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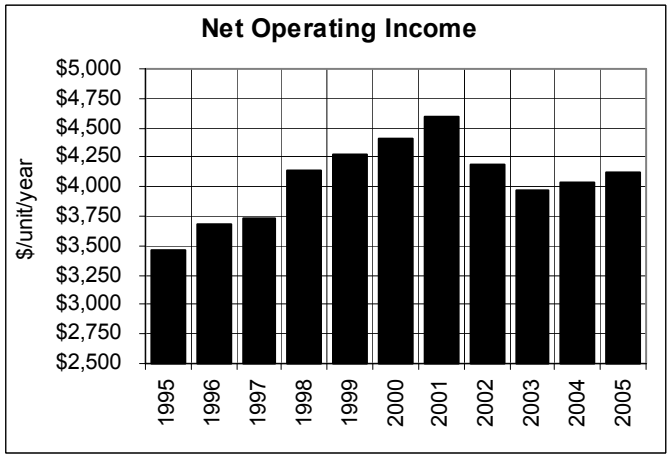
Expenses



Expenses…
"I Get High Blood Pressure When I Say Your Name."
— Dr. John

We thought of Dr. John's lyrics the other day because he was coming to Seattle to perform at Jazz Alley. He's a musician from New Orleans, Patty's home town. And even though he wasn't singing about apartment expenses, those lyrics sure fit.

Rents rose 1% last year, operating costs climbed 2%, and investors increased their capital expense budgets by more than 20%. Sounds like a recipe for high blood pressure, or at least a dose of heartburn.

But wait. Vacancies and rent concessions fell. And property managers got a lot more thorough about charging residents for repairs and damage. That combination pushed total collected revenue up almost 3%. The result was a 2.2% increase in net operating income last year. Ah, plop plop fizz fizz.

Here's a little more detail. After rising steadily for five years, the economic vacancy rate finally fell in 2005, to 9.6%. That's still a high rate, but it is well off its peak in 2004, when physical vacancies, rent concessions, and credit loss pushed the economic vacancy rate up to 11.7%. Plus, much of the improvement took place in the second half of the year, so things are looking even brighter for 2006. We will publish the results of our spring survey of rents and vacancies in *The Apartment Vacancy Report* at the beginning of April, and discuss the findings of that survey in next month's *Advisor*.

Operating expenses climbed 1.9% last year. It cost $3,896 a unit to operate the typical apartment property in the Puget Sound region in 2005.

That excludes capital expenses. Adding those in bumps the median cost to $4,454 a unit. This total cost represents a jump of 8.6% over a year earlier. That's because investors held back on capital expenses in 2004. Remember, they were still reeling from the beating they took from the market over the prior few years. But 2005 saw investors reinvigorated. Revenues rose faster than expenses. So investors bumped their capital budgets by more than 20% to take care of some lingering problems and to position their properties for the rebound.

What's typical

The cost numbers discussed here refer to the median cost. That means one-half of the properties we analyzed spent less than $3,896 a unit last year for operating expenses. It also means half spent more.

Looking a little deeper at operating costs, excluding capital expenses, one-quarter of the properties in the region spent less than $3,509 a unit last year, while three-quarters spent more. At the other extreme, one-quarter spent more than $4,358 a year. Remember, these costs exclude capital expenses. Why exclude those costs? We didn't want to depress you any further.

There are a number of factors influencing operating costs, including property age, condition, quality, revenue, size of units, location, and management style. This 12-page issue of *The Apartment Advisor* focuses on line-item trends for the region overall.

About the research

This issue of the *Advisor* summarizes the results of our just published 2006 edition of *The Apartment Expense Report*. The report contains our audit of 2005 operating statements for 683 properties with 76,579 units.

DUPRE + SCOTT
apartment advisors, inc

We provide research on apartment investment and market trends in the Puget Sound region. Our goal is to enhance the quality of information available to help our clients make better decisions. We believe the long-term health of the Puget Sound region's rental housing market is important to everyone involved in this housing market. We are convinced the market will work best when informed, timely, reliable, and unbiased market information is available. Thank you for supporting our research.

Patty Dupré + Mike Scott

The report found a number of significant trends this year, and includes detailed tables and graphs showing line-item expenses and trends by sub-market, property size, and property age-group. The 153-page report analyzes 16 line-item expenses. Some are discussed here. The report lets users analyze cost trends in a lot more detail than we can here. But this *Advisor* will give you a clear picture of what has happened and where things are likely to go. And it points out some issues investors need to focus on more than they have in the past.

Up & down

The *Operating Expenses* graph below shows an important cyclical trend. Although operating costs seem to rise steadily year after year, their impact on apartment investment performance is more varied.

During the economic expansion of the late 1990's, operating and capital costs took less of total revenue each year. By 1996 costs ate less than 46% of a property's collected income. That's because the late 1990's boom in our economy stimulated rent growth. Higher rents and lower vacancies pushed revenue up faster than costs. That was the case, at least until 2000.

Costs began taking a higher share of revenue since 2000, peaking at almost 52% in 2004. Although operating expenses continued to climb in 2005, revenues grew faster. As a result, operating and capital expenses consumed a smaller share of total revenue than the year before. It's not much of a change. But it is an improvement, and that improving trend will continue.

Did anyone ever tell you expenses ran just one-third of revenue? Okay, that's usually said in the context of "scheduled" rather than collected revenue. But still. Really. Maybe it doesn't sound important whether expenses cost 35%, or 40%, or 45% of collected revenue. But it makes a big difference to investors.

A 5% change on a typical, leveraged apartment investment could take away almost 10% of a property's value. Worse, it could cut cash flow by 30% to 40%, particularly in the first few years after purchase.

Buyer budgets

Our *Expense Report* results do not fit closely with what buyers budget. The latest edition of our *Apartment Investment Report* shows buyers of 20-unit and larger apartments budgeted $3,993 a unit for expenses last year. That excludes any major capital expenses buyers planned initially, but it should include an annual replacement reserve for future capital needs.

The graph on page 3, *Buyer Budgets: Percent of Actual Costs*, shows buyer budgets are 10% below the $4,454 a unit cost we found in 2005 for operating and capital expenses. Buyers did get better at budgeting last year though. Fear of rising interest rates helped make the budgeting process a bit more conservative last year. Plus, an expected improvement in the economy made buyers more bullish at the same time. As a result, buyers shrugged off the dismal cash flow their tougher budgeting created, expecting much better results soon.

It's possible some of the difference between these two sets of expense numbers is justified, based on different characteristics of the properties in our expense research compared to the apartments that sold last year. But we suspect the difference is minimal. As a result, many buyers are over-estimating the returns they expect to generate from their purchases.

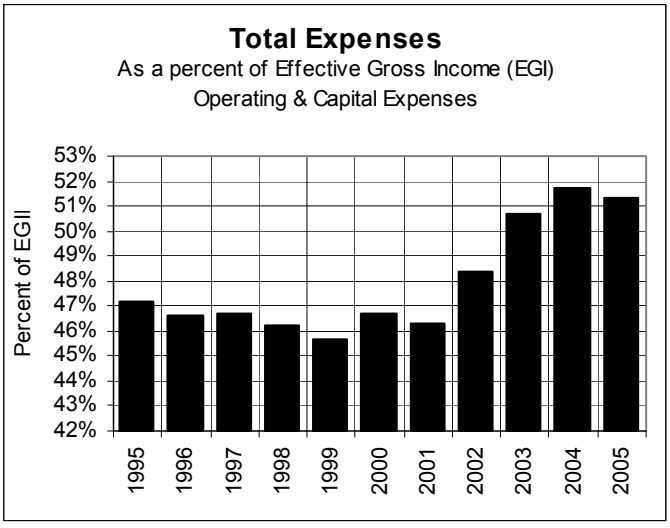
Physical versus financial vacancy

We measure the physical vacancy rate from our semiannual surveys for *The Apartment Vacancy Report*. Physical vacancies report the vacancy rate in the market based on the number of vacant units found from the survey.

