Seven Critical Mistakes To Avoid When Buying an Apartment Building

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Introduction

Congratulations! If you are reading this, you have already joined or are about to join the select group of investment property owners at the top of the investment food chain in America. You have the honor of being a member of a very elite and exclusive club. Less than six percent of our population owns all of the commercial real estate in the United States (excluding owner-occupied business property). You are firmly on the pathway to having money working for you instead of working for money. If you take the time to choose the right multifamily property now, and leverage your growing equity into more apartment buildings in the future, your net worth will grow at an astounding rate that income from a job cannot compete with. Even if you make a six-figure income from working, how much can you really save in ten years? It is so tempting to spend most of your disposable income. In America we are famous for having a negative per capita savings ratio. That means the average American spends more then he/she earns (mostly thanks to credit card debt).

A beginning multifamily investor can start with $150,000 down on their first complex purchased at $750,000, and take maximum cash out or sell through a 1031 tax exchange into a larger property every two to three years. Assuming an annual appreciation of six percent that investment can grow to perhaps eight apartment complexes or more worth over 15 million dollars with equity of between two and three million dollars.

Could you save two million dollars from your job in 10 years? It even gets better. The monthly income from these apartment complexes is in addition to your income from appreciation.

The majority of the income from your commercial property investment will be safely locked away from your reach. This is because much of the income will be in the form of appreciation and depreciation, which will fortunately require refinancing or selling the property to utilize. An investment in a multifamily complex (defined as five units or more on one tax lot) will provide you with four sources of income: rental income, rental increases, appreciation, and depreciation.

Rental income is an amazing way to make a buck. Where else can you get paid handsomely while someone else collects the money, pays the bills, and hires out the maintenance, while you are sitting in the shade drinking a pina-colada. Of course, you have to manage your property manager to make this happen. Rental income is even better than royalty income in that it will not dwindle over time. Rental income almost always stays ahead of inflation, and as long as the building is standing, it will provide you with ever increasing passive income. If you

purchase an apartment complex for one million dollars at an 8.5 CAP (capitalization rate is the rate of return determined by dividing the net operating income by the purchase price, or value), and finance 75% of it at 6.75% with a thirty year amortization, you will net about $27,000 annually after loan payments.
Rental increases are the gravy of your investment. Let us assume your milliondollar
purchase consists of thirty units renting at $575 per month, and occupancy is at 95%. Let's also assume that you can safely increase rents by 5% annually. This will be achieved by raising the rent $40 on apartments that turn over and $20 on units with long-term tenants. In one year, your rents should increase by about $25 per unit per year. After we allow for a 2% increase in expenses, you are left with a 3% annual increase. This will come to about $5900 per year in additional net income.
Appreciation is the golden egg of your investment. At an estimate of just five percent appreciation annually, a million dollar property will grow by $50,000 the first year. When compounding this appreciation your money grows even faster. Furthermore, you can do a 1031 tax exchange (IRS code 1031 allows you to sell your investment property and use your equity to purchase another property and deferring the capital gains tax) or you can apply for a cash out refinance two to five years later and leverage your equity into a much larger property, which will appreciate in even larger numbers. It can be a fun prosperity exercise to draw a real estate tree showing what cash out from your first apartment building can branch out to, and then having those properties branch out to additional ones. You can project your net real estate worth in five, ten, and twenty years. Holding these real estate investment trees in an irrevocable living trust is how the wealthiest of families in America have skyrocketed their net worth by expanding their real estate portfolios through generations.
I often tell folks that I work for a lot of rich people who don't pay taxes, and soonto-
be rich people who are soon-to-be not paying taxes. Many of my real estate investors earn over one hundred thousand dollars annually from their commercial properties. Most of them pay almost nothing in taxes. This is not because they are cheating the government, or because they can afford a genius accountant, it is because of depreciation. A million dollar apartment complex can give you approximately $25,000 in annual depreciation. Four properties of this size may give you $100,000 in depreciation. Depreciation is deducted from your taxable income. If you are in a 35% federal and state tax bracket, just one property of this size will save you about $8750 per year in taxes.
Now comes the fun part. This is what your multifamily investment has the potential of earning per year:
Net Rental Income $27,000
Rental Increases 5,900
Appreciation 50,000
Depreciation 8,750 (amount you are saving in taxes)
Total Earnings $ 91,650
Before you read the Seven Critical Mistakes To Avoid When Buying An

