



How to Invest in Apartment Buildings

A Layman's Guide to Getting Started

Michael Shields
Apartment / Investment Broker
michael@svmultifamily.com
408-354-7470
Lic. 01327546



Agenda

- The Investor
 - Developing Objectives & a Profile
- The Market
 - Commercial vs. Residential
- The Property
 - Analysis & Due Diligence



The Investor



Develop an Investment Plan

- Goals & Objectives
- Market & product knowledge
- Assemble a qualified team
- Action plan
- Just do it!

*“A good plan, violently executed now,
is better than a perfect plan next week.”*

-- General George S. Patton, Jr.



Financing

1. Source and amount of down payment?
2. What are your financial limitations?
3. Are funds available for future emergencies?
4. Have you chosen a qualified mortgage broker or lender?

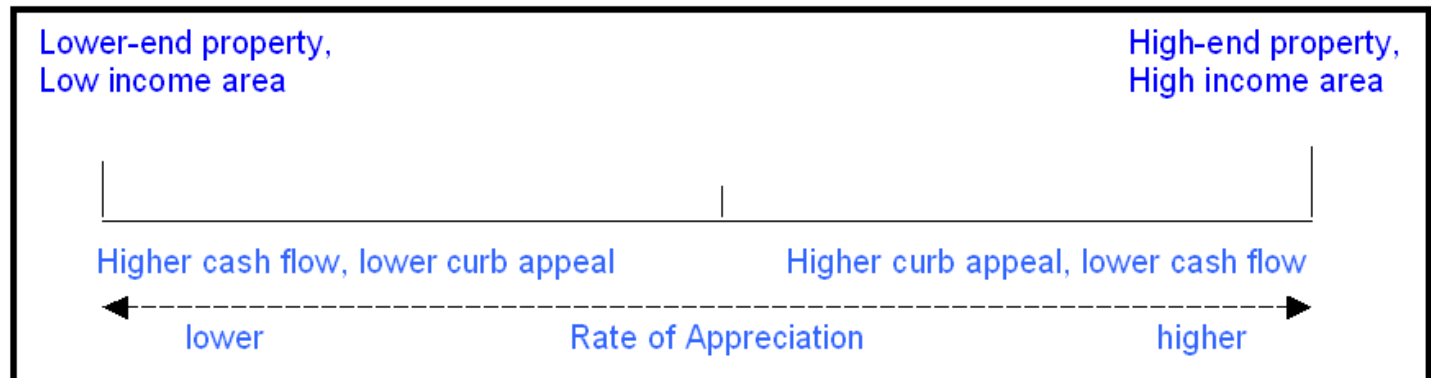


Profile Your Ideal Property

- Size
- Location
- Financials
- Condition
- Management involvement

POO vs. Slums

Condition vs. cash flow?

