Getting Started in Multifamily

One- to four-unit apartment buildings are a good option for single-family home builders looking to invest in real estate

by Fernando Pagés Ruiz

As a California home builder during the early 1990s, I experienced first-hand the boom-or-bust cycles of residential construction. So when I moved to Lincoln, Neb., later in the decade, I began building one or two small rental properties per year, which I hoped would help insulate my business from those inevitable cycles. My strategy proved at least partly successful: Even though the recession of 2008 wiped out my home-building company, my apartments have provided a significant financial cushion that helps keep me afloat.

If you've been thinking about building or buying a rental property, this may be a good time to jump in, because multifamily construction is actually booming. Census Bureau numbers show that while single-family housing starts for February 2012 climbed nearly 24 percent nationally, multifamily shot up 60 percent. And numbers for small two-to-four-unit residential projects — the focus of this article — were 73 percent higher than the previous year.

Sizing up the Market

I used a simple strategy to plan my Lincoln projects. First, I would find out who the competition was and what they were building, which told me where oversupply was likely. Then I would try to find out how long it took to rent out typical one-, two-, three-, and four-bedroom apartments, which gave me a good indication of where demand was strongest. Back then, I gathered this information informally in conversations with friends who were real estate agents. Nowadays, it's much easier to get a feel for the market by looking on craigslist or other online bulletin boards to see what's being offered and how long the ads remain before the units are taken.

For example, in Lincoln, a college town of 250,000, most new complexes under construction when I was getting into the market offered only two- and three-bedroom units. One-bedroom and studio apartments were mainly available in old, rundown buildings, creating a niche for newer stock. But at the time it made little

In this four-plex, each apartment is a vertical unit with its own street entrance, which eliminates upstairs neighbors and simplifies fire-barrier and sound-control details. The apartments have separate laundry facilities and garages, making them attractive to young families.

Pro Forma for a Typical Small Apartment Building

$385,000 purchase price ($35,000 lot and $350,000 net construction costs)

Building Description: *Four-unit apartment building, three stories, each unit 1,500 sq. ft. • 4 garages, 6 parking spaces • Cluster mailbox and dumpster area • Utilities: house electric meter, water/sewer, trash*

Income		
Annual Rental Income	**$57,600.00**	($1,200 monthly rent for each four-BR unit; assumes 100% occupancy)
Expenses		
Mortgage	$24,824.00	per year based on $96,250 (25%) down, $288,750 mortgage, 20 years at 6%
Vacancy allowance	$1,728.00	or 3%, based on two apartments turning per year with 10-day vacancy to turn and rent
Insurance (property and liability)	$950.00	
Landscaping maintenance	$450.00	
Maintenance/apartment turnover	$1,800.00	
Property taxes	$6,500.00	
Snow removal	$750.00	
Utilities	$1,020.00	
Gross Annual Expenses	**$38,022.00**	
Building Depreciation Tax Credits (Building and improvements assessed at $385,000)		
Building depreciation @ 3.9 % x $325K	$12,725.00	(27-year straight-line depreciation, structure only)
Personal property: appliances, fixtures, carpet @ 20% x $25K	$6,500.00	(5-year mixed depreciation, wear items)
Total Tax Depreciation Credit	**$19,225.00**	
Summary		
Annual Gross Income	$57,600.00	
Annual Expenses	–$38,022.00	
Annual Gross Profit	**$19,578.00**	
Depreciation Credit	–$19,225.00	
Taxable Income	**$353.00**	

This pro forma is based on the four-plex shown above, which the author built on the site of an old house he held for five years while paying down the lot. The building sold in 2008 during the height of the real-estate crisis for the full asking price.

sense for me to build these units, because the local going rent — $300 to $400 per month — would barely cover my mortgage payment. So I focused on four-bedroom units, which had the lowest vacancy rate and were renting for $900 to $1,200, an amount that would easily pay the mortgage and expenses with a few dollars left over.