Apartment Building, please keep the following in mind: If you are a first time investor you will most likely feel overwhelmed by all the “right moves” you have to make to invest successfully. You might feel after reading “The Steps” that you want to keep your money in the bank. If you are a repeat multifamily investor you might also feel overwhelmed from the awareness of some of the mistakes you have made in the past. I am going to tell you a secret. The advice given in the “Seven Critical Mistakes, came from over a hundred successful investor clients of mine, and a few unsuccessful ones. All of them fell into some holes along the way. Most of them are very well off financially today and consider investing in apartments an adventure. My purpose in writing this article is solely to assist you in avoiding some of the pit falls; no one can eliminate all of them for you. Now the secret! *If you just follow the advice in number two and number three, it will be very difficult to fail.* So why did I come up with seven steps? Yes I could have written this article with just two. Well I felt that the subject matter was worthy of more of the material I had discovered and I knew you would expect more steps. Furthermore I think you will find the tips in the additional steps helpful.

Seven Critical Mistakes To Avoid When Buying An Apartment Building

1. Falling in Love at First Sight

You wouldn’t ask someone to marry you on the first date. Do you want to risk your financial future on a first impression? Remember, you are not buying a sports car. Do you want to believe what a salesman is telling you about this purchase without fully investigating it? Who cares if you do not like the t-1-11 siding, or the industrial grade carpeting. You do not have to live or work out of this property. Your friends will probably never see it. So what if it does not have balconies, a swimming pool, or tile counter tops. If you can afford a property with higher end amenities, I assure you it will provide you with a much smaller rate of return on your investment. You need to get to know the property thoroughly, and make a decision based on the facts and your long-term investment strategy. (Refer to number seven, “*Not Knowing Your Financial Purpose and Investment Strategy.)* This is not an intuitive or spontaneous decision. This is a business decision. Making the wrong choice could wound you financially. Making the right choice could someday give you the security of having money work for you, instead of you working for money.

Often first time investment property buyers see attractive photos showing a complex with solid brick town home good looks, immaculate landscaping, covered parking; the kind of place they would live in. They get more excited when they see the listing agent’s pro-forma income statement (projected income not actual), or perhaps a claim of 20 percent cash on cash return (percentage of net profit you are earning on your down payment annually), and they picture themselves on a secluded beach living the good life on the monthly income from their good fortune.

John Blythe, 54, was surfing the Internet one Sunday afternoon when he found what seemed to be the perfect 36-unit apartment building for sale at $900,000 in east Dallas. Having $180,000 to invest from the sale of a duplex in Orange County, California, he had spent weeks looking for such a perfect match. He was amazed that he could sell the residences of two families in California and from the proceeds buy the homes of 36 people under one roof in Texas. John's brother-in-law, Tony, who had invested in income producing real estate for years, told him that this looked like a good one.

This multifamily building had it all: a great solid brick look, 94% occupancy, and an on-site property manager who could fix anything. It also appeared that the real estate was offered below market value and produced enough income when combined with John's pension to support him and his wife in an early retirement from the Postal Service. John contacted the listing agent, and asked for more pictures to be emailed. The additional photos showed a solid brick colonial style building with looks that John could not resist. John had always loved colonial. After a restless night, the next morning he was advised by Tony to make a conservative offer of $850,000. To John's surprise, his offer was countered late that afternoon at $875,000. John talked to Tony and he accepted the counter the next morning.

John's problems with this property started with love at first sight. John became emotionally attached to this complex because of its good looks and what he thought was a low sales price. John felt proud owning this property, and showed his relatives and friends pictures of the complex with pride. His judgment in analyzing the property was tainted by his first impressions. His instincts did not tell him to question the listing realtor's financials. He had a gut feeling that this was the one. As problems with the property were identified, he believed that because he was getting the property for a steal that it balanced out. He could not find another complex that turned his head. He did not know that he was paying more than the property was worth based on its real income.

At Business Loan Store, your loan officer is a non-biased number-crunching professional who will not be influenced by a property's good looks. We will provide you with a letter of pre-approval that has an over 95% success rate of closing as proposed, and closing on time. This is because we do three preapprovals:

the cash flow, the quality of the property, and the borrower. All it takes is for one of the three to not qualify and the deal is dead. Your Business Loan Store Loan officer will work diligently as your consultant sharing their demographic, and financial analysis with you. This will take the your perspective investment out of the world of appearances, and solidly into the world of the actual. You cannot afford to waste your time and money on the wrong deals, and we cannot afford to make bad loans. So we are on the same team.