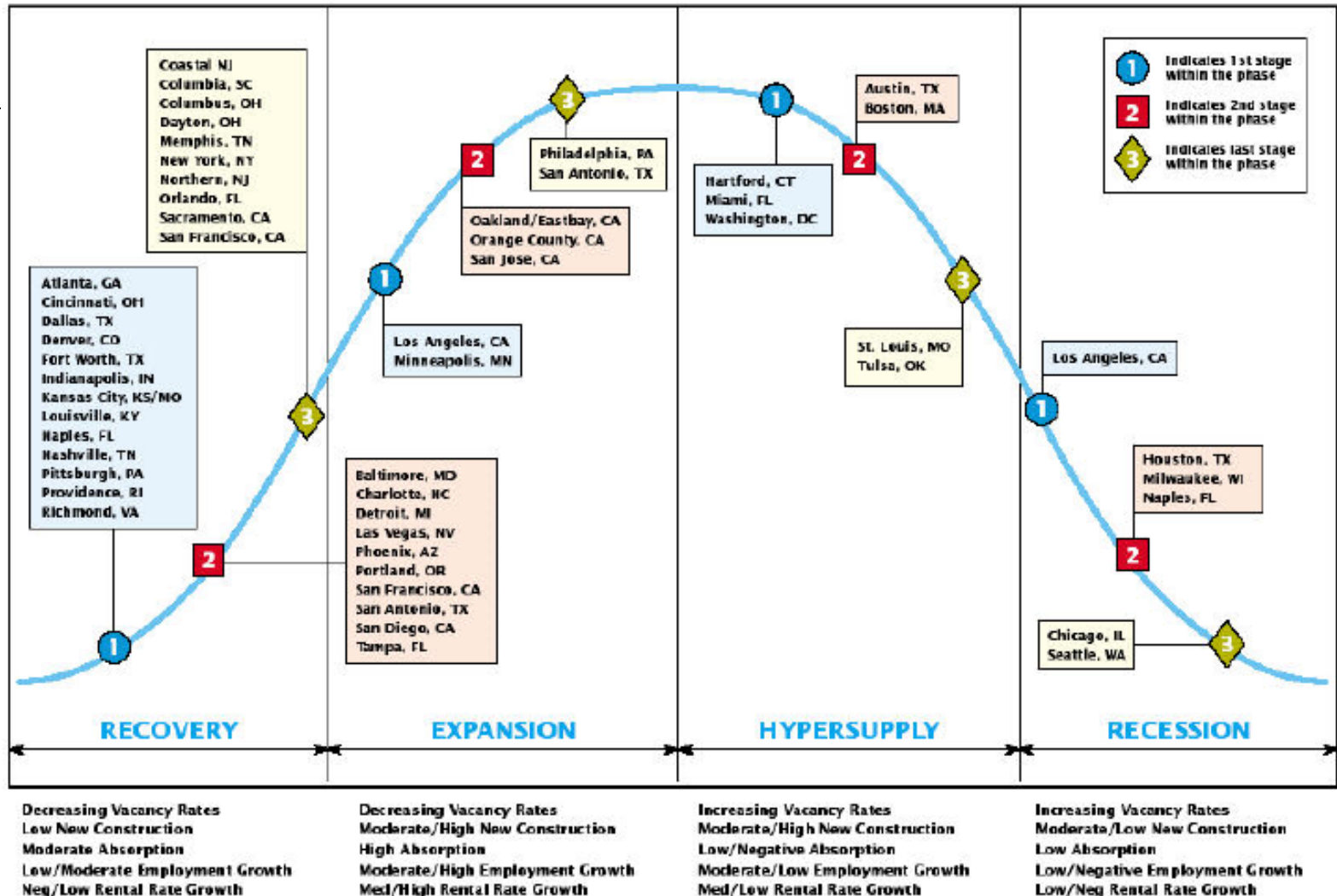


Are funds available should the building's income drop below the point at which it pays for itself?



