

Beginners Handbook to Multifamily Investment

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1 Intro

Investing in the stock market has been the standard advice from financial planners for decades; however, we have learned time and time again that the stock market can fluctuate and **market volatility** can erase years of growth in an instant.

Investing in real estate is a great way to grow wealth if done responsibly and with an understanding of the risks and rewards involved. It is also a better investment for those who wish to take an active role in growing their capital, rather than passively putting their money into a managed account. One of the great things about real estate investing is its **flexibility** and **scope of strategies** used.

There are lots of ways in which to get started investing in real estate. Everything from crowdfunding sites to residential real estate fix and flips to commercial storage units and office buildings are at your fingertips if you know where to look. This is also why, as a beginner in the whole wide world of real estate investing, you might feel overwhelmed. However, with a little guidance, you will be able to narrow down which types of investments suit your lifestyle, financial goals, and personality best.

The goal of this eBook is to provide some education on multi-family real estate investing so that investors can make a determination on whether this type of opportunity is a good decision for their portfolio.

2 Active vs Passive

Investing in real estate is an excellent way to diversify and strengthen your portfolio. Real estate investing provides attractive total returns, tax advantages, and the opportunity to acquire a tangible asset. Typically, investing in real estate takes two major forms; active and passive investments.

ACTIVE INVESTING

An *active*, or direct, investment is when the investor takes full responsibility for the investment after the transaction is complete, including managing and maintaining the property and making all decisions regarding the asset. Active real estate investors purchase and manage properties for rental income, or renovate them to flip the properties for a gain.

Benefit of Active Investing

The main benefit of active investing is control, including specific deal selection. The investor selects which properties to buy, based on their preferences for type, location, budget and other factors. Investors can choose between single family homes, multi-family houses, large apartment buildings, commercial/mixed use properties or industrial properties, or even a mix of different types.

Common Stressors of Active Investing

Although an active investor has complete control over budget and all decisions made including acquisition, renovation, and/or management of a property, active investors often find themselves financially limited. Therefore they typically only have a few projects maximum. An active investor can also expect to deal with the day to day headaches of owning or managing a property, including tenant complaints and unexpected maintenance problems.

PASSIVE INVESTING

A passive, or indirect, investment is when the investor is interested in adding a real estate asset to their portfolio, but does not have the time, interest, or level of sophistication required to actively manage and maintain the asset. Unlike active real estate investing, passive investing features another entity managing the investment. Once the investment is made, all investment returns are dependent on the decisions made by the entity or organization that is managing the investment. Investors can also passively invest in real estate through real estate-related mutual funds and real estate investment trusts (REITs).

Benefit of passive investing

Because another organization is managing the investments, this frees up time for investors to devote to other projects or demands. The process of passively investing can generally be more stable. The minimum investment amount for passive investments can vary significantly depending on the type of investment. Investors can purchase publicly traded REITs from online brokerage firms for as little as a few thousand dollars, while many private placement offerings will require minimum investments of \$50,000 or \$100,000.

Pitfalls of passive investing

The biggest pitfall of passive investing is less control. Having less control requires the investor to really trust the investment policies of the managing entity to ensure the investment produces profits and not losses.

Both active and passive investing provide significant benefits for investors who are interested in real estate. It's important to understand your goals and invest wisely using the strategies that best compliments your financial and personal needs.

3 Why Multifamily?

Investing in apartments (multifamily properties) is one of the best investment strategies for investors who want an added source of monthly income with slow but steady appreciation in the value of their portfolio. However, deciding to invest in an apartment building is only the start. There are several different angles to consider. The way you choose to pursue the investment depends on how involved you want to be, how much capital you have, and how much time you want to commit.

Here are some reasons why you should consider investing in multifamily:

- Multifamily investments provide a regular and dependable income stream that produces positive cash flow which is higher than typical stock dividend yields.
- The amount of the property's net operating income (NOI) reduces the debt on the property. The NOI is calculated by the gross income minus all expenses before debt. It will sufficiently fund the debt payments, thus reducing the debt balance and creating equity.
- The U.S. Tax Code benefits real estate owners in several ways. This includes no limit mortgage interest deductions and depreciation acceleration that shields a portion of the cash flow generated and paid out to investors.
- Apartment complexes increase in value as the net operating income of the property improves. This can be done through rent increases and more effective management of the asset. Remember, you should maintain your property so it retains its value over the long haul.