2. Being Duped by the Numbers

OK, I think you will agree that investing in an apartment complex is not the lottery. Successful investments take a lot more skill than luck. Yes, this might be a sellers' market, and being in the right place at the right time does have something to do with your success in finding the right investment property. But when it comes to the numbers, we are talking about the property financials (the current rent roll and a minimum of two years income statements-three years are even better) they have nothing to do with luck. And yes, those numbers can be manipulated, skewed, even downright lied about.

In John's case, he made an offer on the 36 units based on the realtor's marketing piece, which "oh my gosh" just happed to fill the property at 100 percent, and then took six percent off for market vacancy, resulting in 94 percent occupancy. The real estate professional then used a list of expenses that the seller gave him, which showed a healthy $3800 per month net income after loan payments. This is called a pro-forma statement of income, or shall we say a work of fiction or at best intuition, showing the property in its best light. The actual (remember the word "actual") numbers would tell a different story. A week after the purchase contract was signed, John was able to pry a rent roll out of the seller. Actual occupancy was at 72 percent, and the actual income after debt service, well, no one could quite figure that out. But it was somewhere between $1750 and in the hole about (-$1200). To John's credit, he did try to get the seller's financials. But the seller had this complex run financially with two other complexes, and at best, he could only estimate what expenses pertained to John's building. John's brother-in-law, Tony, suggested that he obtain several years of schedule E's from the seller's tax returns (the schedule of profit or loss on investment properties) to verify the income. Are you surprised to know that the seller did not file taxes for three years? Whoops!

It wasn't until John was three quarters through the loan process that his lender asked him if the building was master metered (where the owner pays most or all utilities), and if there were any concessions (a move-in discount in rent, usually in exchange for the tenant signing a six month or one-year lease). It turned out that the building was master metered and that there were heavy concessions. These two items, along with a few others, would come back to haunt John four months after owning the property. Going into the winter months of 2005, oil prices soared, raising John's gas bill on the property by a third, and taking $17,000 annually off John's bottom line. The rental concessions added up to $7600 annually which took $633 per month off John's bottom line. Concessions in some markets tend to be like credit card debt in that they revolve. If concessions are on going you have to annualize them and subtract this amount from the gross annual income. In the most favorable cases, concessions are used temporarily to rent up a complex that has had a downturn due to renovations or poor management. In the worst cases, there are simply too many units available in the neighborhood and the only way to get yours rented is to discount the first month's rent. Some landlords will take an amount like $25 off each months rent for a year in exchange for signing a year lease.

It is of utmost importance for you to obtain actual, real, verifiable financials on the property. We highly recommend, along with writing a financing contingency, including a due diligence contingency clause in your purchase contract that states what financials you will be asking for and gives you the authority to verify the numbers. You really do have to be diligent to reel in all the critical items for financial verification. Your loan officer at Business Loan Store will gladly assist you with this list of items, and compare the actual expenses with market expenses. By the time you are done, you will have reviewed tax bills, utility bills, shopped for insurance, reviewed the leases, and so much more. You will be advised to ask for annual rental concessions and, if they will be on-going, we will subtract them from the gross annual rental income. We will also advise you to ask for as many historical rent roles and income statements as necessary, including the seller's schedule E from his tax returns (which will show what he stated the property was earning on his taxes). Occasionally we ask for a cash ledger or bank statements verifying collections if we question the authenticity of the numbers, or suspect that there might be substantial collection problems.

Your loan officer at Business Loan Store will evaluate the property financials with you, compare them to market comparables to ballpark a value, and offer his or her opinion on the strength of your investment.

Here are the items Business Loan Store will need from the seller or listing agent to accurately evaluate the income of the property:

1. Current rent roll
2. Past two years plus current year-to-date profit and loss statements on the property
3. The seller's schedule E's (schedule of this properties income from taxes)
4. List of rental concessions
5. A copy of all the leases (only way to verify rental concessions)
6. A projection of current year utilities if the complex is master metered

3. Falling Asleep at the Wheel

When making an investment in a large commercial property, it's not the time to sit back and become a follower. As a follower you will have the opportunity to wait for everything. You get to wait for the seller or listing agent to give you the desperately needed property financials to determine net operating income, your real estate agent to write up and present your offer, the seller to provide verifiable historical financial data and sign the purchase contract, your attorney to review the contract, your lender to order the appraisal, and on and on. If you want to be on a scavenger hunt wearing a blindfold, be a follower. As the leader of your commercial property investment, you can put down a timeline on a calendar and hold all the players to it. At Business Loan Store, our motto is "Either manage the deal or the deal will manage you."

