Property Management Essentials:

Assessing Mid-Sized Multifamily Properties for Investment

There are a many things to consider when purchasing a multifamily property. This paper will cover some key considerations when investing in the mid-sized multifamily apartment rental market. Here the purchase price plays a much more important roll. When considering the purchase of a medium sized building every point of change and expense can translate into a significant amount of money either from a month on month annualized basis or a cash flow basis when analyzing the return on investment over time.

Key Topics

- ***Financing differences***
- ***Legal Entities***
- ***Insurance***
- ***Management***

Consideration # 1: Financing

Unlike the small multifamily units that range from 2 to 4 units once the decision is made to enter the realm of medium to large multifamily buildings the first difference is the loan. No longer can the property be owner occupied and secured with a personal loan with up to a 30 year note. Now the financing is done through a commercial loan. Ironically, this process is less tenuous today than obtaining a personal loan for a single family or small 2 to 4-plex. In obtaining a commercial loan most banks will require at least 20% down and, many times, up to 40%. The greater the amount of the down payment the lower the interest rate. Also, commercial loans have a shorter amortization schedule…many times only for five years.

Consideration #2: Note Recourse, Non-recourse

The size of the property will dictate how the financing is secured. A mortgage is not a loan. A mortgage secures a loan and the loan is evidenced by a promissory note. So the mortgage secures the payment of the note and the person(s) taking out the loan personally guarantee it. A nonrecourse note applies to the larger buildings from which the loan is not guaranteed by the individual taking out the loan, but by the property itself. The lender will be limited the value of the collateral (in this case, the building) for repayment of the debt, even if that value is less than the amount due on the loan.

Consideration # 3: Banks will look at experience of owning / managing multifamily property

Before banks will provide the loan they, most likely, will assess the person or organization's experience in this arena. The larger the property the more important this becomes in the eyes of the bank. If the experience level is minimal having a good property management company in place will help credibility. Also, a bank won't loan on a vacant building unless it is a construction loan. Having a trailing history of rental rates, leases and lease terms, expenses, etc with the building **at purchase** plays a much greater roll with the banks. Lastly, though the loan will be secured by the property the banks will still consider the purchaser's personal balance sheet as well.

Consideration # 4: Legal Entities and other legal information

As one invests in bigger buildings it's important to consider creating a legal entity (e.g LLC) to protect the investor from liability. By creating a legal entity it provides a "firewall" against liability. 1031 exchanges are another complex situation that demands attention to details and adherence to law. The 1031 exchange is used when swamping the proceeds of one sale to the purchase of another property in order to not recognize capital gains or losses. This transaction has very strict rules, timelines and procedures for handling the money and by whom so be sure to execute the exchange “by the book!” Another thing to pay attention to is the strength of the Articles of Incorporation and bylaws of the company. The documents are widely available and very useful in defining policy and procedures for an organization…especially when and adverse situation occurs. There’s no way to predict all situations that might happen but having thorough legal documents in place can bring clarity to the situation once it arrives.

Consideration # 4: Insurance
There are many kinds of insurance. When buying larger buildings it’s critical to have a good policy and understand it completely. Economies of scale come into play here. Where a single family or 4plex might have a $1000 to $2000 deductible on a 30 unit building the deductible could easily be $5,000 top $15,000 in which cash reserves need to be in place. Also, certain lenders might require specific insurance riders or policies for special items like a boiler system or roof. More expense but more consideration. Legal exposure continues to increase in our society. People can sue for almost anything. Consider having commercial liability umbrella policy.

Consideration #5: Management
This final consideration requires a significant mental shift from owning a small multi family unit to a large commercial building. With small units it is easy to look at them from the bottom up, but with big buildings from the top down. What does this mean? In a small multifamily unit 1 vacancy can fundamentally change the economics and business model. However, in the 20 to 30 unit building 1 vacancy or a small unexpected expense doesn’t really impact the overall business model of the company. That’s why it is important to build a solid budget to account for revenue and expenses on the larger buildings because certain expenses are simply on a larger scale so it is just good business.

One last point…buildings are living and breathing organizations as dictated by the personality of the owner or manager. If the manger lives for drama and anxiety then the tenants will take on that trait as well and everything could be a crisis. So it’s VERY important to hire a good manager to set the tone. Another point around the manager, it is highly recommend to NOT have a live-in onsite manager. It’s expensive because the following might be needed: workers comp insurance (because of the owner’s exposure to liability), keeping track of the manager’s pay and a strong working knowledge of the complexities of labor law. Also most live-in managers rarely fulfill the owner’s expectations of performance. So be careful! On the tenant side 1 bad tenant can have a similar impact disrupting the “vibe” of the building’s tenants. So be on the lookout for someone that likes to create drama and do not show favoritism toward anyone.

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