,250,000
10 year holding	
Depreciation over 10 yrs	454,545.45
Cost	795,454.55
Sale Price	2,500,000.00
Actual Gain	1,250,000.00
Paper Gain	1,704,545.45
25% Tax	1,250,000.00
15% Tax	454,545.45
25% Tax Amount	312,500.00
15% Tax Amount	68,181.82
Total Taxable	**380,681.82**