Southport Financial

2507 Post Road
Southport, Connecticut 06890 USA
+1-203-255-3434

Multifamily Boot Camp

Investment Strategy

Almost every occupation or profession has its own vernacular and this is certainly true of real estate. I remember once attending a lunch in London with half a dozen commercial real estate brokers. Even listening carefully, most of the time I had no idea what they were talking about. The various accents were not the problem, they were just using a vernacular or descriptive language completely different from anything in my own real estate experience.

To some degree, it is useful to have common words and phrases which act as a form of useful shorthand when members of a profession are working together. Just listen to competitive sailors discussing a race or litigators rehashing a court case amongst themselves. Too often though, it just signifies that one is a member of that occupation or group, while unduly complicating the subject for outsiders.

If you happen to be talking with real estate investment professionals who work on an institutional level, investing sums in the tens or hundreds of millions, you will hear the words **Core, Core Plus, Value Add, and Opportunistic.** Within the multifamily or rental apartment sector of the real estate business, these words are a key part of our vernacular and explain important risk distinctions in investment strategy regarding type of property, location, age, condition, and leverage or borrowing ratio. On the risk & return spectrum, they are arranged in order of least risk and lowest expected return to highest risk and highest expected return.

As in any vernacular, these definitions are not precise and, within the industry, opinions will differ.

CORE refers to the safest, most conservative type of multifamily investment. It will typically be a larger property, recently built (but not always), located in a major metropolitan area, fully leased, with highly predictable cash flow, and with professional management. It will usually be fitted out to a high standard for the top end of the rental market, what we call a class A property.

A key part of the Core definition is no or almost no borrowing or leverage. Core properties will only rarely have a mortgage exceeding 30% of value. In a sense, these investments are similar to bonds designed to provide a safe income stream and are usually found in the portfolios of large institutional investors such as banks, pension funds, insurance companies, and endowments.

CORE PLUS (CORE +) originally referred to Core properties with moderate leverage but the definition has expanded to encompass larger properties that are still class A but might be located in smaller cities or prosperous suburbs and possibly somewhat older but in nearly "as new" condition and fully occupied with very predictable cash flows. Leverage or mortgaging might range from none up to 50%.

VALUE ADD refers to a range of apartment properties that do not fit the Core and Core + definitions. They might be in a smaller city or suburb or rural area, be older, have some relatively minor leasing, upkeep or management problem, or some combination of the foregoing. Leverage might range from 50% to 80%. As suggested by the title, the likelihood of being able to add value through correcting or improving these problems is a key component in this classification.

OPPORTUNISTIC refers to a multifamily investment which carries a higher risk and involves a major change in the property or its management. The property might be older, run-down, partially or wholly unoccupied, in arrears on its debt, or badly managed. The leverage ratio or borrowing is likely to be high and correction of the problems might need a significant investment of money, effort and time.

Where does Southport Financial fit in this spectrum of rental apartment investments? We have had successful outcomes in the last three of these investment strategies. We have never owned or managed a property that would fit the CORE definition.

Currently, we fall somewhere between CORE + and VALUE ADD. Our preferred investment is a property of 200 to 350 apartment units which is located along the Eastern and Southern Seaboard (we call it "Sunbelt - Seaboard"), in or near a growing city with large concentrations of economic activity in healthcare, technology, education or energy. The property should be relatively new and be in very good physical condition or with defects that can be easily corrected. Our approach is to apply good management and to make relatively small changes that can quickly impact property value.

Take for example, a 256 unit apartment property located on the Florida east coast in the New Smyrna Beach, Daytona Beach area. It is six years old and in nearly "as new" physical condition, with four stories, elevators, and all modern amenities. The location is excellent, near employment, transportation, and the beaches. Rents average $1,441 per unit. It is well above the 100-year flood plain and is built to withstand winds in excess of 150 mph. Management has been lackluster, occupancy is 87%, the pool and grounds have not been properly maintained, and the overall visual impact is somewhat tired.

The purchase is at a 5.00% Cap Rate (yield on the purchase price) and we negotiate a 75% mortgage at 3.5% interest.

What is our strategy? Essentially, apply good management. We have to clean, polish, landscape and paint the property so that it looks fresh and new. We need to upgrade the onsite management and leasing staff and make full use of technology and social networking. Rental distinctions need to be established for units with views, penthouse units with vaulted ceilings, and units near the pool. We can establish a jogging trail, put in a fire pit and outdoor kitchen and barbecue area, upgrade the gym, add a coffee bar and lending library, and add electronic locking and security so that these features can be 24-hour access. A package room or lockers will need to be added. All of this is relatively low cost, or within a usual takeover budget, except for the electronic entry and security system.

If we set aside $5,000 per unit for adding quartz or granite countertops and backsplashes in kitchens and bathrooms, wood laminate floors in the dining areas, upgraded lighting, charging stations for phone and tablets, and the electronic entry and security, this is a significant upgrade.

We believe, based on our prior experience and a model we have developed, that improving day to day management and service to residents and accomplishing these improvements and upgrades will enable us to increase occupancy from 87% to 93% over three years, increase the rents somewhat due to unit differentiation, and increase rents for each upgraded unit by $75.00/month (about 5% of the monthly rent). We also assume that rents and expenses will increase at the expected rate of inflation, 2% annually. Here, we should add the disclaimer that, regardless of how well we plan and manage, we live in a world of some uncertainty where inconvenient events like recessions, depressions and pandemics can cause unexpected disruption.

Looking at the numbers; upgrading 256 units spread over a four-year period at a cost of $5,000/unit will cost $1,280,000. Increasing the rents by $75.00/unit will bring in an extra $230,400 per year. This translates to an increase in overall value of $4,189,000, using a less favorable selling Cap Rate of 5.50%, ($230,400/.055 = $4,189,000). Accordingly, if we spend $1,280,000 on these upgrades, we can expect an increase in value (selling price) of 3.3 times that investment.

Overall, based on our calculations, initiating good management practices and these specific changes will increase annual cash flow from an initial 3.87% to **9.36%** after five years of operations. If we sell the property in the fifth year, using the less favorable Cap Rate, we expect to achieve an internal rate of return (**IRR**) in excess of **17%.**

Conclusion: Our investment strategy is to buy properties that fit into the Core + category or close to it in terms of quality and safety of investment and to apply somewhat more leverage and the Value Add techniques of aggressive management and close supervision.

The effect is to meld the relative safety of a quality Core + property type with the higher returns expected from Value Add techniques.