

Maximize the Potential of Your Multifamily Investments Through Careful Planning and Thorough Investigation

by Gary Smith, Ascenture Realty Investment Group

When considering investing in multifamily rental properties you should analyze several factors in your life. You are going to have to be very honest with yourself about your current stage in life as well as your weaknesses and strengths. You need to really understand your level of tolerance for risk as well as your spouse's tolerance when it comes to your finances. Let us lay out a few questions that are a good start to putting together a plan for your venture into multifamily:

- Are you looking to invest in a property or group of properties that will produce enough cash flow to allow you and possibly your spouse to leave your current jobs and work for yourselves?
- If the answer to the questions above is yes, then do you have the experience to make sound investment decisions and manage the residents as well as the financial aspects?
- Do you want to use real estate as a passive investment that will grow your wealth?
- Do you require liquidity similar to what is provided with publicly traded stocks?
- Do you have experience with being in a business partnership and good legal counsel to advise you?

Time and Money

If you have the financial ability to purchase a multifamily property, the likelihood is that a 20 to 30 unit property is the most that you are going to financially risk on your own. If you do purchase a property in that size range, you will likely have to run it yourself. There is not enough cash flow to hire an experienced property management company. If the numbers are right, you may be able to retire from your job. Guess what – you just bought yourself another job. The difference is that this can be a 24-hour, seven-days-a-week job. Are you willing to take phone calls at 7:00, 8:00, 9:00, 10:00 at night or even 2:00 in the morning?

I think by now most people have seen at least a couple of episodes of the MTV show “The Real World.” One of their tag lines is, “What happens when you put seven strangers in a house together?” For the most part apartments are not nearly that bad, although it is a bit like adult day care sometimes. The good thing is that [AOA] offers a variety of very informative classes and workshops to help you understand not only the financial and operational aspect of apartments, but resident relations as well. If you are running it yourself, you are going to need some handyman skills as well.

Education and Due Diligence

Before you purchase a property that you plan on running yourself, you really need to get as much education as you can on understanding the cycles in the market and the dynamics of the specific submarket, financial management, Fair Housing and city code requirements. Proper due diligence is an extremely important aspect to realizing your

investment goals. Knowing as much as possible going in will help you formulate a plan to hit your numbers.

Bring in experts to assist you in performing due diligence. You should get on the roof, check the complete HVAC system and use cameras to inspect every underground plumbing line. You should also have a licensed general contractor or inspector go over the property and include in his or her report any municipal code violations. You also must go over the current rent roll and financial statements. It's not unheard of for the seller to fill a poorly run property with anyone with a pulse and "adjust the books" to make a property look like a more sound investment in order to sell it.

If you decide to purchase a property on your own, please take all of these factors into consideration, join [AOA] and start taking classes and going to workshops. If you educate yourself enough and put in the effort, you can make a solid investment decision. That good investment will not only provide you and your family with a comfortable income and grow your wealth, it will also allow you to execute your financial plan for the property and provide your residents with a nice home. A poor investment decision could result not only in you working 24 hours a day and suffering negative cash flow but also in your not being able to generate enough revenue to pay your bills and winding up on the news because your residents' water was turned off.

Partnerships and Passive Investors

The majority of investors seeking to diversify their portfolios to include real estate enter partnerships as passive investors. A partnership should receive the same attention to due diligence as purchasing a property on your own. In this case however, you need to look at the dynamics of the group, the terms of the partnership and the person or entity that act as the general partner or managing partner. Partnerships can be a very emotionally taxing situation. Part of this reason is that whether people want to admit it or not, this type of real estate has a lot of ego driven people. You should try to put your emotions aside, look at the details and use common sense.

There are several options for investing in a real estate partnership. The most common is a cash investment. In this case you are the investor, and your percentage of ownership is in direct relation to the percent of capital you contributed to the fund after adjustments for any general partner considerations. Most general partners get a percent of ownership above their experience (and often the person guaranteeing the loan as well). This can range from 15 to 20 percent with returns being equal to all other investors or subordinate to investor returns based on a number of factors. Some partnerships call for a minimum of eight percent return before the general partner receives his or her additional percentage, which is then based on returns above the eight percent. This normally depends on the track record or experience of the general partner. A general partner with a proven track record of making successful investment decisions and providing investors with solid returns will likely be able to command a general partner interest with equal priority to the passive investors.

