Multi-Family Investing 101

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You’ve probably heard it before — real estate investing is one of the best ways for someone of modest means to become wealthy.

When done properly, apartment building or “multifamily” investing provides a vehicle for wealth that’s hard to beat.

For anyone who owns a home or single-family rentals, the leap to multifamily apartment investing can feel like a natural progression.

Apartment properties come in all shapes and sizes, in good shape and in bad shape. But there's often an upside for any apartment type, depending on the investor's goals. You could be looking into a Class A stabilized asset in one of the best cities for real estate investment. It's already performing. Your goal would be steady, long-term cash flow.

Alternatively, you could buy a commercial REO property sold by a bank after a foreclosure, and your goal would be to make improvements and turn that property around for a hefty return on investment.

The possibilities for cash flow, growing equity, and/or return on sale are hard to find in traditional investments such as stocks and bonds. The risks themselves, when handled properly, can give multifamily investing such a great return — that's what leverage is all about.

If you're overwhelmed by shouldering a hefty down payment, there are creative ways to finance. But nothing comes easy in real estate; sound decisions rest on acquired knowledge and trusted partners.

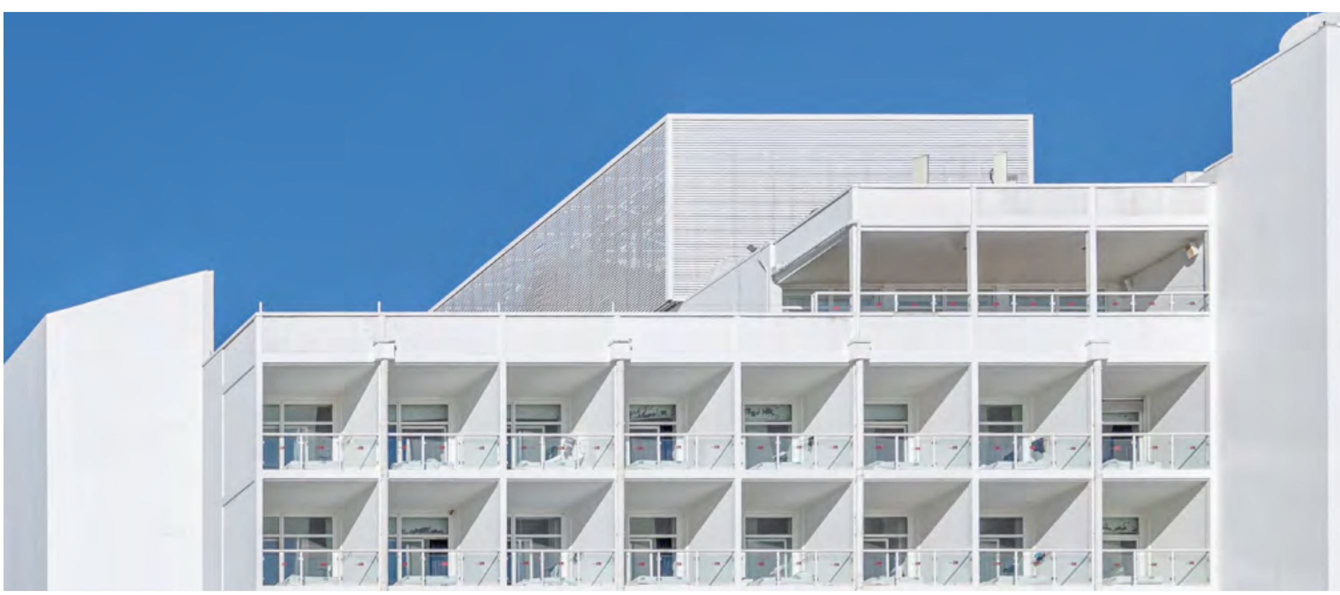
6 Benefits of Apartment Investing

There are many benefits of investing in apartments. Here are six, which we'll examine more in more detail below:

1. **Cash Flow**
2. **Leverage**
3. **Equity**
4. **Tax Incentives**
5. **Creative Financing**
6. **Economy of Scale**

1. CASH FLOW

Cash flow oils the gears of apartment investing. Without it, banks wouldn't loan, investors couldn't leverage themselves into equity and buildings would fall into decay.