- Multifamily real estate investors produce more income each month and have the flexibility to outsource property management services without the need to significantly cut into their margins.

What type of investment property is best? This question comes up more than any other from long-term buy-and-hold investors. Let's analyze single-family rental (SFR) versus multifamily rental (MFR) properties, so you can choose the best route for you.

Advantages of Single-Family Properties

No tenant conflicts

The challenge with owning apartments is that eventually some tenants won't get along. When this happens, it is common for the landlord to get a call from one of the tenants asking for them to get involved. That can be a difficult call to take because there is really not much a landlord can do.

Less maintenance

Apartment tenants tend to be much harsher on the property than those that live in houses. There is also little to no common area to maintain with single-family homes.

Easier to finance

The money an investor can earn on single-family is the best money out there. It is relatively inexpensive with a long-term and fixed interest rate.

Diversified across several (local or non-local) markets

When you buy single-family homes, you are likely spreading your money out into different markets or neighborhoods.

Liquidity

Single-family homes are much more liquid. Your buyer pool will consist of first-time homebuyers, move-up buyers, downsizing buyers and investors.

Lower tenant turnover

Tenant turnover costs time and money. Every time someone moves out, you have to coordinate cleaning, repairing damages and general wear and tear, marketing and showing the listing, and screening applicants. And, of course, there's the loss of rental income while the unit sits vacant. SFR's traditionally experience less tenant turnover compared to MFR, which represents considerable cost-savings when factoring in rehabbing and re-leasing costs.

Advantages of Multifamily Properties

Easier to manage

Having everyone in one place makes managing multiple units easier. In some cases, the property can afford an onsite manager who helps keep it clean, can help show units and meet contractors.

One roof

Multiple units offer economies of scale. Let's assume, if I replace one roof, I replaced the roof on 20 units at one time. The same will apply to painting or any number of other maintenance or improvement items.

Financing

A downside to single-family financing is that banks want to limit how many loans you have, which limits the number of rentals you can buy. Multifamily housing allows you to own more rentals with fewer loaned dollars.

Cash flow

Unless you own multiple SFRs, an MFR will typically translate into higher rental income. If a tenant moves out of a single-family rental, it is 100% vacant. Alternatively, if a 10-unit MFR loses a tenant, it's only 10% vacant. Even after that reduction in cash flow, you'll still have 90% of your regular monthly rental income to cover the property's mortgage and operating costs.

You can live there too

For many new investors, “house hacking” is one of the biggest advantages of owning a multifamily investment property. If you don’t mind living in one of the units, you can avoid paying rent somewhere else or having a second mortgage on a separate primary residence.

Beneficial economies of scale

Economies of scale, or reduced costs per unit, will work to your benefit in a variety of issues. You only need one insurance policy. You only have to drive to one location for showings, inspections and routine maintenance issues.

Whether you’re buying your first investment property or your 50th, choosing between an SFR or a MFR boils down to your access to financing, budget, overall goals and appetite for risk. Both options have their own risks and rewards, and both can be smart additions to your investment portfolio. Keeping an open mind and understanding that they both have their place will help you create a great investment portfolio.

4 What is a Syndication?

Real estate syndication is a way for investors to pool their capital and intellectual resources to invest in properties and projects much larger than they could afford or manage on their own. In the past, syndications were limited to the affluent and well connected. Syndications are now much more available than ever before, with minimum investments that put them within reach of many investors. Investing in a real estate syndication enables you to acquire a single or diversified portfolio of properties with your finances, without having to take on any managerial burdens.

Real estate syndication is a transaction between a Sponsor and a group of Investors. Professional real estate investors, known as sponsors or general partners, form a syndication so that they can buy large properties but they couldn't on their own. A sponsor structures each syndicated investment, raises the capital, secures any necessary financing and manages the assets. Investors, or limited partners, provide the rest of the capital for deals in exchange for a portion of the profits.