Today, most new apartments that aren't subsidized housing are being built in urban locations that can attract high rental rates, with designs geared toward younger, educated professionals ("echo boomers") and empty-nesters. To attract them, the big boys can offer large-complex amenities like health-club fitness centers. As a first-time multifamily builder, you won't be able to compete with a seasoned developer, but you can look for a property close to restaurants, cafes, health clubs, universities, and libraries. Another option is to rehab a rundown apartment in the right area of town, though this can involve some risk because of the uncertain costs of renovating an older building.

I discovered a slightly different market niche and built my first four-bedroom apartments near ethnic enclaves where culturally appropriate services like ethnic groceries and foreign-language video rentals were within walking distance. Nobody else was cultivating this market, which created an opportunity for me. If you're a small operator facing well-capitalized professional competition, a good strategy is to find a unique niche that nobody else serves.

How an Apartment Makes Money

The financing procedures for apartments and other commercial buildings are not that different from those for building a spec house, but you'll want to be well-armed with financial details before seeking out a lender (for more on the subject, see "Getting Started in Commercial Real Estate," *Business,* 2/12).

Glossary of Terms

Net operating income (NOI): A property's yearly gross income minus operating expenses is its NOI. An apartment building's fixed costs include taxes, insurance, utilities, and maintenance; what's left over is the net operating income, an important measure that tells the bank how much money is available to pay the mortgage.

Coverage ratio: The debt service coverage ratio shows the relationship between the rental income and property expenses, including mortgage principal and interest payments (P&I). Here's a simple example: You receive $1,000 in monthly rent, your P&I payment totals $500, and your expenses (utilities, taxes, and maintenance) amount to $300. This means you have an NOI of $700. With a mortgage payment of $500, your coverage ratio is 1.2 percent, or 120 percent of the money needed to pay the bills. Most lenders require a minimum coverage ratio of 1.1 percent to 1.3 percent for a commercial loan (the bigger the ratio, the better).

Of course, in the real world the equation is more complex and includes other factors, such as the vacancy rate in your area (a knowledgeable commercial real estate agent or an appraiser can help you pin down this information). In older buildings, you may need a replacement escrow for major components, which is an amount set aside every month to pay for major capital expenses. For example, if your building has a 10-year-old roof with a life expectancy of 15 years, you will want to reserve enough money during the next five years to pay for this anticipated replacement. If the new roof will cost $20,000, you'll need to set aside $20,000 ÷ 60, or roughly $333 per month, in an escrow account to cover the anticipated expense — your bank may require this and hold the money from your deposits.

Loan-to-value ratio (LTV): The LTV is the total amount that you are borrowing relative to the appraised value of the asset, which in this case is the building. If your building has an appraised value of $100,000 and you are asking the bank for $75,000, your loan has a 75 percent LTV. The lower the LTV, the safer the investment for both the bank and you.

During the recent real-estate downturn, a very conservative LTV of 75 percent would still have left you upside down if the property dropped in value by 40 percent (the national average). In other words, if your property was worth $100,000 and you borrowed $75,000 (75 percent LTV), you would still owe the bank $75,000 even if the market value dropped to $60,000. Your LTV has shot up to 125 percent. The good thing about income property is that the value is generally based on the income and capitalization (cap) rate. If your rents go up, the cap rate rises and your property's value increases.

Capitalization (cap) rate: Based on the net operating income, the cap rate measures the rate of return on the cash investment in the property, and is used by lenders to determine a property's value and risk. In the first example, with a capitalization rate of 10 percent on a property with a $700-a-month net income, or annual NOI of $8,400 (12 x $700), you would have an estimated property value of $84,000. Investors generally look for a cap rate between 8 percent and 10 percent. Had you paid $100,000 for the same property, your cap rate would be 8.4 percent ($8,400 ÷ $100,000). The cap rate estimates the relationship between the total property value (or cost) and income.

Cash-on-cash return: Since I can't (or won't) buy rental property without a loan, I prefer to look at the cash-on-cash return rather than the cap rate. This is the return on investment based on the amount of cash I have to put up to buy the property. I typically look for a cash-on-cash return of 6 percent to 8 percent. In other words, the actual cash invested in the deal, after collecting rents and paying expenses, yields a return of 6 percent to 8 percent on an annualized basis. For example, if the bank requires a $50,000 down payment to buy the building, and I net $3,000 a year after paying mortgage and expenses, the cash-on-cash return is 6 percent — much better than a savings account, and better than my 401K retirement account.