We measure the financial vacancy rate from our annual audit of year-end operating statements for *The Apartment Expense Report*. Financial vacancy is measured by comparing total rent collected, prior to deductions for credit loss and concessions, with the rent schedule.

The total financial vacancy rate for 2005 was 6.1%, the lowest we've seen since 2001. Between 1997 and 2001, the financial vacancy rate ranged from a low of 3.7% up to 4.6%. Between 2002 and 2004, it was 7% or higher. The financial vacancy rate measures the total rent lost during the year from vacancies only.

Our *Apartment Vacancy Report* showed a similar trend, with the physical vacancy rate moving from 4.6% in 2001 to an average of 7.4% by 2004. Last year it fell to 5.9%, the lowest vacancy rate in the region since 2001.



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Auditing vacancy surveys

We use our survey for *The Apartment Expense Report* as an audit tool to test the accuracy of our survey for *The Apartment Vacancy Report*.

The financial vacancy rate over the past six years, from *The Apartment Expense Report*, averaged 6.07%, while our vacancy survey reported an average 6.09% vacancy rate. That's close enough. Last year the financial vacancy rate was 6.1% for the 77,000 units in our expense survey. Our rental market surveys last year reported an average 5.9% rate for the year.

Over the years we have heard a number of people express the view that vacancy survey respondents might deliberately understate vacancies to present a better picture of the market for prospective buyers, lenders, or to boost the share price of their REIT stock, or some other self-serving goal. Others thought respondents might overstate vacancies to discourage new construction, in order to minimize competition.

We don't find this to be true. Our annual comparison of physical and financial vacancies confirms the reliability of the semi-annual physical vacancy surveys we conduct.

Maybe we should be more jaded. It's actually odd that we're not, given that we have spent more than 25 years in this industry. But all those years of research have made it clear to us, that as long as we respect the privacy of information people share with us, and use it appropriately, they will share information honestly. Sounds corny, but we've got the data to back it up.

Besides, there is a technical reason for this outbreak of veracity. Game theory logic reasons that as a society gets more complex we lean more toward cooperation. A good read on this topic is Robert Wright's book *Nonzero: The Logic of Human Destiny*. Still, we monitor this carefully once a year.

Why there are differences

Differences between physical and financial vacancy rates, when they occur, are due primarily to two factors. The physical rate is based on the number of units vacant, not the value of the rental income lost. As a result, studio vacancies have the same impact on the physical vacancy rate as three-bedroom vacancies. However, the larger units usually have a more significant financial impact.

We calculate physical vacancy just twice a year, in March and September. We expect that during a generally improving market physical vacancy could initially overstate actual financial vacancy.

That was the case last year, as well as back in 1996. Similarly, in a generally deteriorating market, physical vacancy could understate actual financial vacancy, as it did in 1998.

So what about expenses?

We started this issue of the *Advisor* saying we would discuss the results of our annual *Apartment Expense Report*, and then drifted into a discussion of vacancies after only a brief overview of expense trends.

Now we're going to confuse you even more. We are going to talk about revenue trends last year. Don't worry, we will get around to discussing line-item expense trends soon. Just saving the best for last, that's all.

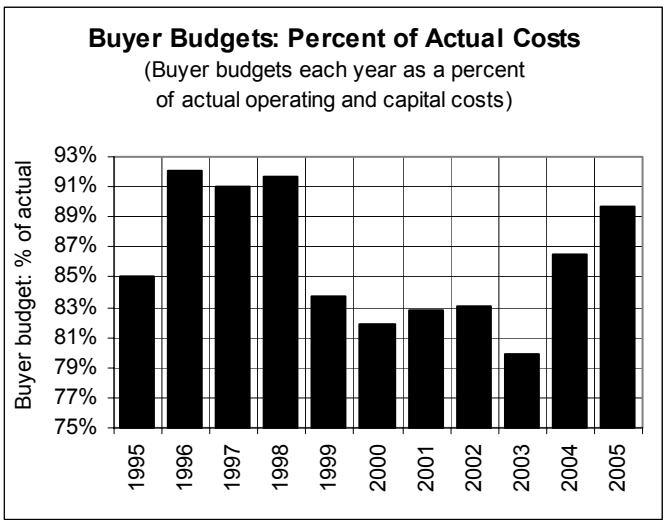
The Apartment Expense Report has evolved over the past few years, but we have not changed the name. Because we collect actual annual statements, we are able to look at all aspects of the apartment market's financial performance.

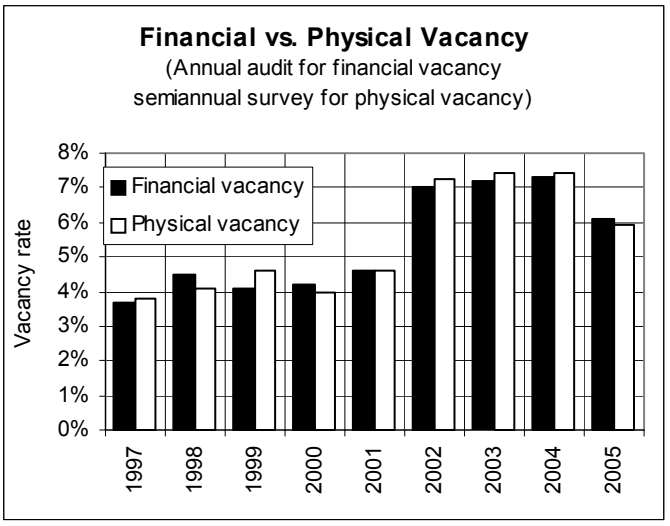
And, because we are collecting information for close to 80,000 units, the results are a good indicator of overall market performance. So it makes sense to review what actually happened on the income side last year, as well as the expense side.

Effective apartment income

Deducting the financial vacancy rate leaves actual rent collected for the year, or "effective apartment income."

The table on page 11 shows effective apartment income climbed 1% in 2005. Now that's exciting. Really. We mean it. Last year was the first time since 2000 that effective apartment income didn't fall.





This category includes only apartment rents, excluding parking and other income sources. It can rise faster than scheduled income due to falling vacancy rates, fewer concessions, or less credit loss. It can also fall faster, as it did between 2001 and 2004. We have been forecasting for the past few years that it would start climbing faster in 2005 and continue to do so for the next few years.

Economic vacancies

Neither the physical nor financial vacancy rate measures the total revenue loss each year. They just measure the rent loss from vacant apartments. But there are other ways to lose money.

The economic vacancy rate considers the impact of vacant units, but goes beyond that. It also includes losses from concessions and credit loss.

The economic vacancy rate increased steadily from 1998 through 2004. It took a dramatic jump in 2002 and kept climbing in 2003 and again in 2004, when it peaked at 11.7%. Last year was the first time in a long time that the economic vacancy rate fell. It dipped down to 9.6%, and we expect it to fall a lot more this year and next.

Concessions

Our *Apartment Vacancy Report* found only 23% of the properties in the region offered concessions as recently as 2001. The use of concessions jumped to almost 70% of the properties in the region over the past few years.

But managers cut back on the use of concessions last year. By last fall, our survey found only 41% of the properties offered concessions. And the amount of concession was lower too.

As a result, concessions cost 2.6% of gross rental income in 2005, down from 3.3% a year earlier. That's a positive move, but concessions are still well above the level common in the late 1990's, when they took away about 0.6% of gross rental income.

That cost we're talking about is for all the units in a property, not just the ones that had to offer concessions. So, if rent concessions were only offered on turnover, and if half of the units each year experienced turnover, the concession cost for the turnover units only would be close to 5%. That's almost three weeks of rent, so it's no small matter. Remember, we're looking at results for all of 2005. Since the market improved significantly in the second half of the year, concessions likely cost more than three weeks of rent early in 2005, and closer to two weeks by the fall.