Syndications are usually structured as a Limited Liability Company or a Limited Partnership. The Sponsor acts as the General Partner or Manager. And the investors act as limited partners or passive members. Syndications also offer a way to diversify your real estate portfolio—you provide only a part of the total equity in exchange for a corresponding partial ownership interest in the property. So, instead of investing all of your capital in a single property, you can spread your funds among multiple properties.

Syndications are generally offered through private placements. The investment should include an offering memorandum that describes:

- The financial and operational details of the transaction, including financial projections

- The structure of the offering, including the “waterfall” (how proceeds will be distributed to investors)
- A description of the project financing
- Market data
- Background information on the sponsor and any other parties involved

Real Estate Syndication Profits

Property appreciation and rental income are the two main ways the Sponsor and the Limited Partners make money from a real estate syndication. Rental income from a syndicated property is distributed to investors from the Sponsor. This typically occurs monthly or quarterly based on preset terms. In addition, a property’s value usually appreciates over time. Therefore, investors can earn greater profits when the property is sold.

Why Invest in a Real Estate Syndication Instead of Directly Buying Real Estate?

Real estate syndications are a passive way to invest in real estate. The average investor does not have the time or desire to constantly search for profitable real estate deals. Investing in a real estate syndication allows you to participate in the real estate market while leveraging the expertise of professionals and avoiding the hassles of day-to-day management.

Real Estate Syndication and Crowdfunding

Crowdfunded real estate syndications are more accessible, have lower investment minimums and offer a vast amount of project information to potential investors. With real estate crowdfunding, you don’t have to risk hundreds of thousands, if not millions to invest in commercial real estate. Instead, you can invest as little as \$1,000 and be much more diversified.

Advantages of Real Estate Syndication

Portfolio Diversification

An investment portfolio needs different kinds of investments to minimize risk. Just as you should have a mix of different types of stocks and bonds, real estate syndications can be a profitable addition to a portfolio that offers diversification into a new asset class.

Passive Income

Syndications provide real estate exposure to your portfolio without the hassle of owning property directly. The general partners conduct all the managerial duties and you simply collect a check.

Leverage Other People's Connections

Connections are key in real estate and without being a part of the club, the most profitable deals will pass you by. The general partners in a syndication network constantly, allowing them to find deals the average investor will never have access to.

Benefits from a Professional's Expertise

Syndicators have done this before – they know what you need to make a property profitable and what changes will raise its price the most. You can invest with sponsors who have years of experience in both up and down markets, as opposed to struggling through on your own.

Access Larger Deals

Let's face it, you make more money when you can do anything on a large scale. By pooling your money with other investors, you can access large deals you couldn't take on alone.

Minimize Downside Risk

As an investor (limited partner), you can only lose what you invest and nothing more. By investing in a real estate syndication, you can only lose what you choose to invest.

Protect Your Personal Credit

The syndication gets its own loan from the bank, totally independent from your credit. There is no need to start piling debt onto your personal credit report.

Cash Flow

Most syndications distribute monthly or quarterly cash flow, in addition to the payout at the end of the deal.

Taxes

The IRS loves real estate – the tax code in the US allows investors in real estate syndications to enjoy the benefits of depreciation.

Disadvantages of Real Estate Syndication

Lack of Liquidity

Unlike a mutual fund or other assets most investors are familiar with, syndications are illiquid. This is a fancy way of saying you can't hop on eTrade and buy or sell it in an instant.

Limited to Accredited or Sophisticated Investors

Not everyone can invest in a syndication, as some syndications are only open to accredited or sophisticated investors.

The Timeline Can Change

To avoid being forced to sell in a market downturn, syndications give a range of when the investment will end but don't specify an exact date.

Real estate syndications have become increasingly popular as real estate investors seek to diversify their investment portfolios. There are various ways that a real estate syndication can be organized. Below we will discuss these different structures and the pros and cons to each of them. A real estate syndication occurs when various investors pool together their resources, capital, and skills to purchase a particular real estate asset.

When it comes to real estate syndications, there are many ways you can splice a deal. The way a real estate syndication company structures its syndication will depend largely on the sponsorship team's experience, track record, the specific deal, the market, as well as many other factors.

The way a real estate syndication is structured will affect the returns for passive investors. Which is a large reason why passive investors must understand the various deal structures available.

