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Village of Pinehurst

Memo

To: Village Council

From: Doug Willardson

CC: Village Managers

Date: July 20, 2022

Re: Amortization Schedule

As Council continues to sort through the data surrounding short-term rentals (STRs), we are anticipating what some of the future questions or needs may be. If Council determines to prohibit STRs in specific zoning locations, there will need to be a transition or amortization period in which STR owners can recoup their initial investments in homes and transition them into other uses. Below is our reasoning for recommending, at a minimum, a three-year amortization period.

First, we determined the expected net operating income of a property. This was done by using the capitalization rate (cap rate). The cap rate is the net operating income divided by the purchase price multiplied 100. Industry sources show that the cap rate varies but the typical range is from 4.5% to 6.0%. Information from Lodgify shows that the cap rate for the Raleigh-Durham area is 4.6%. For our purposes, we used the rate of 4.5%. Therefore, by multiplying the purchase price by 4.5% we can get an approximate net operating income of a property.

Second, based on industry standards we estimated that 60% of the initial improvements made to a home will be recouped in the increased market value of the home. Thus, the remaining 40% is lost to the STR owner and will need to be recouped through operating income. The cost of improvements for each home will vary, but we will assume on the high side that 25% of the purchase price will be invested into the property initially.

Finally, to determine the length of time needed to recoup the initial lost investment in a property, we need to divide the lost value by the annual net operating income. The entire formula can be seen in the example below:

Purchase Price: $350,000

Net Operating Income:

$350,000 purchase price * Cap Rate of 4.5% = $15,750

Lost Value of Improvements:

$350,000 purchase price * 25% for improvements * 40% lost value = $35,000

Years to Recoup Lost Value of Improvements:

$35,000 / $15,750 = 2.22 Years

In this formula, the variable is the amount spent on improvements; the higher the percentage of the home's purchase price spent on improvements more time is needed to recoup those costs. If 23% of the home's purchase price were spent on improvements, exactly two years would be needed to recoup those lost dollars. If 34% were spent on improvements, the time needed to recoup the costs is three years.

Three years provides even those STR owners that spent significant amounts of money on improving their property the opportunity to recoup those funds. Also, a minimum three-year period will provide adequate time for owners to transition their properties to other uses and ensure that an excess of properties don't arrive on the market simultaneously.