But if they do their due diligence, the savvy investor will find and shape an opportunity that provides recurring rental income for years to come.

2. LEVERAGE

If cash flow oils the gears, loans are the fuel for this investment type. Without them, investors of modest means could never afford the steep prices of such properties. With them, investors can leverage themselves into a vehicle that builds wealth in the form of equity with as little as 20% down, sometimes less. It's all made possible because lenders bet on both the property and the borrower.

If an institution is willing to put their money behind your choice, you could call that a vote of confidence. Furthermore, if you choose a property with "good bones," shape it up and nurture quality tenants, it is likely that your relatively small stake will see an outsize increase when the property grows in value.

In fact, the risk of debt itself creates this unique opportunity for potential upside. Let's break down this term called "leverage."

Let's say you've found a $1M multifamily rental property and managed to secure a loan at 75% loan-to-value. Your down payment is $250,000. Should the property go up 5% in value, you stand to build $50,000 in wealth (25% x ($1M x 5%)).

If you were to sell the apartment building at that value, that's a hefty return of 20% of your down payment ($50,000 /$250,000). Of course, you stand to lose 20% should the value decrease by 5%.

But if you found a solid property and didn't overpay, you're likely insulated or prepared for the loss. You could either improve the property and ride it out, or predict the downturn and sell before it gets bad.

3. EQUITY

Apartment buildings can generate a wellspring of wealth in the form of equity. An easy way to think about equity is as potential energy. Building up equity is like pulling back a slingshot. It's not money in your hands until you decide to release that shot. When to do that is up to the real estate investor's current financial goals, as well as timing the market.

There are situations in which it would be prudent to hold an investment to build even more equity. On the other hand, there are times when it's best to cash out, either to reinvest in a better rental property or simply to enjoy the fruits of a deal done right.

4. CREATIVE FINANCING

Now, you may be asking if apartment investing is out of your reach. Did you know that it's possible to use creative financing and partnerships to invest with far less than you had imagined?

There are too many methods to cover, from the master lease option method, to using "options", to self-directed retirement funds. Then, there are partnerships where you can team up with trusted associates to go bigger than you'd imagined.

If you find the right deal and do most of the legwork, chances are your wealthier partners will contribute an outsize piece of the pie.
None of these creative methods are easy. They require someone who's diligent, keen on the possibilities, and who's willing to sweat for equity.

5. TAX BENEFITS

A lesser-known benefit to real estate investors is the slew of tax benefits they can enjoy.

For example, did you know you can claim a deduction for building depreciation even if your property grows in value? It's counterintuitive, but the IRS treats property much as it would a car, allowing for this "wear and tear" deduction, even if no wear and tear occur. The owner of any well-maintained rental property in a growing neighborhood will enjoy the windfall. The increase in value will outstrip any maintenance costs, as long as they were taken into account with cash reserves and vigilant management.