One key piece of information is the pro forma, the financial projection you'll prepare to accompany your loan application (see sample, facing page). In a few lines, this summary tells the story of how you expect the building you're buying or developing to pay expenses, repay the loan, and make a profit. The pro forma will include at a minimum the yearly gross rents, a vacancy factor, building operating expenses, and the yearly mortgage payments.

Hold or sell? Most people build or rehab apartment buildings in order to hold them for many years and realize the combined benefits of cash flow, building depreciation (a paper tax loss), and land appreciation. More than once I have spoken to a landlord who pointed proudly toward his or her property and declared, "That's my retirement." But that's not the only strategy.

I built several of my apartment buildings on speculation and later sold them. Unlike homes, which have an intrinsic value that can go up or down, income property derives its value primarily from rents. My strategy was to build, lease, and then immediately put the building on the market. Since the mortgage and expenses were being covered by the rental income, I had plenty of time to wait for the right buyer and had a fairly narrow negotiating range on price, since the basic value was set by the income.

Bear in mind that while the market is favorable in multifamily right now, with low interest rates and easy leasing, multifamily mortgages typically come with a five-year interest-rate reset. That means that the 4 percent mortgage you banked on to make the numbers work today could go up 2 percentage points or more in five years — in fact, you should plan on it. Plan too for lower rents, higher costs, and a mortgage that rests at the upper limits. If you prepare for the worst and don't bank on optimism, your apartment buildings may indeed provide a handsome retirement. (If you're interested in learning more about real estate as a wealth-building strategy, I recommend *What Every Real Estate Investor Needs to Know About Cash Flow,* by Frank Gallinelli.)

Buy or Build?

Rehabbing an older building in a good location can look good on paper, but rehab dollars are notoriously uncertain, making it difficult to develop an accurate pro forma. For example, it would be wise to include a large construction fudge-factor cost (20 percent would not be excessive) on any pro forma for a rehab project. Likewise, yearly maintenance costs on an older structure can be very unpredictable. Even the amount that you'll be able to charge for rent might turn out to be lower than you expected because of the perceived desirability of new vs. older property.

Offsetting some of these risks, many municipalities offer deferred (no interest and no payment until you sell the property) or very-low-interest loans to entice landlords to update and upgrade rental property in blighted areas (often called redevelopment zones).

New construction. If you've been building single-family homes, transitioning to two-to-four unit construction should be easy. You can use the same set of subs and — if you keep the building height at two stories or less — the same design team you used to draft single-family plans.

Building five units or more pushes you into another category that typically involves more stringent requirements and — in some jurisdictions — the commercial code instead of the more familiar residential code. In most areas, your plans for five units or more will also require the stamp of a licensed architect, and you may need a commercial contractor's license to build them.

Financing becomes more complex and expensive, too. While a building with up to four dwelling units would typically qualify for a residential mortgage, most lenders consider a building with five units or more to be commercial property, financed by mortgages with stricter underwriting requirements, significantly higher down payments, higher interest rates, and more expensive origination fees and appraisals.

Rehab projects can be difficult to budget accurately. For example, the three-plex shown here had an original purchase price of only $28,000, but renovation costs totalled $145,000. A deferred city mortgage for $30,000 helped defray some of the author's carrying costs during renovation.

Fire Barriers

A key difference between a single and a multifamily dwelling is the requirement for an occupancy fire barrier, which is needed to prevent relatively small kitchen or cigarette fires from spreading from apartment to apartment. There are three basic fire barriers you'll deal with in small multifamily construction.

The most common is the one-hour fire barrier, which resembles the required fire barrier separating an attached garage from the dwelling portion of a house. You can achieve this separation easily by laminating both sides of the occupancy wall with 5⁄8-inch type X gypsum wallboard from the foundation right up to your roof sheathing, or by creating a one-hour envelope with 5⁄8-inch type X drywall on the occupancy wall and ceiling. This one-hour occupancy barrier is typical for two-to-four-dwelling buildings built on a single lot with one owner.