Credit loss

In spite of an improving economy, credit loss remains at a relatively high level. Credit loss took 1.1% out of scheduled gross income last year. That's an average for all the units in a property, not just the units suffering collection losses.

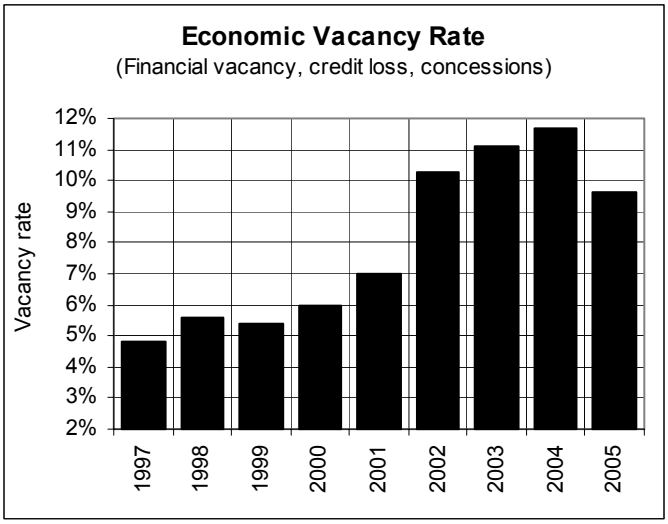
Credit loss should be half of last year's level in a strong economy. And we have a strong economy. But many property managers tell us that even though demand has picked up, screening for quality residents remains challenging because low interest rates are taking many of the better candidates out of the rental market. Well, both housing costs and interest rates have risen, so we expect to see an improvement in applicant profiles.

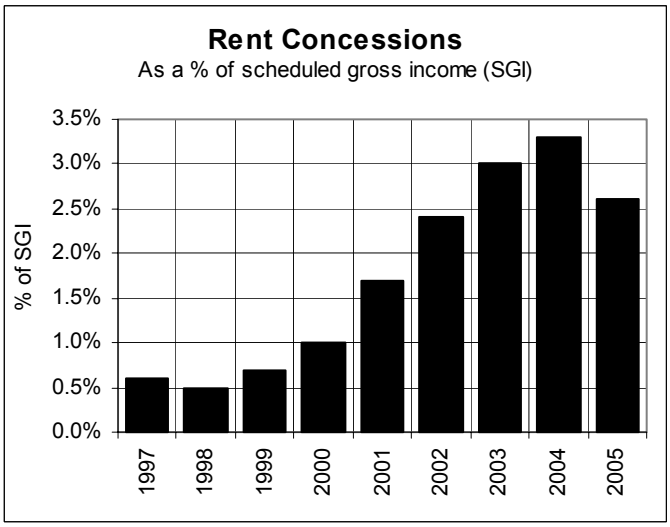
Most financial pro forma statements include a line for "vacancy and credit loss." It looks to us like investors plug in a vacancy rate, but forget to allocate something for credit loss. Even in the good economy we enjoyed in the late 1990's, credit loss added 60 basis points to the physical or financial vacancy rate. So don't forget to budget for it in your financial analyses.

Other income

This category includes income from a variety of sources, including: laundry, parking, late fees, water/sewer, bounced check fees, forfeited deposits, non-refundable deposits, antenna leases, and other miscellaneous income. It excludes commercial space, corporate suite, and unusual sources of income.

The typical property collected $516 a unit last year in other income, up significantly from $347 in 2004, and $273 just a half dozen years ago. This revenue source has increased 9.5% compounded annually since 1997. A lot of the increase in 2005 was the result of managers being more





thorough in charging residents for repairs and damage they caused. We talked about that strategy in a special report we put together in 2004, *Controlling Apartment Expenses*. If you haven't already read it, we'd be happy to give you access to a copy of it through your online account on our website. Just email us at research@dsaa.com .

Late fees & NSF charges

Late fees and non-sufficient funds (NSF) charges are included in the other income totals discussed above. They have not changed much in the past year. Combined, they added $45 a unit to income last year.

Forfeited deposits

These charges are used to defray some of the costs on turnover for repairs beyond normal wear and tear. Just over 95% of the properties in this year's study reported income from forfeited deposits, up from 85% of the properties last year. The typical property collected $130 a unit last year, up slightly from 2004.

Laundry income

Prior to 1980, few properties provided washers, dryers, or hook-ups in units. Laundry income came primarily from common area washers and dryers. A little more than twenty years ago, washers and dryers, or at least hook-ups, started to appear more frequently in apartments. Most new construction includes this amenity.

As a result, fewer than 40% of the properties in this year's study report any income from laundry. The typical income, for properties with only common area equipment, was $97, up slightly from 2004.

Effective gross income

After taking into consideration all of the additions and deductions to the scheduled gross income discussed above, we're left with "effective gross income." That's what goes in the bank, at least for a little while.

Last year effective gross income rose almost 3%, to $8,455 a unit for the year. In spite of rent gains in the mid- to late-1990's, effective gross income has only increased 2.7% compounded annually over the past ten years. That's because it lost ground between 2001 and 2004.

So last year's gain of 3% signals the return of revenue growth. It should get another boost this year. Revenue losses are exaggerated in a softening market, but increases are similarly exaggerated as the market improves.

Real estate taxes

The typical real estate tax bill was $734 a unit last year, about the same as year earlier. But taxes climbed fairly steadily over the past few years, even though revenue went down. Taxes increased 3.8% compounded annually over the past three years. Looking back a little more, taxes rose 3.4% compounded annually in the past ten years.

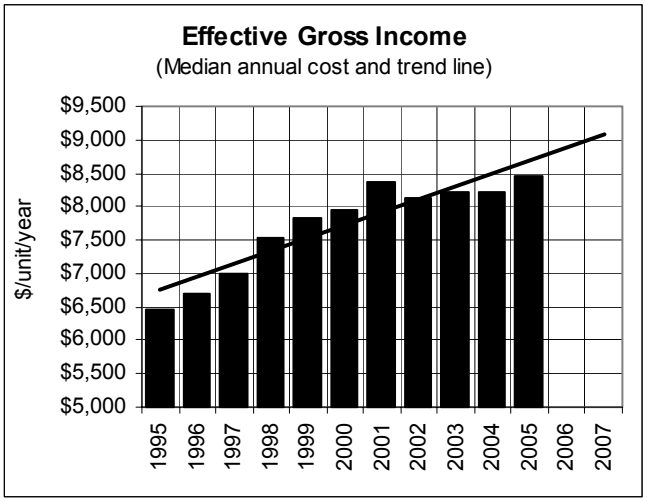
We monitor levy rates in 45 cities around Puget Sound. Levy rates for 2006 are higher this year in just four cities. That means that if assessed value did not increase for 2006, your taxes will be lower in nine out of ten cities in the region. We found a similar pattern last year. And taxes didn't climb as a result. But don't bank on that tor this year or next. Valuations are on the rise, and we expect the trend to continue this year.