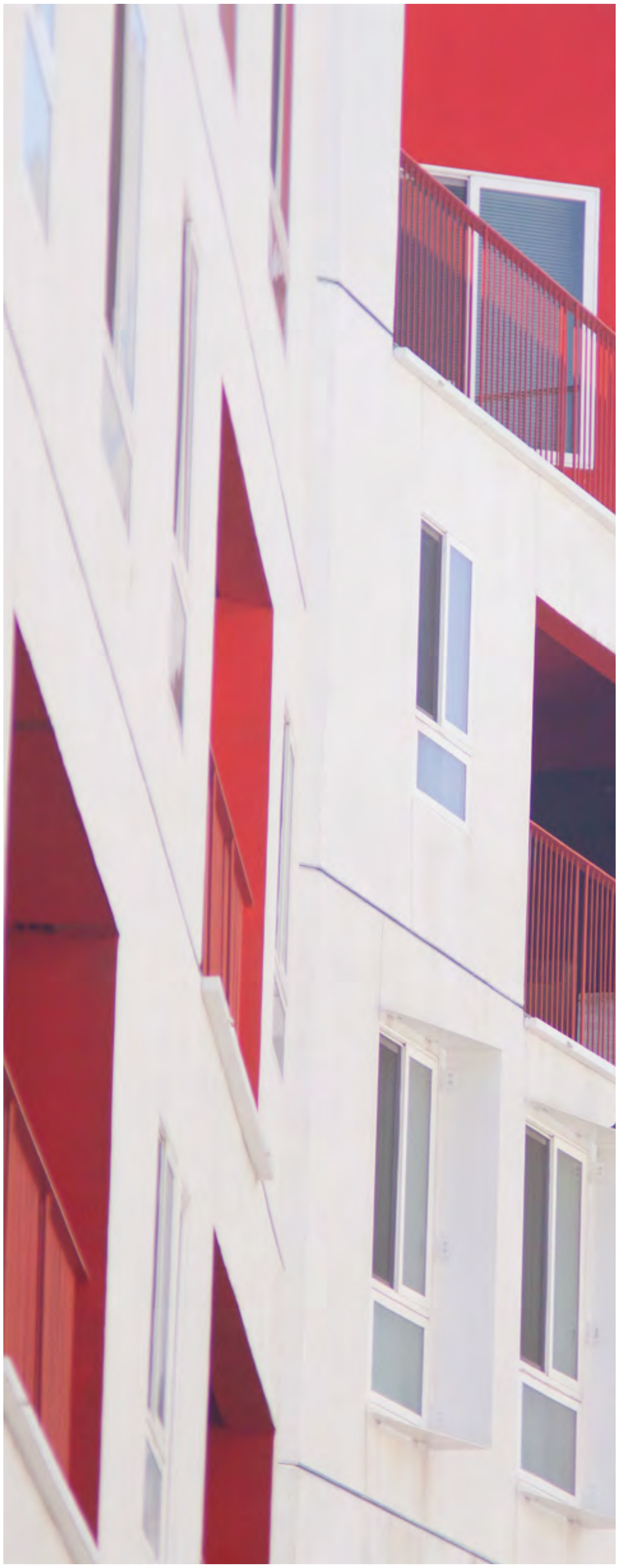
Another popular tax perk is the use of the 1031 Exchange, whereby a real estate investor can defer their capital gains tax by swapping one property for another "like-kind" of equal or greater value. This dynamic means an investor can profit from the sale of one rental property without paying capital gains. In theory, there is no limit to how many times one can swap. In practice, the deduction necessitates ever-greater real estate investments.

6. ECONOMY OF SCALE

Finally, apartment investments benefit from the economy of scale. There are perks to having multiple tenants and having them under one roof. When a single-family leaves a single-family rental, well, that's 100% of its cash flow. That same risk is spread to 4 or even 100 tenants in an apartment complex. Whereas small-scale residential properties may be scattered, all requiring their own maintenance, an apartment can be efficiently maintained with one set of contractors and management. It's one yard, one set of taxes, one roof!

Let's take this a step further. A single value-added amenity, such as a basement converted into a communal gym, can attract higher rents and ultimately improve the value of the property itself. A rather modest increase in rent can really stack. Whereas increasing rent in a single-family rental by $25 amounts to a $300 annual increase, the same increase in a 20-unit apartment building amounts to $6,000 annually. Going further, we can make a quick estimate of what that does to the property value.

If we assume the property boasts a 5% Capitalization Rate, we can use the following equation: Value = Net Operating Income ÷ Cap Rate. If our annual income increases by $6,000, and we divide by 5%, we finally understand the gravity of the situation: our property increases in value by $120,000!



4 Risks of Apartment Investing

1. **Requires a Large Cash Outlay**
2. **Responsibility**
3. **Expertise...or Expert Fees**
4. **"Glued to the Ground"**

Now let's take a hard look at the challenges and potential pitfalls of multifamily real estate investing. For the most part, this is no passive investment. Yes, you can invest in real estate by proxy through a REIT, but taking a personal stake in an apartment building takes plenty of capital, enough expertise to make sound judgments, and ongoing oversight.

With more than one tenant, apartment buildings are a bigger operation with more moving pieces. There's no quick way in or out. The buying and closing process simply takes time.