It is equally important to actively participate in the financial analysis. There are plenty of experts with informed and uninformed opinions about the solvency of your investment. Quite often investors start out by evaluating the numbers and then fall

asleep before the task is completed. At Business Loan Store, we will do everything
within our ability to encourage you to be present and fully participate in the process of
understanding the numbers.

John's brother-in-law, Tony, had evaluated the property for him and told him, "You can't lose on this one. Tell the seller that since the occupancy is much lower than they told us, you will only pay $800,000 for the place and they have to get it up to 94 percent occupancy like they said it was before closing. We will need a 90 day close; with good management we will get it up to 100 percent occupancy. If you don't snatch this deal, I will." Tony pointed out that, at worst, it would then have a 24 percent cash on cash return, would be priced at $22,000 per unit, have less than $2,400 per unit in expenses, and would have a 10 percent CAP rate, have a great internal rate of return and will have a gross rent multiplier of . . . John wasn't exactly sure what all that meant, but he did know that Tony knew, after all Tony lived in a five thousand square foot house and was making good money on his rental properties. Tony had always made good money. To John's surprise, the seller refused to lower the sales price but did agree to lease the building to 85 percent occupancy by closing. Tony was very busy when John asked his opinion, and told him, "I already told you, you can't go wrong at $850,000 if the property is 80% filled, so if it is at 85% what part of this do you not understand?". Late that day John accepted the sellers counter offer, and the deal was signed; now all he needed was financing.

We are not suggesting that you do not get the advice of experts, but only that you fully participate in the process. Much of the advice that Tony gave John was good, but John did not really understand most of what Tony was talking about. This means being present and asking a lot of questions even at the risk of looking stupid. This is your money—your life savings—we are talking about. If you do not understand something, it is your responsibility to find the answer. Participate fully in the analysis. Hire a mentor or coach if you need one to train you in evaluating properties. The peace of mind is worth the price. How many people do you know who blame their stock broker for losing money in the stock market? How many of those investor's actually participated and learned all that they could about their investments?

At Business Loan Store, our entire staff has been hired based on their desire to assist you in evaluating and understanding your commercial property investment. We will take the time to answer your questions. We invite you to participate in our bi-monthly phone training sessions for income property investors (no cost to you). If you are a beginning investor and want the most fail-safe method, I highly recommend one-on-one mentoring. We are affiliated with a national mentoring service and will have a professional coach call you. Your own personal mentor will stick to you like glue to make sure that you are choosing the right property, assist in writing the offer that best represents your interests, make sure that you are buying low or at least purchasing the property at the right price. Further more your mentor will guide you step-by-step through the due diligence process.

4. Being in the Dark About the Condition of the Property and the Neighborhood

As an investor, you will have what we call a comfort level in the quality of the building and the neighborhood you are choosing to invest in. At one extreme, you have "A" quality properties that are located in middle-class neighborhoods, are 15 years old or less, tenants pay all utilities, apartments look like upper-class condos, grounds have that country club look, and there is a recreation entertainment center and pool. Furthermore, tenants have some college, have worked for the same employer for 3 years or more, have good credit, and take care of their apartment like they own it. So why are they renting? Many of these tenants have owned their own homes but are living there because they are going through a divorce, or for some other reason have been bumped out of the housing market. On the down side, many of these tenants will return to the housing market.

On the other extreme, you have a "D" property in a neighborhood that would not be safe to walk in after dark without pepper spray and karate lessons. This property is over 30 years old and is in dire need of repair. We are talking about anything from sagging leaking roofs to peeling paint and dry rot. Furthermore, many of the units have original floor coverings and appliances, and the smell of second hand smoke. Most of the tenants are lower blue collar, on minimum wage or unemployed, and many are section 8 (rents are paid or subsidized by the Housing Authority). It will not surprise you that many of these tenants have poor rental references, bad credit and might be living here because it is the only place that will accept them; the deposit is low, and most of all, the landlord pays the utilities. If they have defaulted on the power company before they will not be able to get utilities in their own name without a substantial deposit. Furthermore it might be difficult to determine how many people are living in each apartment. Only the water bill knows for sure, and since the landlord pays for water…

So getting back to your comfort level. Keep in mind that in the business world you generally get what you pay for. Without doubt, the best price per unit buys, and the best cash on cash returns come from the "D" properties, as long as you can collect the rent (this might take a body guard). This could be the right investment for you if you can obtain good on-site and off-site management, if you preferably live near the property so you can oversee the management, if you are willing to give the complex a major face-lift, and if you do not already have a full time job. But keep in mind that the "D" properties are not the ones that the best management firms want to take on. If you can even find a management company to sign on, it will be much more expensive than better properties. This is because they are already overworked and underpaid and "D" complexes are the ones with the most maintenance problems, rent collection problems, eviction problems, and domestic problems. As owner of the property, if there are excessive police calls, it will not be just your manager who is called in the middle of the night, you will receive calls from the authorities as well; after all you are listed as owner on public record.