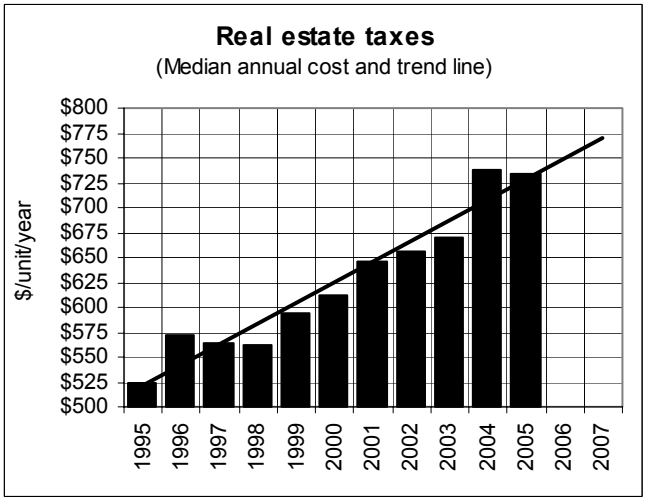
Our last *Apartment Investment Report* found the average assessed value was less than 80% of the sales price for apartment transactions last year. Why are assessments lower than sales prices? For one thing, prices jumped significantly in 2005. The average price per unit for 20-unit and larger sales last year was over $92,000, compared to $76,000 in 2004. The table on page 12 shows a similar trend. Prices for all 5-unit and larger sales climbed 14% last year. That was great for sellers. But it will have an impact on your future tax bills.

Another way to look at your real estate tax bill is its cost compared to your total collected revenue, or effective gross income. Real estate taxes took 8.7% of property income in 1994. Its share fell to 7.3% by 1998. The change was the result of a strong rental market pushing income up faster than valuations.

The share of income going to pay your tax bill increased steadily between 1998 and 2004, when it reached 8.8%. It retreated a little bit in 2005, consuming 8.6% of collected revenue.

So now may be the time to take a careful look at your





2006 tax bill. Once you receive your assessment notice for a property, you have thirty days to file an appeal, or July 1st, whichever is later.

Appealing?

By itself, a higher tax bill does not do much for your residents, so they won't pay extra rent because of it. Higher costs here cut into your ability to spend money in ways that improve the environment for residents, and your property value, and cash flow at the same time.

Assessed value in our region generally trails market value. But that's not always the case, so it pays to monitor your tax bill. Our *Apartment Investment Report* compares sale prices to assessed values. Sale prices seem to be a reasonable measure of market value, the assessor's target.

The latest online version of the report, summarized on page 12, found the average assessment last year for all 5-unit and larger sales was just 74% of the sale price. It's a simplistic and incomplete analysis, but it reasonably suggests apartments are not over-assessed. That's true for most apartments. But not all.

Just over 4% of the sales that closed since the start of last year sold for less than the assessed value. The average over-assessment was more than 9%. That translates into almost $4,500 a year of overpayment for the typical 50 unit property. If you cut your tax bill by 9% we're sure you will find something to do with the money you save.

Insurance

The aftermath of Seattle's Nisqually earthquake in 2001 shook investors with a jump in premiums. Apparently that increase was not enough to solve the insurance industry's problems. Investors saw rates climb almost 15% in 2002 and a 20% jump in 2003. Investors did not see insurance costs increase much between 2003 and 2005, partly because they changed coverage to control costs.

The longer term trend shows insurance increases rose faster than overall operating costs. The average insurance bill increased 13.4% compounded annually over the past five years, and 11.1% compounded annually over the past ten years. Those increases are exaggerated by the dramatic bump in rates over the past few years.

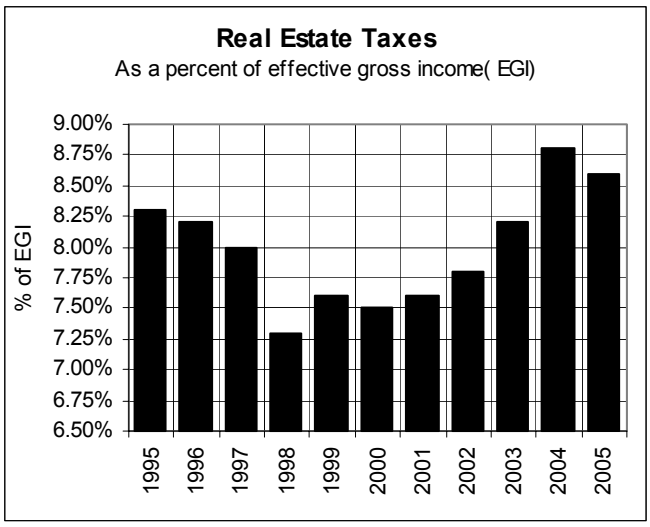
Utilities

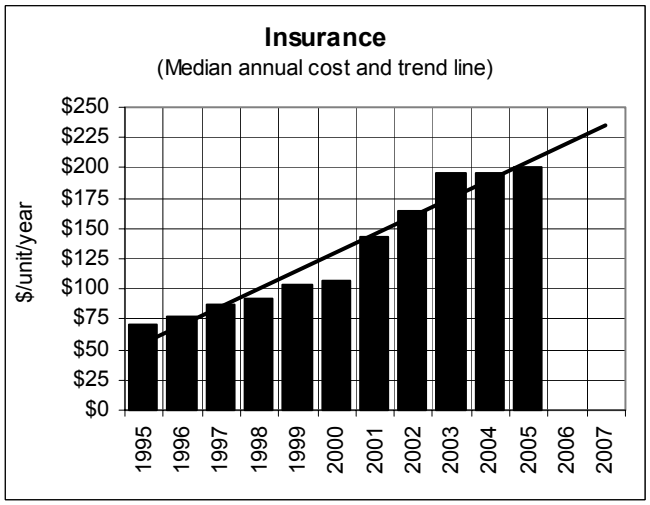
Utility costs paid by the property rose less than 1% last year, to a typical $723 a unit. By comparison, they climbed 3.5% compounded annually over the past five years.

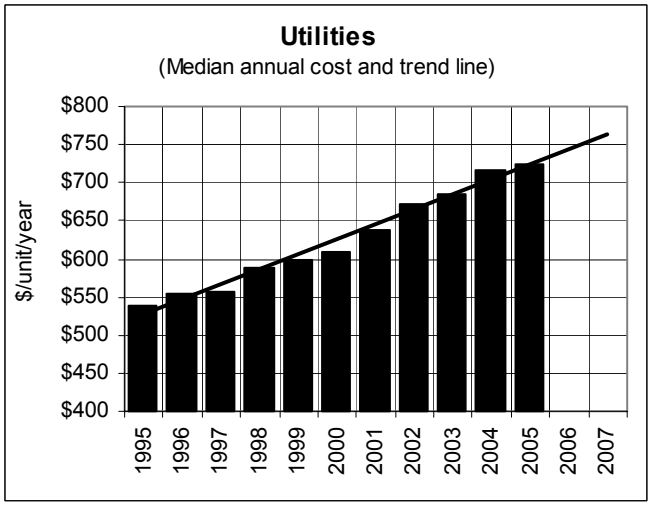
Who pays water?

More than half of a property's typical utility bill is for water and sewer charges. A dozen years ago every property paid those charges. Since then, more properties have begun passing on water and sewer charges to residents. This change is holding overall utility charges for apartment properties in check, at least to some degree.

We began talking about the need, and opportunity for water conservation in the August 1995 issue of *The Apartment Advisor*. It has been a slowly growing trend since then, but our fall 2005 *Apartment Vacancy Report* found just over two-thirds of the units we surveyed in King County and 83% in Snohomish County pass through water and sewer charges. Almost 60% the units in Kitsap County and 53% in Pierce County pass through these costs. But only 30% have switched to resident-paid water in Thurston County.







The number of properties in the region that have switched to resident-paid water and sewer is lower, since this change is more common in larger properties. Even so, our *Expense Report* found 48% of the properties charged residents for water and sewer costs. The median charge was just under $30 a unit a month, resulting in almost $360 a unit of additional annual revenue.

Resident management

On-site management costs increased 3.3% last year to $537 a unit. That's close to the norm. Over the past ten years, total on-site resident management costs climbed 4% compounded annually.

To help put resident management costs in perspective, median family income in our region climbed 2.8% in 2005 and 3.5% compounded annually over the past ten years, according to data recently released by the Department of Housing & Urban Development.