1. CAPITAL INTENSIVE

Apartment investing is capital intensive. While you can certainly employ creative financing or partner up, at the end of the day, you have to bring a large cash outlay to the table: You have to factor in more than just the down payment.

There are closing costs, reserves, and capital expenditures to stabilize or improve operations. Then there are carrying costs, an umbrella term for all the ongoing expenses an investor incurs such as the mortgage payments, interest, taxes, maintenance, marketing, and more.

Of course, the usual strategy is to have the building produce income over and above these operating costs. That's why a solid business plan is crucial for any investor taking a personal stake in real estate.

It's important to overestimate such costs. Unexpected problems will arise inevitably, taking a bite out of your returns.

2. RESPONSIBILITY

And that brings us to responsibility. Unlike, say, investing in stocks, owning an apartment complex is far more hands-on.

You're going to be spending a lot of time educating yourself, hunting down deals, shuffling between parties to close, and setting the property up for success. However, once things are set in place, your time commitments will ease. It doesn't have to be a full-time job, but it's also not as easy as tapping through selections on an investing app.

The benefits of multiple tenants also bring more moving parts, and sometimes headaches. When it comes to turnover and wear-and-tear, solid leases can thwart the worst of such problems. However, you will always be nervous about vacancy rates.

To stay profitable and build equity, you have to retain a certain number of tenants. But the winds of change in your city's economy can be hard to read, making your particular block more or less desirable over the years.

To add — or should we say subtract — from the equation, many municipalities enforce inclusionary zoning, whereby a percentage of your units may need to be at or below market rate.

3. EXPERTISE...OR EXPERT FEES

Apartment investing is not brain surgery, but the savvy investor ought to know a thing or two about real estate in general, including property types and conditions, local market trends, and greater economic forces at work in their city. Without expertise, expect expert fees.

4. GLUED TO THE GROUND

Finally, unlike many traditional investments, you cannot easily sell and walk away. As opposed to something abstract, like cryptocurrency, real estate, by its nature, is not a liquid asset.

There's a popular saying that God isn't making any more of it. That scarcity is what can give an investment long-lasting value. However, this risk raises the stakes of choosing just the right property in the right location at the right time.

To cash out of an apartment investment, an owner must typically sell or refinance. The process from finding a qualified buyer to closing the deal is notoriously slow. In investor jargon, this is called illiquidity. In plain English? Your building thrives or withers where it lies.

4 Ways to Invest in Apartment Rental Properties

If you wonder how to invest in apartments, there are several methods available to you. The main question an investor must ask is how involved they want to be. The following methods follow a path from the most active investments — taking sole ownership — to the most passive—investing in a company that invests in real estate for its shareholders.

1. DO IT YOURSELF (BOOTSTRAP IT)

Should you have the funds, expertise, and courage, you can invest in an apartment building all on your own. The benefits and the risks all come down to you. You have more to gain and more to lose, but if you are wise, find the right deal, do your due diligence, and consult trusted advisors, this can be the power move that gives your wealth wings.

Many real estate investors get their start by purchasing a duplex, triplex, or four-unit fixer-upper and living in one of the units while renting the others and adding value through repairs and addition.

Established developers may work with capital groups to build their own apartment buildings. This investment varies depending on location and building size. In 2020, the average cost to build an apartment building was $22 million.

2. JOIN A SYNDICATE

For the rest of us, there are syndications. Syndications are a fancy term for an organized partnership that can raise more capital than the sum of its partners. Certain investors are hands-on while others remain passive, and it's all run through an LLC created for this sole purpose. While formerly reserved for the moneyed elite, new tech is connecting people across the world through digital financing.

Should you join a syndicate as a limited partner, your investment will be relatively passive but not liquid (you can't cash out at will). Keep in mind, that with less responsibility comes less power. While you can offer direction and feedback, it is the general partner who has the final say on business decisions.

But if you get a great deal, trust your associates and structure the partnership well, syndicates are a great way to build wealth with modest means, and the returns can be far greater than traditional stocks and bonds.

3. FORM A SYNDICATE

If you're a bold self-starter, you can form your own syndicate. With the right connections, business acumen, and real estate knowledge, you can take the reins yourself, doing all the legwork for your limited partners while you take on the role of general partner. In return, your partners may be willing to provide the lion's share of the capital.