In John's case his building was a solid "-C" because of the quality of the lower-class blue-collar neighborhood, and the age of the buildings. This should have been obvious to John when he visited the complex and was shocked by a few mattresses and a vintage sofa on the lawn. What kept it from sliding to a “D” quality property was that it was in relatively good condition with little deferred maintenance needed. However, hidden from the buyer’s knowledge was a looming financial disaster. Four months before the property was put on the market, it was at somewhere around 54 percent occupancy. It was because the complex was tanking that the seller decided to sell. In attract an offer at market value, the apartment complex needed to achieve market occupancy (about 86%). The property was filled by offering a $99 move-in special, with a $200 rental concession ($200 off the first month’s rent for signing a six month lease). The two bedroom apartments were going for $645, about a hundred dollars over market rents, but since the landlord was paying utilities, the rents were close to market.

Good news and bad news! The good news is that the property reached 94 percent occupancy after two months and John was thrilled to close early. The bad news is that most of the tenants who came in on the $99 move-in special never paid another dollar in rent. In fact, at the time John purchased the property, he did not know that 12 of the 34 rented apartments on the rent roll were not paying rent. Some of them were relatives of the on-site manager, the guy who could fix anything, who provided free rent for his uncle Donny who had offered to do interior painting on all the units in exchange for rent, but never did. A nephew Sam had agreed to install carpet in exchange for rent, but the carpet was never provided… It took John’s new property manager an average of two and a half months to evict the non-paying tenants. After four months of ownership John’s new multifamily investment was back to 72 percent occupancy and dropping. To make matters worse, the price of oil went to over $60 per barrel and the utility bill went up 40% over the preceding year. John’s investment was in the red.

A “B” property will be 25 years old or less and be in excellent condition and be located in a good neighborhood. Often a brand new property will be a “B” just because it is located in a small population center (under a 100,000). A client of mine purchased a 248-unit “B” complex built in 1984 in Forth Worth Texas. It took my client three days, but he actually walked all 248 units and made detailed notes on their condition. He had been told that all the units had recent upgrades on floor coverings and appliances. He found that 17 of the apartments had 1980s floor coverings, older appliances, and stained bathroom fixtures. There were 19 buildings in this complex. The backsides of 11 of the buildings, not in view from the main street, appeared to the buyer to have original paint that was peeling. The front and the sides were recently painted. He held the seller to his word and an addendum to the purchase contract was signed stating that the 17 units would be upgraded and the backsides of all buildings would be painted prior to close of escrow. If he had not examined all the units and walked all sides of the buildings he would have been up a creek without a canoe.

It is imperative that you know the exact condition of the property. If the complex

was built over 20 years ago, it is imperative that you order a property condition report from a licensed company. The report will cost between $1200 for a short summary report on a smaller complex (40 units or less) to $2500 for a thorough report on a large complex. It is important that the report provides dollar amounts to cure the injuries. The report will evaluate the condition of the structure; signs of mold and dry rot; paint, roofing and sub-roofing; gutters, windows, railings, subflooring,
general plumbing and sewage system; electrical; boiler; heating and cooling system; and more. A wood-destroying insect report (WDR) is highly recommended in states that have termites or carpenter ants. If it appears that there is structural damage, an engineering report will be required. At Business Loan Store, we can assist you in ordering these reports. We always send a field inspector out to examine and rate the property as excellent, good, fair, or poor. We will not lend on properties in poor condition. If the condition is fair, we will need a property condition report. We highly recommend that you include in your purchase contract a contingency for the condition of the property with an agreement as to who will pay for what. The listing agent might insist that the property is in excellent condition based on what the seller has told him or her. Many sellers do not live in the same state as the property they are selling. And often they might genuinely believe the buildings are in great condition when, if fact, they are not.

To start your evaluation of the condition of the property, if it is not within driving distance, ask for at least a dozen or two color photographs (preferably all sides of the buildings, a few close-up shots, some interior shots, and a few street scenes to view the neighborhood). Quite often the listing agent will be willing to take these for you. Keep in mind he or she only gets paid if someone buys the property. Ultimately if you decide to make an offer, we highly recommend that you visit the property and walk all the units. Almost all rental contracts and leases give the landlord the right to enter and show the unit with notice.