Legal & Organizational Structures

- **REITs** - Real estate investment trusts (REITs) can be either privately or publicly traded and listed on stock exchanges. REITs can actually be organized as corporations or trusts as well. They are unique in that they must pay out at least 90% of their taxable income in dividends.
- **LLCs** - Limited liability companies (LLCs) are one of the most common structures for large investment deals. With an LLC, you will have managing members who will be sponsors or active organizers and investors, as well as passive capital investors who will be classified as regular members of the LLC.
- **LPs** - Limited partnerships (LPs) are also common syndication structures for sophisticated investors. These include a general partner (GP) who acts as the organizer or "sponsor" and who will take care of the active investing. Limited partners are the passive investors who provide capital for projects.

Fundraising, Fee & Payout Structures

- **Debt vs. Equity Fundraising** - The two main types of syndications involve raising debt financing or equity capital. Each has its advantages. Some funds use their capital to either invest in hard real estate assets or paper assets in the form of mortgage notes.
- **Preferred Returns** - In other structures, the sponsor will promote and offer preferred returns. This means that those passive partners are owed a predetermined rate of return on their money before the sponsor can take any profit share. Only after those dividends are paid does the sponsor get to participate in the profit action.
- **Straight Equity Split** - Syndicators can give their investors straight ownership splits. Returns will be split according to ownership or share percentages.
- **Sponsor Earnings** - Sponsors have a variety of other ways to earn in syndications as well. Some try to structure their deals in a way that gives potential investors a lot of confidence, because interests need to be closely aligned for the long-term. Others are very good about balancing this with earning enough to fuel their team to do the best work at every stage of the process.

People in a Real Estate Syndication

Here are the key roles that come together to make a real estate syndication happen:

Real Estate Broker

The person or team who surfaces the property for sale, either as a listing or as an off-market opportunity. Having a strong real estate broker is crucial, as they are the main liaison between the buyer and the seller throughout the acquisition process.

Lender

The lender is the biggest money partner in a real estate syndication because they provide the loan for the property. The lender performs their own due diligence, underwriting, and separate appraisal to make sure the property is worth the value of the loan requested.

General Partners

The general partnership team includes both the sponsors and the operators (sometimes these are the same people). Sponsors are the ones signing on the dotted line for the loan and are often involved in the acquisition and underwriting processes. Operators are generally responsible for managing the acquisition and for executing the business plan by overseeing the day-to-day operations. Operators guide the property manager and ensure that renovations are on schedule and within budget.

Key Principals

For a commercial loan, the sponsor is required to show a certain amount of personal liquidity. One or more key principals may be brought into the deal to help guarantee the loan if the sponsor's personal balance sheet is insufficient.

Passive Investors

A real estate syndication's passive investors have no active role in the project. They simply invest their money in exchange for a share of the returns.

Property Manager

Once the property has been acquired, the property manager becomes arguably the most important partner. The property manager works closely with the operator (i.e. the asset manager) to ensure the business plan is being followed and that any unexpected surprises are addressed properly.

In addition to the key roles discussed here, there are inspectors, appraisers, cost segregation specialists, CPA, legal team, insurance agents, and more, who work in the background to make sure that the syndication gets off the ground. While all their respective roles are different, they are all needed to ensure the success of the syndication.

What is the Best Real Estate Syndication Structure?

The reality is that there is no one way to invest in real estate syndications and depending on the deal, one structure may generate better returns than the other. Various factors must be considered to decide if an investment is right for you. It is incredibly important that before you invest in syndication, you understand every aspect of how the deal is split as that could have a large effect on your ROI.

5 Due Diligence

Multifamily apartments fall into asset classes, which are A, B, C, and D. They can all result in profitable investments, but you need to take the right approach. Here is a description of each asset class:

- **Class A**

This property type is usually less than ten years old and bought for its appreciation value. There could be a vacancy spike in class A homes during a recession period in white-collar neighborhoods.

- **Class B**

These homes are about 10-25 years of age and purchased for their appreciation value. However, you can't expect the same kind of appreciation as class A homes.

- **Class C**

The average age of these homes are about 30 to 40 years. There is a limited amount of appreciation value here, and cash flow is typically good due to high demand.