Professional management

The typical management fee remained unchanged in 2005, holding at 3.9% of collected revenue. That means management companies saw revenues climb some last year, as effective gross income finally made some gains. The median management fee was $325 a unit last year, up from $305 a year earlier.

Even with that gain, management fees are still 6% lower than they were in 2001. Almost always based on a percentage of collected income, fees fell victim to vacancies, lower rents, and concessions over the past few years. They started to rebound in 2005 and we expect a continuation of that trend this year.

Office administration

This includes all costs associated with operating the on-site rental and management office. Items such as phones, computer software, fax machines, office supplies, office furniture rental, dues, subscriptions, credit check fees, legal fees, and bank service charges are included in this category. Office administration costs during 2005 remained unchanged at $115 a unit a year.

Decorating & turnover

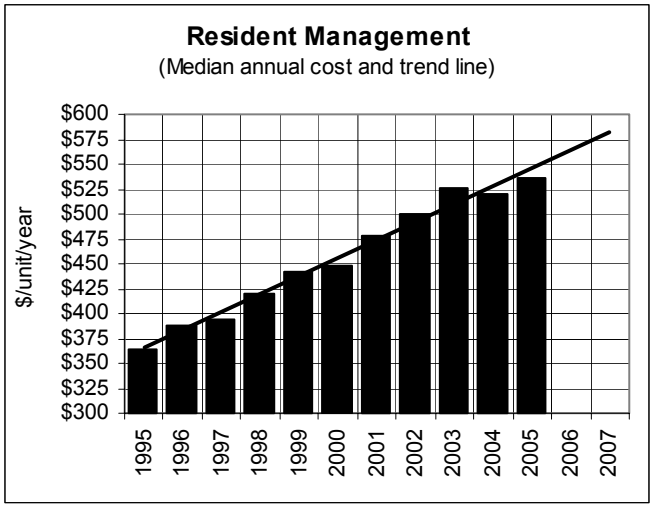
Decorating and turnover costs have held constant at close to $170 a unit a year for the past four years. That's due primarily to two factors. First, our *Apartment Vacancy Report* found the rate of turnover dropped a little last year in the region, to 49.5%, continuing a downward trend from 52.3% in 2002.

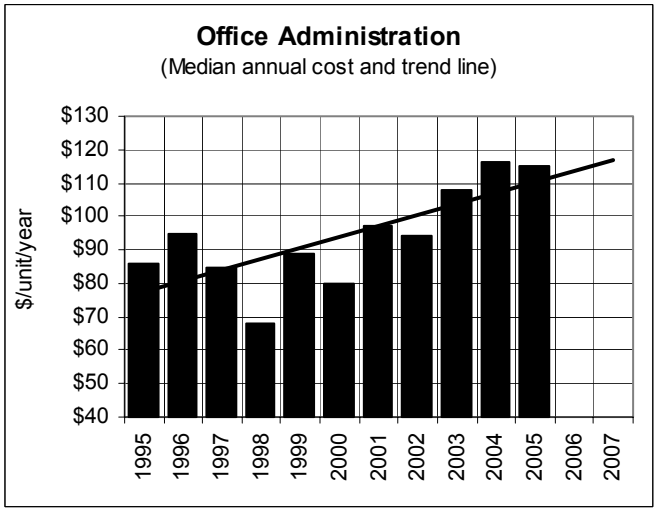
Okay, that's not much of a change, so something else must have happened. Managers dealt with the difficult budget problem of the past few years by being more aggressive last year in charging for damage created by vacating residents.

The *Decorating & Turnover* graph on page 8 shows there is no clear trend in decorating cost increases. That's because these costs depend almost completely on market conditions.

The weak rental market in the early 1990's resulted in rapidly rising turnover costs. That's because there was more turnover, and more competition to fill units.

The strong rental market beginning in the mid 1990's resulted in low vacancies. Turnover costs fell. It was not that the rate of turnover changed much, it was just that managers did not need to do as much to fill a vacancy in that tighter rental market. Now, with competition fierce,





turnover costs are generally higher again.

Repairs

The typical property spent $635 a unit on repairs in 2005, up 4.6% from the year before. Repair costs have increased 3.5% compounded annually over the past five years.

The trend line in the *Repairs & Maintenance* graph on this page shows that even if investors have some say about deferring repairs and maintenance, there is still a consistent long-term trend in these cost increases. Two factors drive repair costs higher over the longer term, and a third factor will keep costs rising this year.

First, everything is getting older. Second, consumers demand more service than they did a decade ago. Third, the soft rental market of 2002-2004 caused some repairs to be put on hold. With an improving market in 2005, investors started to work off that backlog. That trend will continue this year. These facts conspire to push repair costs higher faster, beyond just the normal inflationary cost increases for duct tape.

Even the cost trends shown here likely understate the rate of increase in the costs. Major changes in retailing and wholesale buying organizations in the past ten years likely moderated cost increases in materials. This competition has been good for apartment investors. Without it, costs would have risen faster than this graph illustrates.

Marketing

Advertising and marketing costs reached a record level in 2004, at $173 a unit. Property managers managed to start trimming this expense last year, resulting in a median cost of $161 a unit for 2005. That's a small improvement, but it is the start of what should be a trend, at least for another year or two.

Marketing costs clearly vary by location. The typical marketing cost last year in King County was $163 a unit. Pierce County investors spent $144, while those in Snohomish County spent $179 a unit. Marketing costs also vary by property size. Regionally, properties with fewer than 100 units spent $103 a unit last year, while larger properties spent $217.

Operating expenses

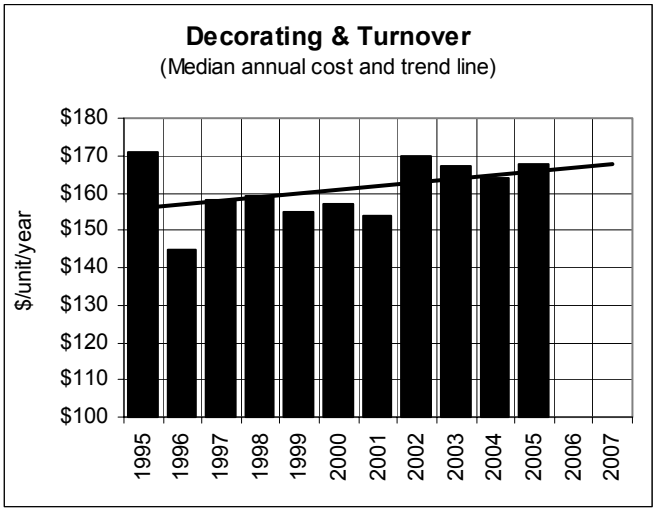
The typical property cost $3,896 a unit to operate in 2005. That excludes any capital expenses or replacement reserve budget. Operating costs rose 1.9% in the past year, and 3.3% compounded annually over the past five years.

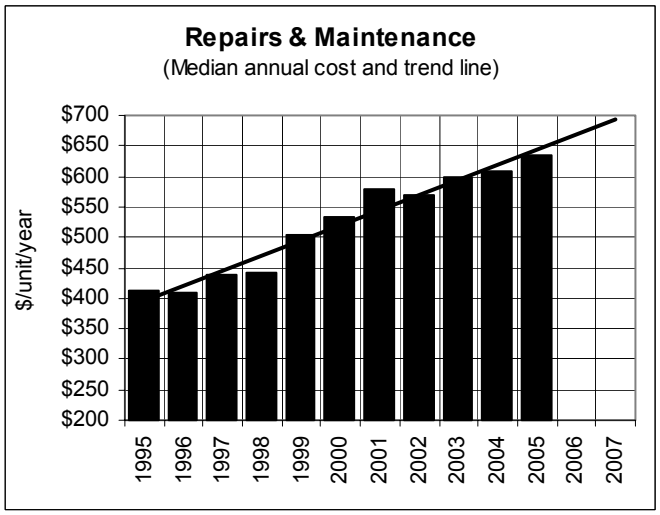
Although investors have little control over some operating costs, they do have some control over others, as discussed in this issue. The result, as the trend line in the operating expenses graph shows, is that the rate of expense increase is reasonably predictable.

