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## Real Estate Investment Newsletter – February 2003

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### **The Mobile Home Park Niche: Pro's and Con's**

This month I will look at a specialized sub-market within the larger multi-family category. Investors in this niche will find more reasonable pricing of properties along with lower maintenance and less exposure to recession risks. On the other hand the properties are harder to finance, evictions are potentially more expensive, and there is little or no depreciation to shelter income from taxation. We'll look at these issues in detail to see why these properties make great investments in the current market environment.

Mobile home parks are properties where purchasers of manufactured housing (mobile homes) rent land for their home. Park infrastructure consists of water, sewer, electricity, gas, and sometimes, cable hookups, as well as laundry facilities. Manufactured housing enjoys a significant production cost advantage over standard home building. Many people who cannot afford to purchase houses will purchase mobile homes and place them in a mobile home park. These properties are very different from apartments: the renters are also owners; the landlord does not own the structures. These are much less common than apartment buildings; most apartment investors do not know anything about them. Thus they occupy their own special niche in the market.

In an economic downturn people cut their costs if they can. For renters this usually means moving to a lower quality property or moving in with friends or family. Consequently luxury apartment vacancies and rents are more sensitive to the local economy than low-end properties. Most mobile home parks compete in the low rent end of the market and thus may see increased demand in tough times. Another factor insulating them from downturns is their tenants' investments in their homes. These tend to tie them to the park since moving a mobile home can cost a couple thousand

dollars (6 months or more rent). Ownership also gives these tenants more of an incentive to pay rent on time, follow park rules, and maintain their units. Still this segment of the rental market has a bad image with many investors and valuations reflect this fact.

The lower valuations of mobile home parks relative to apartments mean that the intrepid investors who venture into this segment can earn cash returns higher than if they invested in a good condition apartment building<sup>1</sup>. Mobile home parks in the northern central valley (a high growth market) are selling at 7 times gross rents. After deducting expenses, this pricing provides a yield on the asset of 7-8% (the capitalization rate). In comparison, apartments in the same market would go for 9-10 times gross rents, implying asset yields of 4.5-5%. Looking at the up-and-coming Korea town section of Los Angeles (with rent control), well maintained apartments cannot be had for less than 8.4 times gross rent (5.4% asset yield).

There are apartment investments available (to those who make offers quickly) at valuations comparable to the mobile home parks in the northern central valley, but these buildings are typically in need of repair and in lower quality locations. For example, some apartments have recently been for sale in Fresno at yields near 8%. These properties offer returns similar to mobile home parks but require more management attention and may not enjoy the upside potential of properties closer to Sacramento and the bay area.

What do these valuation differences mean for returns? Using my standard assumptions about expenses, financing terms, and reserves, we can derive the following table of relationships between asset yields (also known as Cap rates) and returns on invested equity. Assuming 3% growth in

Property Cap Rate	5 Year Average Pre-Tax Return on Equity
5.0%	7.8%
5.5%	9.0%
6.0%	10.4%
6.5%	12.3%
7.0%	14.4%
7.5%	15.9%
8.0%	17.4%
8.5%	18.9%
9.0%	20.4%

net operating income for all properties, a property purchased at a Cap rate of 8% will show a pre-tax compounded return of 17% compared to a return of 9% for one purchased at 5.5%. Compounded over 10 years such a difference will lead to 80% higher total returns.

Besides the benefits of buying to operate, mobile home parks are attractive investments for those who wish to hold land in a growing area to take advantage of changes in the best use

through time. Since mobile home parks include few permanent structures (usually just a laundry room), it is relatively inexpensive to convert the land

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<sup>1</sup> There are always exceptions. In particular apartments with problems (i.e. rundown, high vacancy, poor management) can yield very nice returns to investors willing to jump in and fix the problem.

to commercial or high-density residential uses when local economic conditions favor these uses.

The lack of structures does, however, have a downside. Costs attributable to a structure can be deducted from taxable income in the form of depreciation over the tax life of the structure, thus sheltering cash income. Since mobile home parks have a much lower proportion of such costs, they are effectively taxed at a higher rate on cash returns.

Mortgaging mobile home parks is also more difficult and costly than the average apartment or commercial building. Many banks will not make loans on this type of property. Thus the cost of finding a lender for the property is higher and the limited supply tends to push up the fees and rates. Required appraisals are also more costly because fewer appraisers are experienced with this type of property. Mixed-use parks (that contain rental structures) are even more complicated to appraise and underwrite.

Perhaps the biggest disadvantage is the cost and difficulty of evicting problem tenants (and their homes). Usually when a mobile home owner wants to move, or is asked to move, they will try to sell their home and buy a different one so as to avoid the expense of moving the home. This may be difficult for older mobile homes because most financial institutions will not provide a mortgage. If a tenant owns a very old mobile home that is not in good repair they may well abandon it when evicted. The landlord can either pay 6-8 months worth of space rent to have it removed or go through the process of obtaining title, repairing it, and financing its sale.

Investors can mitigate most of these disadvantages. For example, an investor buying a mobile home park for the cash flow can pair this investment with an apartment purchase where the returns come primarily from appreciation and growth. These types of deals will usually generate excess tax deductions (from depreciation) that can be used to reduce the effective tax rate on the mobile home park. As for problem tenants, the owner must be careful in screening and selecting tenants. This may include bans on older units moving in. Sometimes both parties are better off if the owner pays the tenant to move his old mobile home out of the park.

The determined investor can always find financing, though it may not be as much, or as cheap, as for other properties. Assuming the investor can put up a larger equity stake, the valuation differences will usually compensate for lower leverage and higher costs so that the investor still earns a higher return than on a similarly located apartment investment. Berkeley Investment Advisors can help find the best financing for these hard to finance properties and facilitate a suitable appraisal to close the deal.

### **Conclusion**

In order to maximize the advantages of this niche property type you must have good management in place to avoid problem tenants and set rents at levels appropriate for the location and desired clientele. Berkeley Investment Advisors can help you find the right local management and monitor their performance to ensure returns meet or exceed expectations. Just as important, we provide the expertise to help you find, evaluate, and finance the difficult to locate properties in this niche so you can take advantage of the high returns overlooked by the average apartment investor.

### **Featured Investment Opportunity**

This mobile home park, located in West Sacramento California, has 36 spaces and 4 units in two duplexes. The park has no vacancy and there were no vacancies at any of the nearby parks surveyed. Based on current rents the net operating income is projected at \$76,000. The asking price, \$948,000, is 7.1 times gross rents and implies a healthy capitalization rate (NOI/price) of 8%. This property may well achieve a 75% loan to value (LTV) financing. Even at 70% LTV, the first year return on equity will reach 17% pre-tax (14% after-tax) assuming appreciation of just 2.5%. At 70% loan to value, the required investment, including closing costs and working capital, is \$320,000. The expected cash on cash return is 7.3%. Given the lack of vacancies and this park's low rents relative to nearby competition, there is significant further upside to be had by raising rents.

### **Upcoming Events**

Ray Meadows, President of Berkeley Investment Advisors will present at a seminar on real estate investing in Tokyo March 10th. He will be available to meet with clients March 11<sup>th</sup> through March 14th. The seminar will be held at the American Chamber of Commerce Japan in Tokyo at 7pm. Light snacks will be served. While past seminars have focused on the big picture, this seminar will delve deeper into the nuts and bolts of the investing process. See Upcoming Events at [BerkeleyInvestment.com](http://BerkeleyInvestment.com) to RSVP.

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