- **Class D**

These homes have an average age of over 40 years, and they are usually government subsidized. The debt problems of the average resident in this home type means the house can be more difficult to manage.

Passive investing is not risk-free. In fact, there is actually an added risk involved. What is that risk? It is the syndicator or deal sponsor that you are choosing to invest with. Before handing over any money, you must complete thorough due diligence to ensure you are investing wisely.

There are a number of questions that you can and should ask before working with any syndicate.

- *How Are the Deals Evaluated?* Find out how they evaluate the validity of each deal to ensure they are making sound decisions with your money.
- *What Is the Target Market?* It is important to understand what market your syndicate plans to invest in.
- *Are You A Specialist in That Market?* If the syndicate does not understand the ins and outs of the market, then they may choose a property in a bad part of town with a high crime rate.
- *How Will the Cash Flow Be Managed?* Understand how and when you will gain access to the returns.
- *How Do You Communicate with Your Investors?* Get an understanding of how you can track your investment and how often you can expect to hear from the sponsor.
- *How Is Each Deal Stress Tested?* Explore how the syndicate stress tests, what the operator reserve is and if they have a rainy-day fund as a safeguard option.
- *What Is the Business Plan?* Find out things like how long do they intend to keep the property? This will help you to understand whether it is the right place to put your money.
- *Who Is Involved in The Transaction?* There are a lot of different parties involved in any deal. Don't just research the sponsor, but look at who is going to complete the transaction, who the accountant is, who is supplying legal advice etc.
- *Who Will Manage the Property?* The property needs to be managed well. Look at the company handling it and also what their workload will be like. Will they be able to dedicate enough time to your property?

- *What Is the Financial Contribution?* Most reputable syndicates will require an investment of at least \$50,000. Some will accept lower contributions, but they may be less experienced or are struggling to raise the money they need to cut a deal.

Things to Look For When Evaluating Real Estate Syndications

Investment Criteria

Before you start looking for deals, you want to know your own investment goals, such as desired annual return, investment period, and risk tolerance. Are you looking for investments with higher returns and risks, such as ground-up developments or an extensive value-add? Or do you prefer less risky investments that provide lower but stable returns for many years? Although higher returns appear obviously better, those types of real estate investments are generally riskier.

Finding the Right Syndicator

A syndicator is an active investor who's putting the syndication together. A syndicator with a track record is preferable, but don't let it be your only criteria. Many syndicators started after the last recession, which means they probably haven't experienced a market downturn yet. Therefore, you should always trust but verify the syndicators that you invest with. On the contrary, a syndicator without a track record isn't necessarily a deal breaker.

How Do You Know If a Deal Is Good?

You don't need to fully underwrite the deal, but here are some numbers or metrics that you absolutely should pay attention to.

Different syndicators have different investment strategies, so make sure that the person's strategy aligns with your investment goals and criteria.

Returns and Investment Period

The first thing you should look at are the returns and the investment period, which we discussed earlier under the “Investment Criteria” section. Even though you trust the syndicator, it’s good practice to verify the underwriting. Since you’re putting significant capital into a single deal, you should do your own due diligence.

Exit Cap Rate

This variable is so important, because a small difference in the cap rate can change your sale price and returns dramatically. The rule of thumb is that the selling cap rate absolutely needs to be greater than your market cap rate. For example, if you’re buying the property at 5 percent cap, don’t assume that you’ll sell at the same cap rate in the future. You want to assume that the economy will be doing worse in five years. A good estimate is five basis points a year, which is 5.25 percent in five years.

Rent Per Square Foot

Rentometer is a great reference for rent per square foot, but it’s not the most accurate. You are basically seeing whether you think the units will be able to lease at the market rate that the syndicator is using for the underwriting.

Expense Ratio

It is more time consuming to check the annual cost of each individual expense, and it’s not necessary for the purpose of this exercise. The expense ratio varies based on the city and the building type. A newer building will have a lower expense ratio, because the equipment requires less maintenance. An expensive city will also have a lower expense ratio, because the EGI (effective gross income) is so much higher. Generally, the expense ratio should be about 40 percent for newer buildings and 50 percent for older buildings. If you’re not sure, check with a local broker or property manager.