Your loan officer at Business Loan Store will recommend that you write into your purchase contract a clause that gives you the right to engage or have your lender engage a property condition report. It is imperative that you decide with the seller in your purchase contract who is going to pay for curing deferred maintenance items, and if these will be paid pre-close or post close. We also recommend that you add the following items to your due diligence list:

1. Eight to 12 exterior photos showing all sides of the buildings
2. Six interior photos
3. A few street and neighborhood shots
4. A list of capital improvements made to the property for the past three years, itemized by year.
5. A list of deferred maintenance items (no matter how small)
6. A copy of the cash ledger or six months bank statements on the property if there are unexplained irregularities in historical and current year cash flows. Sometimes this is the only way to determine if there are rent collection problems.

5. Failure to Manage Your Property Management Company

If you are going to purchase a complex with more than 12 units and you live beyond driving distance of the property, you are most likely going to need offsite management. These firms make it possible for you to have a life. They collect the rents, keep the books, pay the bills, engage handymen, and dispatch cleaning and painting crews to make ready the apartments. They also send out late notices, go to small claims court to evict tenants, and more.

The best management companies do not want to work at below minimum wage, and they know that “D” and even “C” properties are going to consume their time; so they simply refuse to take them on. In fact, the best management companies usually only manage “A” and “B” quality properties. It usually takes 60 units or more to get their attention unless they have other complexes in the neighborhood. Some of the large companies manage in excess of 50,000 units and have it down to a science how to make their job cost-effective without sacrificing quality. If you buy a “C” quality property or less, it will cost you more than the typical four to five percent of gross rents for off-site management—count on paying six to nine percent. Your mentor can help you negotiate a price. When negotiating an off-site management contract, ask the management professional what total expenses will run per unit per year on your complex. This will range from a low of $2600 per unit per year for a new or recently renovated complex, to a high of $4500 per unit per year. It is often a challenge to find a management company that fits your style of taking care of the property and can also manage expenses at a level that delivers the profitability that you expect.

At Business Loan Store, we receive numerous complaints from our seasoned investors about their off-site property management companies. This is not entirely the management company’s fault. Some buildings are not cost-effective to manage due to rent collection problems, maintenance problems, and owners that are too thrifty. To compound this problem, management contracts are often negotiated too low on smaller complexes to make it cost-effective for managers to do anything more than the bare essentials. But in most cases the problem lies in the fact that the property owners do not call their property manager twice a week to make sure that their complex is getting the attention needed.

Remember, since this is an overworked, under appreciated, and underpaid industry, it is the squeaky wheel that gets the grease. Call your property manager every Monday or Tuesday and get them to agree to advertise, show the vacant units, make the vacant units rent ready etc. and then on Thursday or Friday, call them again to verify that they have kept their agreements. Check the online classified ads for the local newspaper to make sure your property is being advertised as proposed and that the ads adequately attract. If you like the ad, call the management company and give them a compliment. They will only improve the service they give you in the future. For the best results, just as in any service field, keep the compliments flowing. Make a list of what the management company is excelling in and another one that lists areas for improvement and communicate respectfully these items to your manager. When you want your offsite manager to create results, call them early in the morning to put your property on their plate first. Think of your multifamily investment as a business, and manage it as such. Your management company will be providing you with a monthly rent roll that shows how many units are rented, how many have given notice to vacate, and how many units have accepted applications on them. You will also receive a monthly profit and loss statement. Take the time to look it over line by line and question numbers that do not make sense.

Many multifamily investors want a truly passive investment with no responsibility on their part. Often they will not look at the financials for five or six months at a time. Suddenly they become alarmed when occupancy and profits fall, and they complain that their management is not advertising, not keeping the units rentready,
etc. It is my opinion that this lack of participation from many property owners feeds the lack of quality so often found in off-site property management. My clients that manage their property managers seem to be quite pleased with the results. Of course there are management companies that are founded on very sound principals of quality and excellence, and will not take on a property or an owner that does not meet their requirements. At Business Loan Store, we advise you to interview at least three property management companies. Provide them with a current rent roll and at least two years of income statements and ask them how much per unit it will cost them in expenses to run the property for you. If they can manage the property for less per unit, it might be worth it to pay them a higher percentage for off-site management.