This opportunity benefits someone of moderate means who has the time on their hands, and the commitment to see it through. This is not the strategy for the shy or faint of heart. It takes a professional who can communicate and pitch effectively and doggedly to pull the deal together.

4. REITS WITH AN APARTMENT FOCUS

Finally, investing in REITs is the most hands-off approach for an investor interested in passive income, rather than studying the complex risks associated with the real estate market.

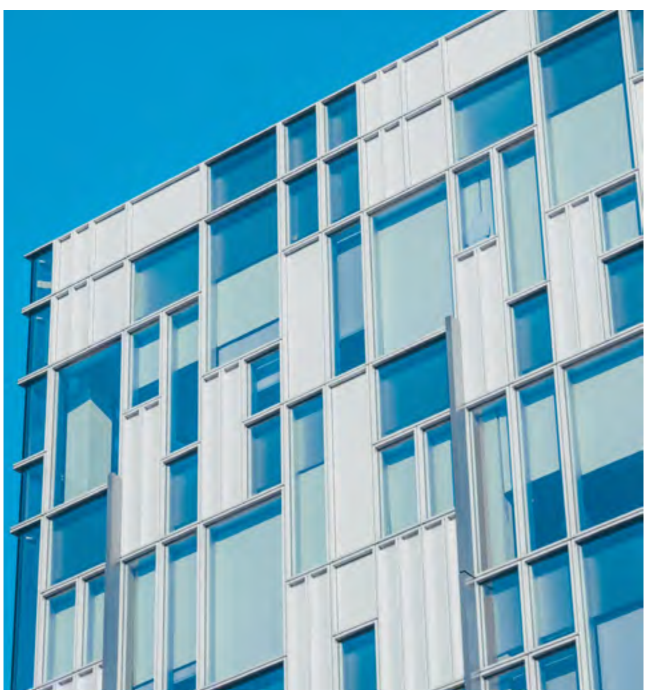
While many REITs are diversified across several asset types such as commercial offices, retail, and industrial, many REITs focus solely on apartment complexes and their unique investment profile. According to Investopedia, "If economic conditions sour or if more Americans choose to rent rather than buy, apartment REITs may outperform other equity investments."

Do Your Due Diligence!

No real estate investment article is complete without a stern section on due diligence. The better an investor scrutinizes a potential investment, the better they can sleep at night knowing they've avoided many potential risks. As apartments are a rather complex investment, due diligence is all the more important. While advisors differ on what a complete due diligence checklist entails, here are some of the most important considerations.

First, you'll want to scrutinize the building and the land. You'll want a proper third-party property condition assessment. Without "good bones," your apartment investment won't grow. Of course, cosmetic wear and tear can be a potential upside in a value-add business plan. But foundations are forever.

You'll want a Phase I Environmental Site Assessment, often required by commercial lenders. Among many benefits, these reports make sure the land is devoid of contaminants and your building is resilient to nature's fury.



Next, you'll want to scrutinize the property's financial health. A financial audit report from the owner should include a trailing 12-month and 3-year profit and loss statement. You'll want a thorough lease audit and rent roll analysis that will bring to light any glaring red flags such as chronic unpaid or late rental payments. You'll want a site survey and title report that will clarify information like property boundaries and disputed claims.

Finally, you'll want to study the market and determine the property's value. You'll want a market report that can show the occupancy level of similar properties in the area. A qualified appraiser can estimate the market value of the property, regardless of what the buyer is asking for. Proper due diligence is all part of evaluating a multifamily property.

Multifamily is Always a Strong Asset Class

Hopefully, this guide has put multifamily investing into focus. While there is certainly more to learn, you probably have a gut feeling about whether this is the right vehicle for you to build wealth.

The future of offices is uncertain, but housing in dense urban or suburban spaces remains in demand in the United States. With home ownership out of reach for many Americans, apartments may be the scarce resource an investor should get their hands on. They house many people under one roof, all of whom are drawn to the perks of living in a desirable area. Their ability to cash flow steadily for a long time makes them a unique asset. Through the power of creative financing and leverage, more people can get involved than they may have believed.