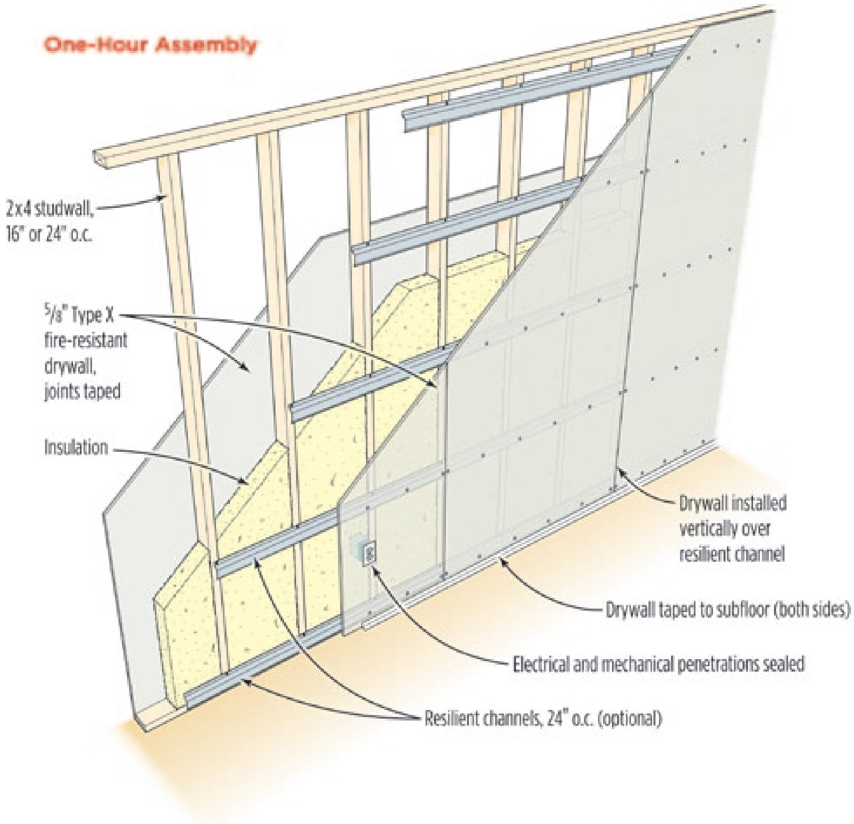
Condominiums and apartments with three or more stories or with five or more units typically require at least a two-hour fire barrier. It's hard to become creative with firewalls, and they are costly to build, but many different approved assemblies already exist.

When there is separate ownership on separate lots, such as with a townhouse or a duplex, you will have to provide a two-hour fire barrier and a structural occupancy separation. The latter consists of two unconnected structural support walls along the common boundary, so that — theoretically — if one half of the building collapsed, the other half would remain intact. This wall assembly typically consists of two one-hour walls built side by side without plumbing or ductwork, with a 1-inch space in between. Furthermore, under certain circumstances, you are required to build a parapet or install

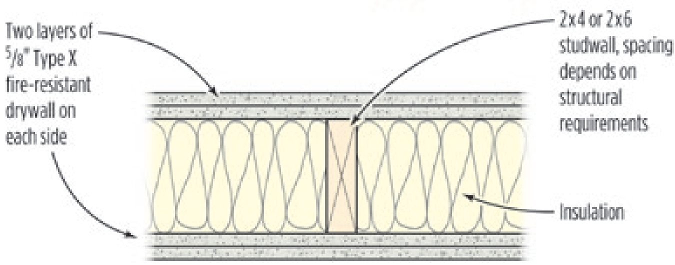
Fire Barrier Options

The author includes low-cost soundproofing details in the fire-rated wall assemblies he uses in multifamily construction. Installing the drywall over resilient channel, for example, improves a one-hour-rated wall assembly's STC (sound transmission class) rating from 46 to 50. He prefers mineral wool or cellulose insulation to fiberglass batts because those materials are more effective at absorbing sound; to block airborne sound transmission, he tapes the drywall to the subfloor and seals gaps and penetrations through the wall with acoustical sealant (top right). Upgrading partition walls to a two-hour rating by adding a second layer of drywall is a cost-effective measure that will make it easier to convert an apartment building into condominiums in the future (center right). Up to two layers of drywall can be fastened to RC-1 channel, giving the two-hour assembly an STC rating of 59. The same soundproofing details can be used in structural-occupancy separation walls between town-houses (bottom right and photo). For more fire-rated wall options, go to usgdesignstudio.com.