The Market

Market Life-Cycle



Market Snapshot

Address	City	Units	List Price	GRM	Cap Rate	DOM	GSI	NOI	Sq. Ft.
262 HIGDON	MV	10	\$1,350,000	14.6	4.5	35	\$97,430	\$60,333	6,000
2002 W MIDDLEFIELD RD	MV	10	\$1,939,999	14.3	5.1	2	\$136,080	\$98,016	9,934
4734 HAMILTON AV	SJ	10	\$1,850,000	13.8	5.8	160	\$134,340	\$107,580	8,252
39 ATLAS AV	SJ	10	\$1,450,000	16.5	4.3	47	\$92,400	\$62,015	5,202
1185 BIRD AV	SJ	10	\$1,468,000	14.2	5.7	70	\$103,452	\$83,718	5,831
2131 MARLBORO CT	SJ	11	\$1,665,000	15.4	4.4	154	\$111,650	\$72,614	5,757
150 BLOSSOM HILL RD	LG	12	\$2,199,900	16.6	4.3	138	\$132,564	\$93,914	6,968
528 S 10TH ST	SJ	12	\$1,560,000	12.1	6.3	40	\$135,720	\$97,559	9,496
260 N 3RD ST	SJ	12	\$1,550,000	13.9	0.0	40	\$117,480	\$10,991	5,680
804 S ALMADEN	SJ	12	\$1,450,000	14.7	5.1	19	\$103,800	\$73,900	5,680
649 BLYTHE CT	SU	12	\$2,050,000	14.5	4.8	25	\$148,800	\$97,500	8,792
358 N 7TH ST	SJ	13	\$1,560,000	12.4	0.0	40	\$132,150	(\$1,192)	6,536
357 S 4TH ST	SJ	13	\$2,155,000	13.4	6.0	181	\$160,450	\$129,877	9,545
655 RESEDA DR	SU	14	\$2,150,000	15.1	4.7	19	\$150,128	\$100,320	7,494
560 S 10TH ST	SJ	15	\$2,125,000	12.2	5.3	6	\$177,540	\$112,604	9,808
270 E OKEEFE ST	EP	16	\$2,850,000	14.6	5.8	8	\$195,840	\$165,565	20,774
2080 MARLBORO CT	SJ	16	\$2,100,000	12.9	5.6	7	\$167,760	\$117,158	9,316
102 S 14TH ST	SJ	16	\$1,500,000	12.4		4	\$127,428	\$86,295	4,042
255 N 3RD ST	SJ	16	\$1,895,000	12.5	5.0	210	\$158,950	\$95,602	6,525

Note: This information is believed to be accurate but is not guaranteed.

Key Metrics

- Gross Rent Multiplier: $GRM = Price/PRI$
- Capitalization Rate: $Cap\ Rate = NOI/Price$
- Price per unit = $Price/\# \text{ of units}$
- Cash-on-cash return = $CFAT/Amount\ invested$
- Internal Rate of Return or Yield

N	\$
0	<Initial Investment>
1	Annual CFAT
2	Annual CFAT
3	Annual CFAT
4	Annual CFAT + SPAT

$i = IRR$

Financial Analysis

Cash Flow After Tax

Potential Rental Income (PRI)
+ Other income (affected by vacancy)
- Vacancy & credit losses
Effective rental income
+ Other income (not affected by vacancy)
Gross Operating Income
- Operating Expenses
Net Operating Income (NOI)
- Annual Debt Service (ADS)
Cash Flow Before Tax (CFBT)
- Tax Liability
Cash Flow After Tax (CFAT)

Gross Rent Multiplier

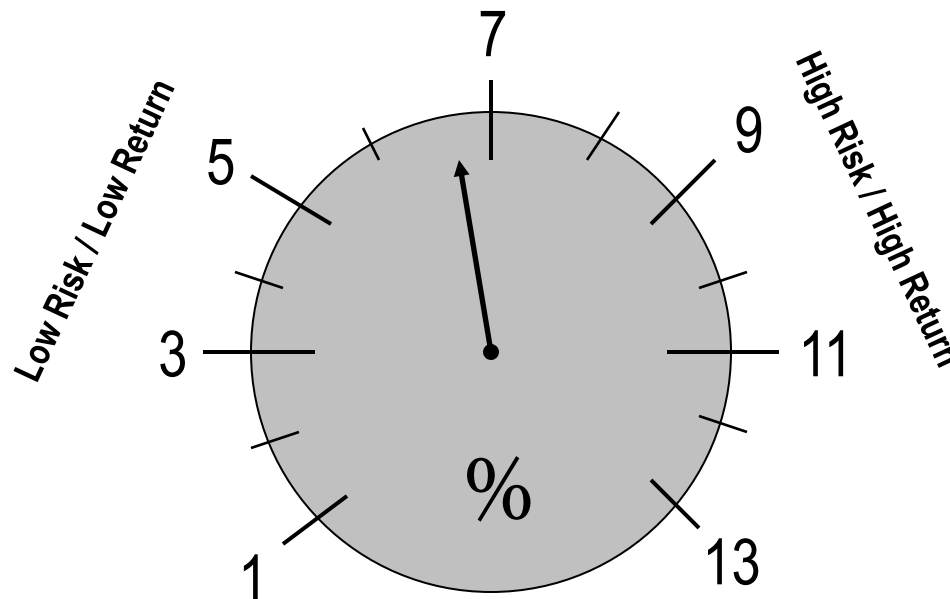
$$\frac{\text{Price}}{\text{Gross Rents}} = \text{GRM}$$