Rental and Expense Growth Rate

You can typically assume that the rental and expense growth rates increase at about 2 percent annually, which is similar to the inflation rate. If the projected rental growth rate for the deal is higher, then you should double-check by referencing the city's historical data.

Stress Test

If you do not see a stress test analysis in the syndicator's investment summary package, then you should ask about it. The main thing to look for is cash flow. You want to know if the property will have enough cash flow to pay the expenses and debt service with decreasing rent, higher vacancy, etc.

Risk Partitioning

One way to analyze the risk of each deal is by partitioning the IRR. To partition the IRR, you need to normalize the net operating cash flow and the net sale price by using the Present Value (PV) function in excel. Then you can partition the IRR by simply adding the cash flow for each year and dividing it by the total PV. The lower the percentage, the higher the risk, because the gains are not realized until you sell the property.

Here are four key questions to ask when vetting any multifamily investment

1. HOW DO WE CONSIDER THE EXIT CAP RATE?

The price that you sell (or refinance) a multifamily asset will have a huge impact on the returns for the investors. And in this asset class, the cap (capitalization) rate is key in determining the value of a property. The cap rate is the ratio between the NOI (net operating income) and the value of the property. The NOI is also straightforward. It's simply the total operating income less the total operating.

In this case, we have the value of the property (\$5M) and the NOI (\$250k) so we can calculate the cap rate by dividing the latter by the former. For example, if we are trying to determine the value of a property, we need to know our NOI and the cap rate. The NOI can be calculated by looking at our financial statements and the cap rate can be estimated by seeing where other properties are trading in our market. Sticking to our example above, we have an NOI of \$250k and the market cap rate of 5%, then we divide \$250k by 5% to get \$5M.

$$\text{Value} = \text{NOI} / \text{Cap Rate} = \$250\text{k} / .05 = \$5\text{M}$$

When you are vetting a deal, it is important to understand where the operator is estimating their exit cap rate so you can see how aggressive or conservative they are and if that is a fit for your risk appetite. Ask them these questions:

- What is the current market cap rate?
- What exit cap rate are you assuming?
- What data do you have to back up your assumptions?

They should be able to give you a solid answer to all these questions and explain how they came up with those numbers. In the end, these are all projections but some good sources of information to support them would be input from brokers in the area, sales comp data, and data-driven projections from services.

2. HOW DO WE PROJECT RENT GROWTH ASSUMPTIONS?

With any multifamily property, most of the income is going to be derived from the rents paid by the tenant base. Therefore, the performance of the asset is being projected based on what the Sponsors believe they will be able to collect in rents throughout the hold period. So, you're going to want to know both what these estimates are and, more importantly, how they arrived at them.

What you want to understand when vetting a deal is how the operators are projecting the rent growth throughout the life of the deal. There are two important factors to keep in mind here.

- **First, the rent levels that the operators hope to achieve after taking over.** In most deals, the sponsor team will be looking to add value to the property in some way to drive rents and thus, boost overall income. This could come in many ways, from upgrading the interiors of the units, adding in-demand amenities, or introducing more tenant-friendly people and systems at the property itself.
- **The other factor is the organic rent growth in the market.** That is the level that rents are growing (or declining) at all multifamily properties in that specific area. This will mostly have to do with market factors, like population growth, major employers moving in/out, and the availability of comparable assets. In areas where large employers are moving in, the population is steadily increasing, and future construction for apartments is low, there is going to be upward pressure on the rent levels because demand is outpacing supply.

You can ask your sponsor about both of these situations to understand exactly what they are projecting for rent growth and how they got their numbers. If they have a value-add plan off the bat, ask about the specifics and if they have rent comps to back up the plan. In terms of the organic rent growth, ask about population, income, and job growth in the area. Find out from them about the future construction. Ask them to share resources that have projections on these types of numbers to make sure they are in line with what the operators are estimating. The main thing you want to make sure of is that the numbers seem conservative and achievable based on the data. This is the income that is going to drive your returns. So, the more conservative they are, the better chance you have of reaching/exceeding your targets.