Most partnerships are in a limited liability corporation structure and allow for pass-through taxation, which can bolster your overall returns by taking advantage of all of the factors involved in real estate, such as depreciation and amortization. It will be well worth the money to consult with an accountant experienced with multifamily real estate. You should also request to review the qualifications of the legal and tax council that the general partner secures for the partnership entity.

As passive investors via individual retirement accounts, most people do not rely on quarterly returns to pay their bills. In fact, many people will choose to reinvest their returns if the partnership they are in is a multi-asset fund that allows for reinvestment. Stocks, mutual funds and commodities are invested in and traded in an effort to grow wealth. Most people don't withdraw their profits until they retire.

Some partnerships record an investor's ownership interest as operating partnership units. This is also done in an acquisition of a single property or a portfolio to defer taxes. The seller receives operating partnership units instead of cash in exchange for his or her property at an agreed-upon price. This is sometimes done when the general partner or managing partner wants to retire but no one in the group is willing or qualified to step in as general partner and the asset has not reached its optimum disposition point or the partners don't want to deal with the taxes. It's pretty similar to a basic merger: The original investors now have a smaller piece of a bigger pie

Finding the Right Investment Partners

Once you decide what type of partnership structure you are comfortable with and whether you want to be a cash or retirement account investor or a combination of the two, you need to find a group to invest with. The best way to find a good general partner with whom to consider investing your money is to network and get involved in different functions. As a minimum, any general partner should be actively involved in workshops, classes and the different seminars and events that are offered [by AOA] throughout the year. Finding the right general partner for you will involve getting to know his or her investment philosophy and personality. Some general partners believe in all value-added investments, which are designed mostly to provide very strong returns on the back end by buying properties that are poorly run, and need a lot of physical improvements and room to raise rental rates, thus greatly improving the value. These deals can provide great returns but can be very risky, especially if the general partner does not fully understand the submarket and underestimates the work involved in renovation efforts to reposition the property. It is fairly easy for an inexperienced investor to renovate a project more extensively than necessary for the market that his property is in.

Some general partners invest in properties that already have stability and a strong cash flow. There is not as much involved in the way of operational and physical improvements that need to be made, but the price will be higher and your quarterly returns will be lower but steady. This is normally a safer investment, but returns will take longer through cash flows and appreciation. A few groups can do a combination of the two. A balanced portfolio of value-added deals and seasoned properties can offer you a

very solid investment that will grow your wealth comparably with the stock market and have a very good potential to far outperform it.

You should consider the general partner's experience and credentials when it comes to actually running the properties as well. It's not always easy to find out whether or not a general partner really knows what he or she is doing. Make sure that the managing agent/general partner is qualified for properties that are going to be owner managed. If not, hire a professional third-party management company. When looking into a company to invest with or hire as your managing agent, look at the company's history. Some of the more successful companies were started by people who had years of education and industry experience, then left the companies they worked for to start their own ventures. These can be some of the safest bets in terms of finding a good general partner as opposed to investing with an inexperienced group or individual as the general partner because they invested a larger share of money. Take a serious look at experience, education and references of the group or individual that will act as the managing agent/general partner.

Selling Out

One of the most important things to structure is your individual exit strategy. This is a little different from dissolution strategy for the partnership. You should have provisions in the partnership agreement that allow you to sell all or part of your interest. There may be a reason at some point that you want to sell. There should be a clearly defined method in place for determining the value of your share at any given time. Remember that the federal Securities and Exchange Commission can regulate and limit the sale of shares of privately held companies. Many companies will also limit the percentage of the total number of shares that may exchange ownership in a 12-month period as well.

Hopefully you've been able to answer a few questions for yourself in deciding on an investment strategy. Hopefully you've also thought of some other questions that hadn't occurred to you before. Even if you plan on investing as a passive partner, you should educate yourself on the business of multifamily real estate and the common structures of real estate partnerships. The right knowledge will help you make decisions that will result in meeting and exceeding your investment goals and growing your wealth.

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