$$\frac{\$1,500,000}{\$150,000} = 10.0$$

**The lower the number, the better.
A relative number useful for comparing similar
properties at a glance. Omits expenses and risk.**

Capitalization Rate

$$\frac{\text{NOI}}{\text{Price}} = \text{Cap Rate} \quad \frac{\$100,000}{\$1,500,000} = 6.7\%$$



The Cap rate incorporates risk.


Price Per Unit/Door

$$\frac{\text{Price}}{\text{\# of units}} = \text{Price/unit}$$

$$\frac{\$1,500,000}{10 \text{ units}} = \$150,000 \text{ per unit/door}$$

A relative number useful for comparing similar properties at a glance.

APOD

		Property Investment Analysis						
Property Information			Investment Summary					
Property Name	Alden Way Apartments		Price:			\$2,950,000		
Address	3517 Alden Way		GRM:			10.9		
City, State	San Jose, CA		Cap Rate:			6.2%		
# of units	20		Price per foot			\$182		
Building Size (approx)	16,200		Price per unit			\$147,500		
Lot Size (approx)	22,900		Est YR1 Cash-on-Cash Return			4.98%		
Age	43		Debt Coverage Ratio			1.26		
Remarks: Income as of Dec 2003.			DCR Qualifying Rate			6.50%		
Initial Investment			Proposed Primary Financing					
Price		\$2,950,000	Primary Loan Amount			\$1,917,500		
Down Payment	35.0%	\$1,032,500	Interest Rate	5.500%		5.500%		
Borrowed Funds		\$1,917,500	Amortization Period	30		30		
Est Acquisition Costs	0.20%	\$25,075	Loan Term	5/30		5/30		
Initial Investment		\$1,057,575	Payments/Yr	12		12		
			Number of Payments	360		360		
			Monthly Debt Service			\$10,887		
			Annual Debt Service			\$130,648		
			Loan Points	1.0%		\$19,175		
Annualized Operating Data			Pro Forma Scheduled Income					
Scheduled Gross Income		\$271,520	<u>Unit Qty</u>	<u>Beds</u>	<u>Baths</u>	<u>Rent/Unit</u>	<u>Current Income</u>	
Actual Vacancy Factor	4.5%	\$12,047	1	2	1	\$1,475	\$1,475	
Effective Operating Income		\$259,473	2	2	1	\$1,295	\$2,590	
Less: Expenses	28%	\$76,168	1	2	1	\$1,250	\$1,250	
Net Operating Income		\$183,304	1	2	1	\$1,175	\$1,175	
Less: Annual Debt Service		\$130,648	2	2	1	\$1,150	\$2,300	
Cash Flow Before Taxes		\$52,656	1	2	1	\$1,095	\$1,095	
Est. Annualized Expenses			1	2	1	\$1,055	\$1,055	
Property Taxes (est)	1.20%	\$35,400	6	2	1	\$1,050	\$6,300	
Insurance (est)		\$8,500	1	1	1	\$975	\$975	
Maintenance		\$1,325	1	1	1	\$895	\$895	
landscaping		\$1,800	1	2	1	\$850	\$850	
Garbage		\$1,463	1	2	1	\$1,025	\$1,025	
Gas & electric		\$3,496	1	2	1	\$1,325	\$1,325	
Water & sewer		\$4,529	(last unit is pro forma)					
Reserves		\$0	20	Monthly Scheduled Rents			\$22,310	
Management (est)	6%	\$16,291	Total Units	Annualized Rents			\$267,720	
Misc: cleaning, paint, supplies		\$3,364		Other Income (laundry)			\$3,800	
Total Expenses	28%	\$76,168		Annual Gross Scheduled Income			\$271,520	