3. HOW MUCH ECONOMIC VACANCY IS BEING PROJECTED?

In general, economic vacancy is simply the difference between the max potential collections on a property and the actual collections. upgrade the units the first month we took over. It's important to understand how your sponsor is modeling economic vacancy on a deal you will be investing in because differences in the estimates can drastically change the returns that are achieved. Being too aggressive with economic vacancy, which is setting it too low, will lead to higher collections, higher income for the property, and higher returns for the investors. But what if those numbers can't be achieved? That rate is going to depend on a number of factors including the current occupancy at the property, the timing on the ends of the tenant's leases, the ability of the staff to sign new leases at the higher rates, the ability of the construction company to perform the upgrades promptly, and much more.

You'll want to get a clear understanding of not only what the numbers are but how the team is planning on achieving them. Quotes, estimates, and timelines from property managers and construction companies would go a long way in verifying the business plan. As with all other assumptions, you'll want to see them leaning on the conservative side. The higher the projected economic vacancy, the more of a buffer the team must execute the business plan and deliver on the projected returns.

4. HOW DO WE MODEL DISTRESS?

All three of the metrics we have discussed so far are critical to calculating the returns on a multifamily investment. They have another thing in common as well- they are all simply estimates. They each quantify one specific outcome out of an infinite number of possibilities. If you have done your homework to this point, hopefully, your sponsor has solid estimates for all of these items accompanied by a reasonable explanation for how they got there. But where do things end up if things play out a little differently throughout the life of the investment? How would tweaks in one or more of these estimates affect the returns you're looking to capture on your capital? This is where stress testing comes into play.

The good news is these questions should be relatively easy to answer given the type of modeling that your sponsor is doing to project returns in the first place. Simply adjusting these assumptions in the model should exactly show what the change in the return profile looks like for your bottom line. You can ask your sponsor what your returns look like if the following occur:

- The exit cap rate is 50 basis points higher? 50 basis points lower?
- Rent growth is lower than expected? Higher? Stagnant?
- The economic vacancy is higher than anticipated? Lower?

The best-case scenario would be that your sponsor already has these answers in chart form. There you can see your returns based on the assumptions of each input alongside how they change with slight changes in each direction. This type of information can provide a great picture of both the risk and upside in the particular investment.

6 Tax Benefits

The US Tax Code is complicated and ever changing. If you have invested in traditional assets such as stocks, mutual funds, and CD's, you quickly learn that they don't provide very many opportunities for tax deductions. However, one of the easiest ways that many savvy investors have found tax benefits is through real estate investing. Like there are tax benefits that come from owning your own home, there are also advantages when you own an income property.

Take a look at some of the advantages of real estate investing to see how you can benefit from these tax savings.

Deductions

One of the most basic tax advantages of investing in real estate is the ability to deduct certain expenses relating to the investment property, which may include:

- Property tax
- Property insurance
- Mortgage interest
- Property management fees
- Property repairs, capital improvements, or ongoing maintenance
- Advertising expenses (such as the cost to list a rental or market a property for sale)

Depreciation

If you own a property that is being used for business or income-producing purposes (like a rental property) for a year or more, you can depreciate the cost of the property over time. Depreciation is the method of deducting a property's loss in value over its expected life, which for residential property is 27.5 years, and for commercial property is 39 years. In essence, it's accounting for a decrease in value from average use as well as wear and tear.

You might be wondering how a property can decline while its value increases throughout time. Well, the IRS treats properties like any other type of asset.

Therefore, to them, the real estate's quality diminishes progressively. Regardless of whether the property is making profits or appreciating in value, owners can deduct a depreciation expense from their real estate income tax. Clearly, it's evident that depreciation offers investors a massive tax break.

Passive income and pass-through deductions

Real estate is frequently praised for its ability to produce passive income, which is cash flow that is earned without having to continuously work for it. But passive income is often confused with passive activity.

Capital gains tax instead of income tax

When you sell a property for more than you originally purchased it for, the profit will be taxed as short-term or long-term capital gains, which is typically a lower tax rate than ordinary income tax.

Invest tax-deferred or tax-free

There are special savings accounts like a health savings account (HSA) or special individual retirement accounts (IRA) like a Solo 401k, SEP IRA, or Self Directed IRA that allow you to invest in alternative assets, including real estate, tax-free or tax-deferred. Annual contribution limits vary depending on the type of account you open, and there are different requirements prohibiting who and what you can invest in with each account. However, this can be a great way to defer taxes but still invest in real estate.