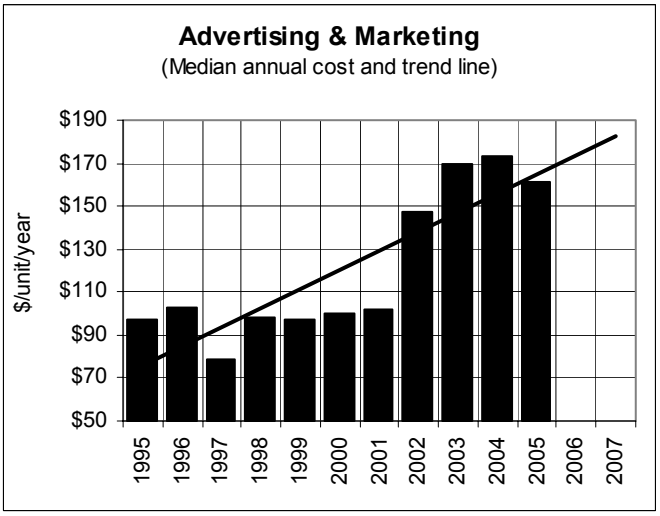
Operating & capital expenses

The trend in operating and capital expenses is a little different. Total costs jumped 8.6% in 2005 because investors finally beefed up capital expenses. Over the longer term, total costs climbed 4.2% compounded annually over the past five years.

Investors often prepare long term projections of income and expenses using expected inflation as a basis for annual increases. That does not seem to work, at least not for expenses. Based on trends over the past ten years, investors should anticipate costs rising faster than inflation. It makes sense. Even if everything a property consumed







increased in cost at the rate of inflation, properties get older. So they start needing more. That pushes expenses higher at a faster rate.

Net Operating Income

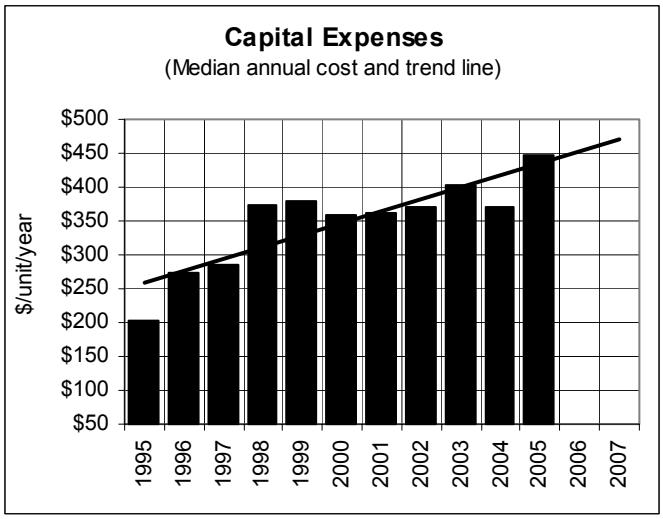
Net operating income fell 14% between 2001 and 2003. It didn't fall further in 2004, but it didn't make any progress either. Last year net operating income increased, for the first time in quite a while. It was up 2.2%, to a median $4,127 a unit. Even with that gain though, net operating income in 2005 was still lower than it was in 1998. If nothing else in the world had changed, there would have been a lot of investment value lost.

Fortunately for apartment investors, interest rates fell during the same period that revenues were deteriorating, bringing capitalization rates lower. As a result, with buyers willing to accept lower yields each year, prices for 5-unit and larger properties in King, Pierce, and Snohomish counties climbed from an average $68,000 a unit in 2000 to almost $96,000 in 2005.

What happened to cut net operating income so much over the past few years? It was a combination of factors. Rents fell while concessions and vacancies increased. The result was an increase in total economic vacancy, from 7.0% in 2001 to 11.7% at its worst in 2004. That lowered collected rental income in 2002, 2003, and again in 2004, but expenses kept rising. That's not a good combination.

Capital expenses

The typical property had capital expenses of $448 a unit last year, up 21% from $370 the year before. One-



Where do you fit?

This table presents selected line-item expenses from *The Apartment Expense Report*. Use the low, median, and high results to see where your property fit over the past few years. "Low" = 25% of the audited properties had costs below the low. " Median" = 50% of the properties had expenses below the median, and 50% had higher costs. "High" = 25 % of the properties had expenses above the high.

	Low			Median			High		
Expenses	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**
Real estate taxes: $/unit	$558	$594	$602	$670	$738	$734	$836	$910	$900
% EGI	7.2%	7.8%	7.6%	8.2%	8.8%	8.6%	9.4%	10.0%	9.6%
Insurance	$146	$150	$160	$196	$196	$201	$277	$274	$279
Utilities	$568	$603	$607	$685	$717	$723	$794	$836	$830
Resident management: $/unit	$424	$439	$440	$527	$520	$537	$631	$630	$646
Resident management: % EGI	5.1%	5.1%	5.0%	6.2%	6.2%	6.1%	7.5%	7.5%	7.4%
Professional management: $/unit	$263	$262	$270	$316	$305	$325	$385	$383	$403
Professional management: % EGI	3.3%	3.4%	3.2%	4.0%	3.9%	3.9%	4.8%	4.5%	4.8%
Office administration	$80	$85	$82	$108	$116	$115	$142	$152	$153
Decorating & turnover	$119	$119	$118	$167	$164	$168	$228	$218	$230
Repairs & maintenance	$475	$482	$494	$600	$607	$635	$732	$741	$794
Pool & recreation	$8	$8	$8	$12	$12	$11	$19	$18	$18
Elevator	$49	$51	$56	$77	$82	$83	$103	$109	$109
Landscaping	$85	$87	$86	$154	$149	$154	$212	$208	$214
Advertising	$102	$98	$78	$170	$173	$161	$259	$253	$241
Miscellaneous	$38	$34	$23	$64	$56	$52	$118	$102	$94
Total Operating Expenses									
Operating Expenses: $/unit	$3,343	$3,418	$3,509	$3,724	$3,825	$3,896	$4,238	$4,341	$4,358
Operating Expenses: $/NRSF	$4.15	$4.22	$4.44	$4.66	$4.73	$4.89	$5.33	$5.48	$5.76
Operating Expenses: % EGI	40.7%	41.5%	39.9%	44.9%	46.3%	44.7%	49.9%	51.7%	50.8%
Capital expenses	$210	$194	$246	$403	$370	$448	$810	$668	$848
Total Expenses									
Total Expenses: $/unit	$3,610	$3,602	$3,832	$4,190	$4,102	$4,454	$4,988	$4,874	$5,146
Total Expenses: $/NRSF	$4.63	$4.65	$4.97	$5.33	$5.28	$5.58	$6.18	$6.24	$6.62
Total Expenses: % EGI	44.6%	45.5%	44.5%	50.7%	51.7%	51.3%	58.7%	58.9%	59.8%

quarter of the properties spent less than $250 a unit. At the other extreme, one-quarter spent more than $850. Investors held back on capital improvements in 2004, so it caught up with them last year. Actually, the market caught up with them. And there's more catch-up in the wings for 2006.

Because each property's capital expense will vary dramatically from year to year, it is worthwhile to look at the average cost. Last year investors spent an average $732 a unit. Capital expenses rose more than 8% compounded annually over the past ten years. The high rate of increase is due to a number of factors, including aging real estate, opportunities to charge more for better product, changing consumer attitudes, and competition.

Unfortunately, many investors don't develop a thoughtful capital plan. That may feel good in the pocketbook now, but it hurts later, and ultimately costs money at the time of sale. Investors typically budget an annual replacement reserve ranging from $200 to $350 a unit. That is clearly not enough to cover capital costs.