The Property



Buying a Building

- Have funds available
- Use a qualified broker
- Know the market
- Run the numbers
- Do your Due Diligence

Residential vs. Commercial

- Residential Property
- Buyer protection laws
- Easier to find
- Lower rate of return
- Lower down payment

- Commercial Property types
- Buyer beware
- Harder to find
- Higher rate of return
- Higher down payment



VS




Finding an Apartment Building

1. Work with a qualified agent/broker
2. Local MLS
3. Commercial Websites
 - Loopnet.com
 - Propertyline.com
 - CCIM.net
4. Commercial Brokerage sites
5. Commercial Brokers



Commercial Sales Protocol

1. “Subject to inspection”
2. LOI first, then written contract
3. Contract Type
4. Legal review
 - Clauses & addendums
5. Due Diligence
6. Renegotiation



Protocol (continued)

7. Remove physical contingencies
8. Increase of deposit
9. Remove financing & appraisal contingencies
10. May or may not **“Go Hard”**
(As in “Hard Money” = Loss of deposit)
11. Longer time to COE



Going Into Contract

- 1-4 units protected by buyer protection laws of full disclosure
- 5+ considered a commercial transaction = Buyer beware
- Seller must disclose known problems, but may not disclose all issues – “materially affect the value”
- Contract terms & clauses
- Commercial sales protocol
 - Subject to inspection
 - Deposits at risk



Commercial Documentation

- Letter of Intent (LOI)
- Variety of contracts
- Marketing brochure with property financials
- Financial Analysis for Client
- Transaction record



Inspecting Books & Records

- Accounting records or tax returns
- Rent role & deposits
- Copies of rental & other Leases
- Tenant Estoppel Certificates
- Receipts for expenses & capital improvements
- Guarantees & warranties

“Talk is cheap.”



Building Inspections

- Walk-through
- Roof
- Professional Commercial Property inspection
- Termite/water inspection
- Phase One Environmental
- Other inspections as needed



Commercial Financing

- Lenders minimize risk
- Property must be self-sufficient
- Scrutinize financials
- Lending Criteria
 - The lesser of the two:
 - Loan-to-value (LTV)
 - Debt Coverage Ratio (DCR)
 $\text{NOI/ADS} \geq \text{DCR}$



Taking Title

- Protection through legal entities
 - LLC, LLP, Subchapter S Corporation
 - Pass-through taxation
- Greater protection
 - C Corp.
 - Taxable entity
- Follow 1031 Exchange Rules
- Cannot provide legal or tax advice



Due Diligence

- Books & records
 - Rent roll & accounting records or tax returns
 - Leases & Estoppel Certificates
- Building inspections
 - Roof and/or General Contractor
 - Commercial Property inspection
 - Wood destroying pests
- Financing
 - Select a lender, although the building is approved, not you
 - Know your limits



Good fishing!

But beware of the sharks!





Michael Shields

- Silicon Valley Multi-Family Specialist
- California State Licensed Real Estate Broker
- Certified Commercial Investment Member (CCIM), Candidate
- Certified California Residential Manager (CCRM)
- Bay Area Apartment Brokers Forum
- Association of Silicon Valley Brokers
- Tri-County Apartment Association
- Silicon Valley Association of Realtors
- Past-President, Park Villas Ridgecrest HOA
- Former Licensed Stockbroker
- 15 years of strategic and tactical professional marketing experience