The Real Estate Tax Benefits of an SDIRA & LLC

Further tax advantages can be found in the way you choose to own the income property. While you should consult a tax professional first, it may be more beneficial to own the income property through an LLC or a self-directed IRA (SDIRA), instead of in your own name.

LLC: Owning an investment property within an LLC serves as a way to insulate yourself from liabilities as well as ensure that you can avoid double taxation. This potentially occurs when you use other types of corporate structures to invest in properties. Double taxation is avoided on the funds received through the collection of rent and if the property is sold later on.

SDIRA: Using an SDIRA to purchase property is also a great opportunity to find some additional real estate tax savings. This process does require some extra steps but offers you many of the same tax-deferred growth advantages you find with a regular SDIRA.

If you choose to utilize one of these additional real estate tax advantaged strategies to purchase an income property, it is essential you do so from the start. Trying to move a rental income property from personal ownership to an LLC or an SDIRA after closing could cause additional headaches and potentially a taxable event.

The tax benefits of real estate investing are undeniable, making it an especially profitable investment. We encourage you to consider real estate as an investment when you're trying to decide if you should buy a house. But, before you make any commitments, be sure to speak with your accountant and thoroughly inspect and research any property you are seriously thinking about purchasing.

Cost-Segregation

Cost-segregation is similar to depreciation. The only difference is that it also involves the value depreciation of certain items in the multi-family rental property.

For instance, items like cabinetry, fixtures, and appliances. According to the IRS, these items have a shorter lifespan. That's why they allow real estate investors to make depreciation expense write-offs on these items for a period of 7 years.

Unfortunately, cost-segregation often affects your tax bill when you decide to sell the property. The more you use cost-segregation, the higher your tax bill will be when you sell the property.

Passive Income Tax Benefits

A passive income tax benefit is yet another great tax break for investors and owners who aren't "real estate professionals." Generally, passive income and capital gains tax rates are lower than the federal income tax rates. This means that, if you aren't a real estate professional, your multifamily real estate investment tax obligation will be much lower.

1031 Exchange Tax Benefits

Under section 1031 of the Internal Revenue Code, a property investor can swap their rental units with little or no capital gains tax obligations. For one to qualify for this tax benefit, they have to meet a few conditions. The following rules apply to 1031 exchanges:

- The new property must be equal or greater in value than the old one.
- The swapped property must be used for productive business purposes.
- Both properties have to be "like kind."

With these tax benefits, you can drastically reduce your tax burden. All it takes is a little research and proper tax strategies to make the most of all available tax breaks.

7 Conclusion

All in all, there are real estate investment opportunities for every type of investor, at every stage of life, with any range of available capital and time freedom. Once you are able to identify which investor type you are at this time in your life, you can see the opportunities within that category and how they make sense for you.

While diversification is key to all investment strategies, real estate should be a foundational piece of all investment portfolios. Specifically, multi-family real estate provides a hedge against risk -- in addition to its stability in valuation and predictability through cash flow. Investing in multifamily can provide steady, high-yield investments to your portfolio that over time can outperform index funds and other types of commercial real estate. Rental properties are not for everyone, since they require more work and responsibility than traditional stocks. Still, there is also no denying that the return on investment that you will enjoy with multifamily properties is always going to be there.

When it comes to investing in multifamily properties, there are many different ways to get involved. The important thing is to consider what works for you. Whatever you decide, real estate investing can be one of the best wealth-building methods out there.

Our team is dedicated to educating our investors. If you have any questions about investing in multi-family, or otherwise, don't hesitate to contact us by booking a meeting [here](#).

8 About the Author

CJ Yamada

CJ Yamada is an entrepreneur who is passionate about sustainability and the environment. He has primarily been in the solar industry since 2016, and started his own solar business in 2019.

After learning about the multifamily real estate market, CJ was inspired to bring his expertise in sustainability to invest in the multifamily business, and founded Yamada Capital.

If you have any questions about investing in multi-family, please feel free to **book a consultation with CJ.**



FOR MORE INFORMATION ABOUT INVESTING IN
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