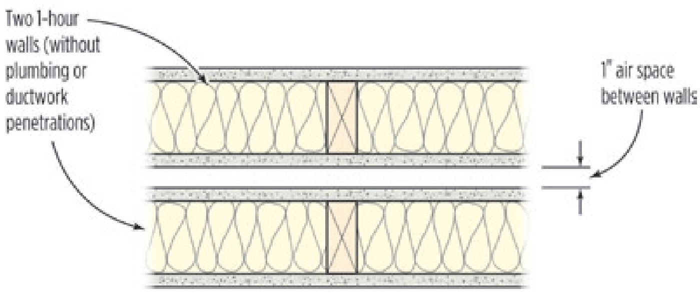
One-Hour Assembly



Two-Hour Assembly (Plan View)



Two-Hour Assembly (Area Separation Wall)



fire-resistant roof sheathing extending 5 feet on either side of the property line. These requirements make townhouse construction inherently expensive.

If you build with common corridors, interior stairwells, and other enclosed common areas, such as a laundry room, you will have to address more issues of fire separation. Most of these are greatly simplified with the addition of a fire sprinkler system.

Insights From Experience

There are some upgrades I think are worth including in my projects, despite the slight increase in construction cost. For example, even when two-hour fire barrier walls aren't required by code, I usually build them anyway. This not only makes my apartments quieter and safer — it also makes it much easier to turn my rental units into condominiums if the opportunity presents itself.

I also believe in good-looking buildings that enhance rather than detract from the neighborhood. Typically, small multiple-unit projects are built within older subdivisions, because that's where you're most likely to find affordable lots with zoning that allows apartments. Unfortunately, many apartment-building developers have earned a reputation for "slipping in" misfit structures that suck the charm out of these heritage neighborhoods. In reaction, neighborhood groups may draft strict neighborhood standards that are challenging to comply with architecturally if you want to remain economically viable.

Even when I'm not compelled to, I always try to build structures that look like they belong. In addition to making it easier to attract better tenants, paying attention to curb appeal goes a long way toward stretching the strict financial parameters set by an investor when it comes time to sell the building. You can get a better price for a better-looking building.

Turnovers cost money, so you want good tenants to stick around. To give them a feeling of privacy and ownership, I try to give every unit a separate exterior entry. I make sure interiors get plenty of daylight and are well-ventilated with quality bath and kitchen fans. I tie the bath fans to the bath light — to make sure they're used — and, in the kitchen, supplement the range hood with a ceiling exhaust fan that vents to the exterior. I tie this fan to the light as well. These touches make living more pleasant and reduce damage due to indoor humidity.

I include garages in my projects whenever possible. They really only need to accommodate one car, and can be either detached or attached; both configurations work well. I also include a laundry room in every unit, rather than try to maintain a common laundry facility with coin-operated machines.

Finishes. In an apartment, finishes need to be durable. Carpet may be initially less expensive than wood or laminate flooring, but it's harder to keep clean and doesn't last nearly as long. Even sheet vinyl and vinyl composition tiles last five times as long as carpet.

If you're angling for high-rent clients, a few tasteful details will go a long way. For example, granite kitchen countertops are a reasonably priced upgrade — and so is a wide bathroom vanity with designer faucets, a large mirror, and nice light fixtures.

To save on maintenance costs, I install painted wood window sills (drywall sills always get damaged). I avoid casement windows, because I don't like replacing cranks, and I avoid bifold and bypass closet doors so I'm not changing tracks at every turnover. I also furnish entry doors with a deadbolt and no locking knob, so tenants are forced to have a key in hand when they lock the door behind them. That way, I don't have to respond to 2 a.m. lockouts.

Multifamily buildings with more than five units — such as this 12-plex, which the author built in a desirable downtown neighborhood — have many more requirements and exponentially higher construction costs per square foot than buildings with fewer units.

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