# Is it a good Idea to invest in Apartment Buildings?

Owning an apartment complex straddles the line between an investment and a career. On the one hand, it usually takes a meaningful sum of money to buy an apartment complex, and what you make from it is usually related to how much you put into it. On the other hand, apartment complex ownership can be much more involved than owning other types of assets, such as stocks or bonds.

## Capitalization Rate

If you have no debt on your apartment building, what you will make is equal to all of your collected income less all of your expenses. If you collect $500,000 in rents and pay $300,000 in expenses, you have made $200,000. Most investors measure income from their apartments relative to the value of the building with a metric called a capitalization rate. Calculating a capitalization rate starts with calculating a Net Operating Income. The NOI subtracts your operating expenses from your recurring income. Add up all of your collected rent and other income, such as laundry room receipts. Subtract your operating expenses from the income to find the NOI. Operating expenses includes everything that you spend to run the building, but it excludes major capital expenditures that you make to either extend the life of the building or increase its value. Once you have the NOI, you divide the price or value of the building into it. For example, if you have a $200,000 NOI, but you paid $2.4 million for it, the cap rate would be 8.33 percent.

## Returns After Mortgages

If you have a mortgage, your return isn't the money you collect in your NOI. It's what you have left after making your mortgage payments. To calculate your after-debt return, called a cash-on-cash return, you divide that net cash flow by your down payment. If you put $700,000 down on that $2.4 million property, you would owe $1.7 million. If your annual debt service was $130,000, and you took it out of the $200,000 NOI, you would end up with a $70,000 annual cash-on-cash return. When you relate the $70,000 to your $700,000 down payment, you would end up with a 10 percent cash on cash return.

## Profits on Sales

When you own an apartment building, you hope to make money when you sell it. There are a few different ways that this happens. Apartment buildings frequently get sold on the basis of their cap rate, which is effectively a multiple of the income they produce. If you increase your building's income by raising rents or cutting expenses, you should be able to sell for a profit. When you sell in a better market or improve the quality of the building, buyers may be willing to buy your building at a lower multiple of earnings, giving you additional profit. Finally, if you had a mortgage, you probably paid it down. Since you have less of a mortgage to pay off than you originally took out, you will be able to collect this equity when you sell.

## Additional Revenue Opportunities

Some apartment owners manage their own buildings. Management fees vary greatly, but typically fall in a range between 3 percent and 7 percent of the rent collected. If you manage the building yourself, you can reduce that expense. On a building producing $500,000 in rent, a 5 percent management fee would add up to $25,000 a year. Doing your own maintenance work can also reduce your repair expenses and let you put more money in your pocket.

# Five most important issues to consider when investing in apartment buildings.

## 1. Cash Flow

*Will this property cash flow?* This is the <u>most</u> important issue to consider, and it depends on a lot of factors, including:

- Strength of the local rental market (vacancy and delinquency)
- Type of market you are buying into (C class buildings usually have more tenant turnover and higher repairs and maintenance than A or B class buildings)
- Interest rate on your financing (is it conventional financing or a hard money loan?)
- Size of your down payment

All of these factors considered, ask yourself, “Will this realistically provide income for me?” Also, ask the question, “How will this property cash flow compared to other potential properties?”

For example, a $150,000 house that rents for $1,000/month has a better income potential than a $300,000 house that rents for $1,600/month. A four-unit building that costs $400,000 may bring in $3,000/month in the same neighborhood.

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Whether the property will provide income to you begs the question of whether income is important to you. Is it? Do you earn other income that would allow you to spend more of the income refurbishing the building? Do you need more income now, or is future equity growth more important?

There are no right answers to these questions, but they are factors to consider when looking at a potential purchase.

# 2. Leverage

Leverage is important in investing because the less cash you put down on each property, the more properties you can buy. If the properties go up in value, your rate of return goes up exponentially. However, if the properties go down in value, and you have a lot of debt on the property, the result can be negative cash flow.

Negative cash flow can be either “bad” or “good.” The “good” kind is short-term and makes you money.

For example, all the foreclosures we’ve bought had high vacancies and needed rehabwork. So we needed the financial capacity to get through the negative cash flow until we could stabilize the property and create a very good positive cash flow. Then we had options to either sell the property or to refinance and pull out most of our money.

“Nothing down” investing is very attractive for the high-leverage investor, but should be approached with caution. If you are a long-term player, leverage will generally work in your favor if the markets in which you invest appreciate in the long run and your income from the properties can pay for most of the monthly debt service.

# 3. Equity

Does the property you are purchasing have equity or can you create equity? Equity can take a number of forms, such as:

- Discounted price
- Fixer upper – “upside” potential
- Rezoning opportunity
- Poor management
- Foreclosure

There are many ways to create equity, but buying into equity is your best bet. Find a motivated seller who wants out of his property and is willing to give up his equity for less than full value. Or buy a property that needs work that can be done for 50 cents on the dollar or less. In other words, if the property needs $10,000 in work, make sure you get a $20,000 discount on the price or better.

# 4. Appreciation

Buying in the right neighborhoods and in the right stage of a real estate cycle will result in appreciation and profit. However, timing a real estate cycle is difficult and is very speculative. If you buy properties without equity or cash flow solely for short-term appreciation, you are engaging in a risky investment.

Buying for moderate long-term (10 to 20 years) appreciation is safer and easier. Look at long-term neighborhood and city-wide trends to pick areas that will hold their values and grow at an average 5 to 7% pace. Combine this tactic with reasonable cash flow and buying into equity, and you will be a smart investor.

## 5. Risk

Risk is a consideration that too few investors consider. Ask yourself, “What if my assumptions are wrong?” In other words, do you have a “Plan B”?

If you bought for appreciation and the property did not appreciate in value, can you rent for positive cash flow? If you buy with an adjustable rate loan and the rates go up, will this put you out of business?

If you have a few vacancies, can you handle the negative cash flow, or will it break the bank for you? Expect the best, but prepare for the worst.

# Warning Signs of a Bad Deal

**The Numbers Don’t Add Up**. You’re in this game because you want to make money. If the numbers don’t add up, and the seller won’t drop the price or give you better terms, move on.

**Missing Numbers.** If the seller can’t provide you with the year-to-date profit and loss statements, plus the actual numbers from the previous two years, move on to another deal.

**Made-up Numbers.** Pro forma numbers are pure guesswork. They may be educated guesswork, but they are still a projection. Lenders won’t give these made-up numbers any weight and neither should you. This is where your experience plays a big role. After a while, you will quickly be able to figure out “who is blowing smoke” or if the numbers make sense.

**Troubled Property.** A property may look good on paper–the numbers are real and they add up. But a site visit paints a different picture. Perhaps it needs major repairs because the seller has been deferring the maintenance, hoping to pass the headache on to the buyer. Don’t let it be you.

**Wrong Area.** Don’t spend your money trying to reverse a trend. If the neighborhood is in decline, the property carries that stigma. Tenants will be moving on, and so should you.

**Months on the Market.** Good properties go fast. Bad properties linger in the listings for month after month. With detective work, you can figure out why it’s a dud. And that’s a viable learning experience. But your time will be better spent going after good deals.