We discussed replacement reserves and capital expenses in a number of past issues of the *Advisor*. A couple of years ago we developed a replacement reserve forecasting model and report, *The Smart Apartment Investor's Guide To Capital Plans*. We're happy to make that available to you in your online account on our website if you want it. Just let us know at research@dsaa.com.

The model helps users set an appropriate reserve to ensure the long-term viability of a property. A long-term plan takes into account the need for much more than paint, carpet, appliances, and roof, most of the components in a typical reserve budget.

The model calculates that a $350 a unit budget will cover a new property's needs for, at most, twenty years. If you own an older property, you need to fund a larger reserve. The model shows the replacement reserve budget necessary to meet the long-term needs of a property, should be $600 to $700 a unit a year.

Sale loaded

Most investors don't hold properties for more than ten or fifteen years, so why bother budgeting long term replacement reserves? Do what you can, then leave it to the new buyer to deal with any problems. That's not far off the mark. Our December *Apartment Investment Report* found a number of buyers last year planned to spend a significant amount on renovation. Their budgets averaged $5,900 a unit. Over the past ten years annual buyer budgets averaged a significant $5,000 a unit.

Since the *Investment Report* also found out most buyers plan to own any apartment they acquire for less than ten years, the initial capital investment covers some of the long term need. So, if a buyer spends $5,000 a unit on immediate capital expenses, plus $300 to $400 a unit a year after that, the total capital cost comes to $800 or $900 a unit after ten years.

Not all buyers plan a lot of money for near-term capital expenses, and they aren't always needed right away anyway. But the trouble is they probably don't budget enough to get them to the next step. Too often, that results in an investor cutting corners on capital spending down the road. That turns out to be a nearsighted strategy, because it hurts revenue, expenses, and ultimately reduces value.

What counts?

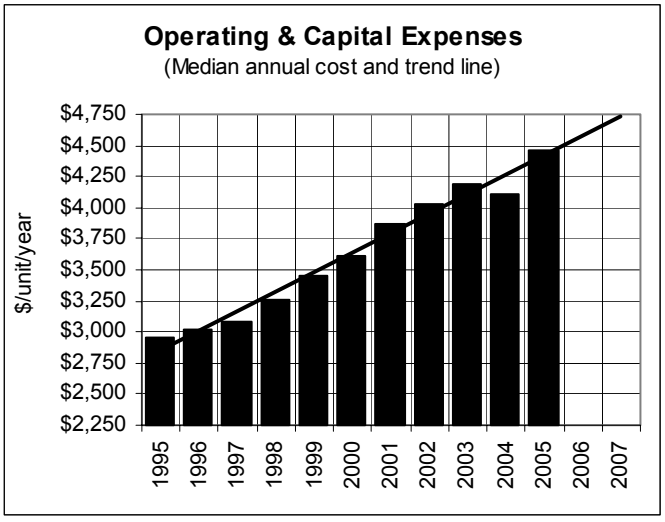
A typical replacement reserve budget includes the cost to replace appliances, water heaters, window coverings, carpeting, roof, and maybe a few other components. But that's about all. If investors budgeted for decks, parking lots, kitchen and bathroom cabinetry, windows, water lines, plumbing, and other property needs, the replacement reserve budget will easily exceed $500 a unit, even for a new property. So why don't investors budget enough? Alvin Arnold explains why in his *Real Estate Investors Deskbook*, essentially saying owners are often reluctant to use a complete schedule of capital components because the resulting reserve is depressingly high.

Forecast

Our expense model forecasts total costs, including operating and capital expenses, will increase 3.6% this year, 3.5% in 2007, and just under 3.5% in 2008. The model is not perfect, but with years of detailed expense statements backing it up, it's a useful tool.

So how good is our forecasting? At this time last year we forecast 2005 operating and capital expenses would increase 3.7%. Costs actually rose 8.6% due to a surge in capital expenses, so we were off. Had investors spent the same amount as they did in 2004 on capital items, total costs would have climbed 4.1%. That's what we meant, at least in hindsight. But even though we expect significant capital expenses again this year, last year set a high base. So we don't think our forecast model is understating expense increases going forward. It may even be overstating them a bit.

We will update our forecasts for rents, vacancies, concessions and apartment prices in the April issue of *The Apartment Advisor*. Those forecasts will use new information from our rent and vacancy survey, which will be reported at the beginning of April in *The Apartment Vacancy Report*. D+S



Expense Trends

This table presents median revenue and line-item expenses for all properties in the Puget Sound region audited each year for *The Apartment Expense Report*. The individual line-item costs will not add up to the totals shown for expenses because each number in this table is the median, or midpoint, cost or revenue for all of the properties audited. The main value of this table is not the individual numbers presented here. Instead, the value of this table is the trend over time for each line-item. The table shows the one-, three-, five-, and ten-year trend. Except for the one-year trend, these are compound annual changes. We have not collected information for all of the line-items for the past ten years, accounting for the blanks. All of the line-item expenses are costs per unit per year unless stated otherwise. "% EGI" = percent of effective gross income (total collected revenue), and "$/NRSF" = cost per net rentable square foot.