A handy on-site manager for buildings of 36 units or more is the best insurance for keeping your tenants happy. Why 36 units or more? Because it may not be cost-effective to give up the rent on a unit in a complex that’s under 36 units. If someone’s toilet breaks on a Sunday, the tenant will know that they are cared for if someone on-site can take care of it the same day. The tenant will take it very personally if they have to wait unit 10 AM on Monday for the off-site management company to dispatch a repairman. Apartment buildings that respond to repairs quickly keep their tenants from moving. Count on compensating an on-site manager with anything from a free apartment to an apartment plus 15 to 25 hours per week at something above minimum wage. In rental markets that have nine percent vacancy or more, you can easily afford to give up one unit for onsite management, since your chances of achieving over 95 percent occupancy are slim.

Do not hesitate to ask your Business Loan Store loan officer for a referral for a property management company. The hundreds of property investors that we have worked with over the years often tell us who works out and who does not. Business Loan Store recommends that you get a bid from at least three property management firms. You will need to provide them with the following items:

1. Current rent roll
2. Two years of profit and loss statements
3. List of deferred maintenance items

6. Not Knowing What the Property Is Really Worth

If you want to make a really big mistake when purchasing your apartment building, why not pay more for the property than its appraised value? Can you imagine putting $10,000 or more earnest money down on a purchase contract, also paying for a commercial appraisal, and property inspection report, perhaps flying out to see the property, spending several hundred hours doing due diligence, and when the appraisal comes in finding out that the real estate is worth less than what you have agreed to pay. Why is this such a critical mistake? Because commercial loans are based on a percentage of the purchase price or appraised value, whichever is less. So a lower than anticipated appraisal usually means a smaller loan. A smaller loan means a larger down payment. If you cannot raise the larger down, this will effectively kill your deal. If you can raise the larger down payment, your *cash on cash return* (percentage of net profit you are earning on your down payment annually) will be greatly diminished. This can also kill your deal. Just try to convince the seller that you have paid too much for the property based on the appraisal and that the agreed-upon sales price should be lowered. He will most likely tell you that you have signed a legal binding purchase contract, and an agreement is an agreement. He might also recommend that you get another appraisal. In most cases there is not enough time to get another appraisal. Commercial appraisals take an average of 30 days to complete.

The only way to truly know the value of the property, market rents and market occupancy is to do the same thing the appraiser does—investigate comparable sales. Business Loan Store will assist you with this. We subscribe to a national database that provides sales comparables, available in most states in larger demographic areas. In smaller population centers, Business Loan Store will contact appraisers that we know directly, or order a paid search. Note that it is very important to know what the going *capitalization rate* (the net operating income divided by the sales price) is in the location of your purchase for a comparable commercial property. When appraisers calculate the income approach for the appraisal, they look at the cap rates on three to six recently sold similar properties based on the expenses on those properties to determine the market cap rate for your purchase. The value determined by this market capitalization rate will be weighed equally with the sales comparable value to determine the final value in the appraisal.

Keep in mind that commercial appraisers have a tough job. They know that if they do not value the property at the purchase price, they might kill the deal, and they really do not want to do that. On the other hand, they want the lender to hire them again, and so there is pressure to be on the conservative side, and not overvalue the property. In this market, lenders are highly suspicious of increasing property values. They have experienced their borrowers buying at the top of the market before, and the market going through a correction, values dropping, and being stuck with loans that become leveraged higher than their risk level can handle. I know I will be offending the commercial appraisal industry by saying that “commercial appraisals are more of an art than a science”. As mentioned above, they consist of two main approaches: the sales comparison approach and the income approach. The sales comparison approach is just like the one in a residential appraisal. If the appraiser wants the appraisal to come in at the purchase price, sometimes he has to work extra hard to find comparables that will support that value. If the appraiser wants the value to come in closer to what he thinks the bank will want to see, he will try to obtain sales comparables reflecting that value. Of equal weight in the appraisal is the income approach, which evaluates the net operating income of the subject property and compares this with the net operating income of three to six properties that have recently sold. A full commercial appraisal will also have a *cost approach* (what it would cost today to build the complex on that lot), however this approach is used mostly for insurance purposes.

