K.I.S.S Guide: Multifamily Investments

The commercial real estate market is an estimated $4 trillion market in the United States alone composed of various asset classes: multifamily, office, hotel, industrial and retail. Each asset class requires a different set of skills, conceptual framework and analysis tools to become a success. Becoming an expert in any one asset class is a lifelong struggle of learning and knowledge accretion. Given the dizzying amount information out on the Internet , I wanted to give a simple overall framework for each of the major asset classes that I have used when I have analyzed investment opportunities.

I call these the KISS Guides.

Why KISS?

I did not take the name from the band as some of you maybe thinking. I am a fairly analytical person and I have been accused of getting lost in the "trees" when I have been analyzing new investment opportunities. On more than one occasion, more experienced investment directors have advised me to KISS (Keep It Simple Stupid) especially with doing preliminary investment analysis. Hence I am going to share my KISS guide for each of the major asset classes over the next few weeks to help provide a framework that is useful to readers as you approach your next investment opportunity.

Multifamily or Apartment asset make up almost 25% of the $4 trillion commercial market size and are the most prevalent commercial investment asset class.

The Basics

The multifamily asset class is composed of apartment properties that are usually 5 units and greater. To start investing into the multifamily asset class, an investor needs to work their way down the investment

analysis framework/funnel. The funnel starts with the Market Analysis and works itself down to the Investment Analysis.

Market Supply-Demand Analysis

Demographic are the primary trend driver associated with growth of multifamily assets. The key indicators to keep in mind are as follows:

Growth (Demand) Indicators

- Household Formation: In the prime rental age group of 25 to 35 years of age
- Household Composition: You want to have more single and unmarried composition of household increase even if household formation is decreasing. This composition of household formation leads to higher increase in rental apartments/units.
- Economic Growth: An increase in the overall economy or regional economy increases the likelihood that prime rental group (25 to 35 years of age) will take apartment with less roommates, which drives up demand for space. This can be a double edged sword as too much prosperity leads to rising income which allows employed earners to become homeowners at a greater rate.

Headwind (Supply) Indicators

- Homeownership Rate: Homeownership is the main competition to apartment rental growth. Homeownership rate is an inverse indicator due to the "substitution effect" and is leading predictor of apartment price growth and decline.
- Supply Growth: is driven by vacancy rates and absorption rates and given the short lead up time to build; this indicator can become a big headwind especially in non-mature markets. Keep watch of construction starts in the 5+units permit space.

Market analysis should be completed at both the regional and local level to better understand the position of an investment relative to the marco (regional analysis) and the micro (local analysis) trend and characteristics.

Investment Analysis

As you work your way through the market analysis framework and start looking at potential investments, an investor will need to define who the building is designed and built for:

- Low Income Renters
- Middle-Class Renters
- Luxury Renters
- Niche Renters: Lifestyle Renters, Senior Housing, Student Housing

The designation of the demand user group will help define if the investment is product-market fit in terms of the needs of the end user i.e. the tenant.

Structure

Assets usually have a horizontal (garden apartments) or vertical layout (high-rise, mid-rise, low rise). Typically the vertical layout costs more as the initial cost of development as well as cost of the operating the building is higher for a vertical layout asset.

Class

Assets are typically assigned quality rating (Class A, B or C) depending on the property characteristics and local market definition of class levels.

Valuation

Multifamily assets can be valued using a direct capitalization approach that is made up of the following building blocks:

1. **Gross Rent** – Rent is the key assumption and is driven by local market conditions and how the subject investment fits into the local market and user demand needs.
2. **Vacancy –** A projected period of time that rent will not be collected due to collection issues and/or tenant eviction issues. This number is driven by local market.
3. **Operating Exp. –** Property expenses associated with operating the asset that is paid by the owner i.e. insurance, real estate taxes, water, security, garbage, heat, and cleaning
4. **Capital Exp. –** A reserve put aside for major expenditures in apartment units i.e. refrigerators, stoves, roof, hot water heaters etc.

The building blocks can be used to calculate the net operating income (Rent-Vacancy-Operating Expenses = NOI) of the investment which is then divided by the prevailing capitalization rate in the local market to ascertain the value of the potential multifamily investment

Asset Class Summary

Multifamily as an asset class has a few defining characteristics that make it different than investing into other assets i.e. office, retail, industrial etc. The defining characteristics are as follows:

1. Stable income streams as it provides space to non-cyclical demand base of space users (everyone needs a place to live)
2. Low volatility resulting from the stable nature of apartment income stream and limited risk of obsolescence
3. Defined rollover and vacancy risk given the relative short time lease duration which is a good thing in a

growing rental price market but a bad thing in a growing vacancy rate market

4. Propensity of lending institutions to provide higher leverage (LTV) debt capital

The multifamily asset class can be a great investment class for any investor depending on [what kind of player](#) you are in the real estate game.

Happy Investing!

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