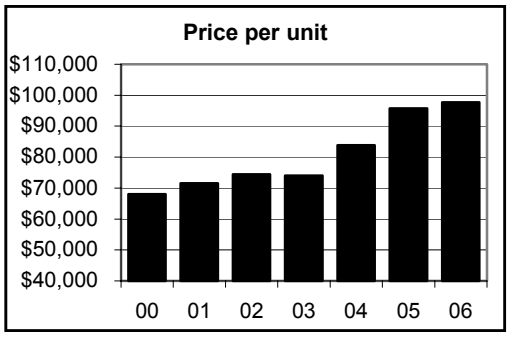
												Change			
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	1 year	3 year	5 year	10 year
Revenue impacts															
Financial vacancy			3.7%	4.5%	4.1%	4.2%	4.6%	7.0%	7.2%	7.3%	6.1%				
Physical vacancy			3.8%	4.1%	4.6%	4.0%	4.6%	7.3%	7.5%	7.4%	5.9%				
Rent concessions: % EGI			0.6%	0.5%	0.7%	1.0%	1.7%	2.4%	3.0%	3.3%	2.6%				
Credit loss			0.5%	0.6%	0.6%	0.8%	0.7%	0.9%	0.9%	1.1%	1.1%				
Economic vacancy rate			4.8%	5.6%	5.4%	6.0%	7.0%	10.3%	11.1%	11.7%	9.6%				
Effective apartment income			$6,721	$7,280	$7,505	$8,206	$8,075	$7,977	$7,894	$7,832	$7,912	1.0%	-0.3%	-0.7%	
Other income			$250	$258	$273	$279	$284	$322	$331	$347	$516	48.7%	17.0%	13.1%	
Effective Gross Income	$6,470	$6,704	$6,993	$7,544	$7,832	$7,938	$8,373	$8,142	$8,211	$8,215	$8,455	2.9%	1.3%	1.3%	2.7%
Expenses															
Real estate taxes: $/unit	$525	$572	$564	$563	$595	$612	$646	$657	$670	$738	$734	-0.5%	3.8%	3.7%	3.4%
% EGI	8.3%	8.2%	8.0%	7.3%	7.6%	7.5%	7.6%	7.8%	8.2%	8.8%	8.6%	-2.3%	3.3%	2.8%	0.4%
Insurance	$70	$78	$87	$92	$103	$107	$143	$164	$196	$196	$201	2.6%	7.0%	13.4%	11.1%
Utilities	$539	$554	$557	$587	$598	$610	$637	$672	$685	$717	$723	0.8%	2.5%	3.5%	3.0%
Resident management: $/unit	$364	$388	$394	$420	$442	$448	$478	$500	$527	$520	$537	3.3%	2.4%	3.7%	4.0%
Resident management: % EGI	5.8%	5.8%	5.8%	5.6%	5.6%	5.6%	5.6%	5.9%	6.2%	6.2%	6.1%	-1.6%	1.1%	1.7%	0.5%
Professional management: $/unit	$281	$279	$296	$304	$324	$333	$347	$323	$316	$305	$325	6.6%	0.2%	-0.5%	1.5%
Professional management: % EGI	4.4%	4.3%	4.3%	4.0%	4.0%	4.1%	4.0%	4.0%	4.0%	3.9%	3.9%	0.0%	-0.8%	-1.0%	-1.2%
Office administration	$86	$95	$85	$68	$89	$80	$97	$94	$108	$116	$115	-0.9%	7.0%	7.5%	2.9%
Decorating & turnover	$171	$145	$158	$159	$155	$157	$154	$170	$167	$164	$168	2.4%	-0.4%	1.4%	-0.2%
Repairs & maintenance	$413	$409	$439	$442	$503	$534	$580	$570	$600	$607	$635	4.6%	3.7%	3.5%	4.4%
Landscaping	$115	$116	$125	$127	$136	$146	$140	$145	$154	$149	$154	3.4%	2.0%	1.1%	3.0%
Advertising	$97	$103	$79	$98	$97	$100	$102	$147	$170	$173	$161	-6.9%	3.1%	10.0%	5.2%
Miscellaneous	$44	$49	$35	$48	$41	$57	$50	$61	$64	$56	$52	-7.1%	-5.2%	-1.8%	1.7%
Total Operating Expenses															
Operating Expenses: $/unit	$2,707	$2,796	$2,896	$3,026	$3,148	$3,311	$3,505	$3,626	$3,724	$3,825	$3,896	1.9%	2.4%	3.3%	3.7%
Operating Expenses: $/NRSF	3.48	3.55	3.79	3.81	3.98	4.14	4.47	4.50	4.66	4.73	4.89	3.4%	2.8%	3.4%	3.5%
Operating Expenses: % EGI	41.3%	40.9%	41.2%	39.7%	39.9%	39.4%	40.6%	42.8%	44.9%	46.3%	44.7%	-3.5%	1.5%	2.6%	0.8%
Capital expenses	$202	$274	$284	$374	$380	$358	$363	$370	$403	$370	$448	21.1%	6.6%	4.6%	8.3%
Total Expenses															
Total Expenses: $/unit	$2,952	$3,020	$3,085	$3,254	$3,448	$3,620	$3,865	$4,032	$4,190	$4,102	$4,454	8.6%	3.4%	4.2%	4.2%
Total Expenses: $/NRSF	3.9	3.98	4.23	4.4	4.56	4.81	5.12	5.24	5.33	5.28	5.58	5.7%	2.1%	3.0%	3.6%
Total Expenses: % EGI	47.2%	46.6%	46.7%	46.2%	45.7%	46.7%	46.3%	48.4%	50.7%	51.7%	51.3%	-0.8%	2.0%	1.9%	0.8%
Net Operating Income	$3,456	$3,674	$3,734	$4,143	$4,276	$4,407	$4,589	$4,193	$3,964	$4,040	$4,127	2.2%	-0.5%	-1.3%	1.8%

SALE TRENDS

This information is from the online version of our *Apartment Investment Report*. The report is based on our analysis of apartment sales of five-unit and larger properties in King, Pierce, and Snohomish counties. Sale trends for the online report are updated every one to two weeks. The online report gives subscribers the ability to create highly customized reports of their own, so they can look at sales trends for any neighborhood, age group, and property size they want to analyze. The data source for this table includes sales as recent as March 1, 2006.

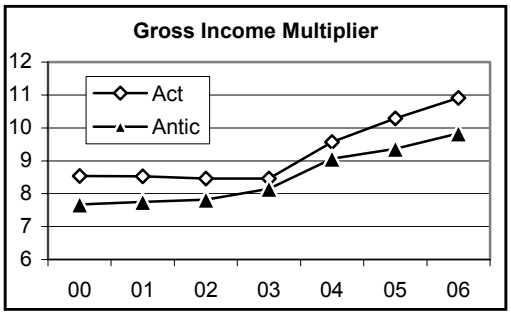
SALES VOLUME

Year	Sales	Units	Volume	Size	Age
2000	356	12,089	$789,016,888	34	1962
2001	353	12,227	$810,822,758	35	1964
2002	392	13,431	$949,205,252	34	1967
2003	422	13,556	$971,598,620	32	1965
2004	527	18,198	$1,548,731,630	35	1965
2005	654	29,320	$2,997,801,078	45	1968
2006	78	4,071	$404,844,710	52	1968



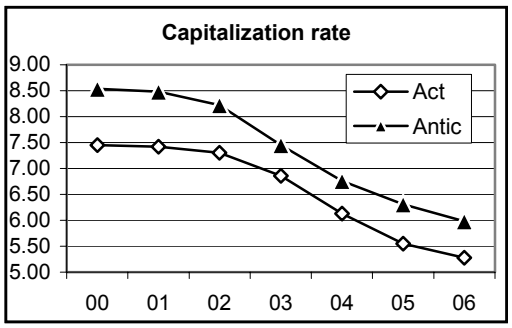
PHYSICAL

Year	Price $/unit	Price $/NRSF	Unit size (NRSF)	Rent $	Rent $/NRSF
2000	$68,016	$93.96	746	$669	$0.91
2001	$71,505	$98.36	753	$698	$0.95
2002	$74,445	$100.66	765	$730	$0.98
2003	$74,007	$100.61	749	$695	$0.96
2004	$83,879	$115.19	745	$728	$1.00
2005	$95,777	$128.24	770	$769	$1.02
2006	$97,743	$133.65	763	$744	$1.01



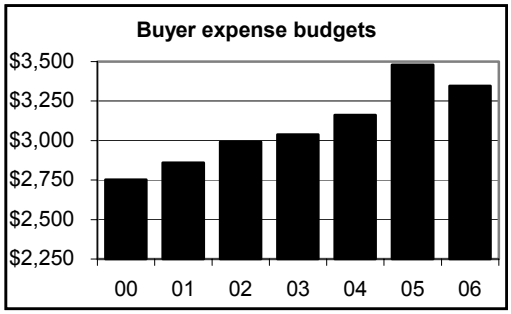
FINANCIAL

Year	GIM Act.	GIM Antic.	Cap. Act.	Cap. Antic.	AV %
2000	8.54	7.67	7.45	8.54	69.9
2001	8.53	7.75	7.42	8.48	72.2
2002	8.46	7.82	7.30	8.22	77.4
2003	8.46	8.15	6.86	7.45	75.4
2004	9.57	9.06	6.13	6.76	79.1
2005	10.29	9.36	5.55	6.31	73.9
2006	10.91	9.83	5.28	5.98	72.5



EXPENSES

Year	% SGI	$/unit	$/nrsf
2000	32.5	$2,753	$3.76
2001	32.5	$2,859	$3.92
2002	33.1	$2,991	$4.04
2003	36.1	$3,039	$4.24
2004	35.4	$3,161	$4.38
2005	37.2	$3,480	$4.65
2006	36.9	$3,347	$4.59



SALES: **year** = current year is preliminary; **sales** = number of sales; **units** = number of units sold; **size** = average number of units per sale; **age** = average age of properties sold; **PHYSICAL**: **nrsf** = net rentable square foot; **rent** = average rent per unit month; **FINANCIAL**: **GIM** = Gross Income Multiplier, based on the scheduled gross income; **Act. or Actual** = analysis based on scheduled gross income at the time of sale; **Antic. or Anticipated** = analysis based on expected scheduled gross income 3-6 months after date of purchase; **AV %** = the property's assessed value as a percentage of the sale price; **EXPENSES**: buyers' expense budgets as a percent of scheduled gross income (% SGI),