Jim Swanson applied for a $760,000, 80% loan on a 24-unit “B” apartment complex in Texas City. The purchase price was $950,000. This reflected a 7.4% cap rate. Jim knew that he was paying top dollar for this property but he was willing to do so because he knew that the rents were well under market and that within a year the purchase price would be a steal. The appraiser could not find any prior sales on apartment complexes of this size and quality in this demographic area in the past year under an 8.5% cap, so he appraised this property at an 8.5 cap. This resulted in a value of $890,000. This value resulted in a maximum loan of $712,000, which meant that Jim had to come up with $48,000 more in down payment to buy the property at the agreed upon price. When he complained to the listing agent that he had overpaid for the property he was told that the best indicator of value is what someone is willing to pay for the property and the appraiser must be wrong. Jim could not afford the additional down, and had his realtor cancel the deal based on his financing contingency.

It is also of utmost importance to know the present market value of the apartment complex you want to purchase if your goal is to buy on the low side, so that some day you can sell on the high side. In this seller’s market, this is becoming increasingly more difficult. Unless you can make this your full-time job, by the time you get real numbers on what might appear to be a good deal, you can easily take six months or more to find a below market deal. I recommend you engage a highly skilled commercial realtor who is licensed in the states you are interested to assist you in your search. Just call Business Loan Store. We are affiliated with commercial realtors that love what they do and some of them can sell property nationwide. We will happily refer someone to you.

7. Not Knowing Your Financial Purpose and Exit strategy

Why have you decided to purchase a multifamily property? Is it because you would like to add some passive income onto the paycheck from your job, or perhaps your desire is to quit your job in two to five years? Maybe you are thinking of retirement and want a long-term source of income that will stay ahead of inflation. In this case, you will want a long-term fixed rate loan. Perhaps you are searching for a slightly wounded apartment complex that you can steal at below market value because rents are low, and it has below market occupancy. With much better management you plan on raising occupancy, and eventually raising rents. Do you want a fixer-upper (called a rehab project)? All you have to do is add fresh paint, a new roof, replace some sagging sub flooring, repair the termite damage, fumigate the termites, update the nineteen eighties floor coverings, change out stained bathroom vanities, replace the gold and avocado appliances, and repair two vandalized units. Maybe you do not want a rehab project. Yes you will buy the complex at well below market, but by the time you do the rehab, unless you are experienced, you might be working for below minimum wage. Perhaps your purpose is to double your equity in two to four years through a cash-out refinance or sell with a tax exchange and purchase a larger multifamily property. Maybe you are in a painful tax bracket and your purpose is a tax shelter. Perhaps your goals encompass many of the above purposes.

What is an exit strategy? Unless you plan on keeping this property until you die, and passing it on to your kids, you will need an exit strategy. We are referring to what you plan to do with the property when your loan balloons (is due and payable) or when your pre-payment penalty expires, or in rare cases when you pay off the mortgage. In most cases, an exit strategy involves selling high after purchasing low, doing a 1031 tax exchange (investing your entire equity capital gains tax deferred into another property). As mentioned earlier, repeatedly leveraging your equity into more or larger complexes with higher net incomes can create great wealth.

Why is it important to know your exit strategy before you buy a commercial property? First, commercial loans typically balloon (are due and payable) in five to 10 years. Occasionally you can find a 30-year fully amortizing loan (amortization and maturity match), but this will be on an adjustable rate mortgage (rate adjusts every 3, 5, or 10 years). If rates were to go up three to four percent by the time your loan balloons, or your rate adjusts, and rents are flat, do you have a plan for this? Will this put the income on your property into a negative? In 1982 mortgage rates really did go up to sixteen, even eighteen percent. If your purpose is long-term income, fixing the rate for ten years, paying down your mortgage and raising rents over time will be your best strategy. In ten years, when your loan balloons or the rate adjusts, if you have planned for your exit strategy, you will be positioned to handle the best or the worst of what the future market will bring. Your best insurance is to continually raise rents three to six percent per year. In ten years the additional income should produce more than enough net operating income to handle the possibility of higher rates. Keep in mind that even if your $1,500,000 purchase today appreciates to $4,000,000 in ten years, your future loan will be constrained by the gross rents and net operating income of that time.

Second, almost all commercial loans today have prepayment penalties. Some of the smaller banks do not have them, but they will make up for it with a much higher rate and shorter amortization. Most prepayment penalties are declining like 5, 4, 3, 2, 0 on a five-year fixed (four percent the first year, three percent the second year and so on). If your purpose is to sell the property or do a cash out refinance in two years, your exit strategy would be to take a three-year fixed rate mortgage with prepayment penalties of 4, 2, 0. Keep in mind that lenders will require two years of seasoning (you must wait for two years to refinance the property to pull cash out).

Business Loan Store is a mortgage banking company established in 1997.
We are members of the Mortgage Bankers Association, specializing in commercial mortgages in all 50 States.