CHAPTER 1

Profit with Commercial and Multifamily Properties

Increasingly, small investors are beginning to explore the wealth-building opportunities offered by affordable commercial and multifamily properties. Because such properties provide many advantages, I encourage you to get into this lucrative field.

Advantages of Commercial and Multifamily Properties

Most would-be real estate investors already own a personal residence, so buying a single-family house to rent out merely repeats a familiar purchase process. In contrast, small investors usually steer clear of commercial and multifamily investments. Most likely, they fear that such properties cost too much or require extensive expertise. Neither of these perceived roadblocks is true.

In fact, at the age of 21, I began investing in multifamily properties with a 5-unit property, followed by a 7-unit property, and next added 10 units to my portfolio. If I could manage to buy and operate such properties, so can you. Neither beginning nor seasoned single-family residence (SFR) investors should fear investing in commercial properties or apartment buildings. A physician in Atlanta recently asked me for advice. I suggested that he look for a

4- to 12-unit apartment building or perhaps a small office building or shopping center rather than the single-family houses that he was considering. I set forth these reasons:

- Cost of acquisition
- Cash flows relative to price
- Search time
- Management
- Tax-free, trade-up potential
- Owner and/or partner financing
- Possibilities for creating value

Cost of Acquisition

The median price of a single-family house in the United States now stands at $225,000. In higher-priced areas such as San Diego, San Francisco, Boston, New York, and Washington, D.C., the median price of a single-family house exceeds $500,000. Unless you invest in less desirable neighborhoods—and even there, house prices can still seem out of reach, such as in East Palo Alto, California, or Chicago Southside—single-family investing becomes too costly for most investors of average means.

By "too costly," I do not refer only to price. Rather, I refer to price relative to rent collections. In San Diego, for example, a $500,000 house might generate no more than $2,000 a month in rents. Even in my (relatively) low-cost city in Florida, a $250,000 SFR typically rents for $1,000 to $1,300 a month. Put 30 or 40 percent down and these properties still throw off negative cash flows. (New investors feel like they are being eaten by alligators.)

Single-family rentals often yield negative cash flows.

Homebuyers, too, are realizing the advantages of owning income properties. Owner-occupied duplexes, triplexes, and fourplexes are attracting renewed interest. Individuals or families

> **Affordable apartment buildings appeal to homebuyers and investors.**

who cannot afford the monthly payments on a $350,000 house find that they can afford a $500,000 or $600,000 fourplex because their rent collections go a long way toward paying their principal, interest, property taxes, and property insurance (PITI).

When I talk with homebuyers who are priced out of their preferred neighborhoods, I tell them to look for a small apartment building. Buy it. Use rent collections to help meet monthly expenses. Create value through improvements and then sell or trade up in a few years. This is the same advice I give to real estate investors.

Given their lower per unit prices (relative to single-family houses), many income properties offer you a more affordable entry into real estate.

Cash Flows Relative to Price

If you think commercial and multifamily properties cost too much, go to www.loopnet.com. You'll find thousands of retail, office, and apartment buildings priced at less than $500,000. How about a retail (hard corner) building in Odessa, Texas, leased triple-net (tenant pays all expenses) to a prosperous local ice cream business? The price: $125,000. The net operating income (NOI): $11,245. Walgreens and other national brand retailers have located close by in this emerging growth area.

Or if you want a real bargain-basement price, how about a $39,000 duplex with long-term tenants who pay (in total) rents of $930 a month with a $7,000 a year NOI.

Yes, these two properties sit near the low end of the commercial and multifamily price range, but my point is that virtually anyone can invest in commercial or multifamily properties. Moving up the price scale, you can buy a building leased to Payless Shoes for a little over $300,000. That property yields an NOI of $32,000 a year. Or perhaps a well-kept 10-unit apartment building in a good area of Omaha for just $349,000. Its NOI exceeds $27,000 per year. In Athens, Georgia, near the University of Georgia campus, and just across the street from the newly proposed medical school, you can buy an 8-unit building (legally set up as condominiums for future sale to individuals) for $630,000. Current NOI totals $53,000 per year.

If you prefer offices, a seven-year-old Athens, Georgia, building net leased to a single tenant can be bought for around $325,000. Financed with an 80 percent loan to value (LTV) mortgage gives you a positive cash-on-cash yield of 10 percent.

We need not go further here because you can review tens of thousands of listings yourself at loopnet.com and other property-for-sale web sites. But the examples above illustrate my point. For prices lower than average California single-family houses, you can own commercial and multifamily properties that not only yield positive cash flows at 80 percent LTV (or higher) but they also offer potential for appreciation and value-add improvements and/or market repositioning.

Expect Yields to Fall in the Future Today, many affordable investment properties generate positive cash flows. Will this situation continue? I don't think so, at least not with 20 percent (or lower) down payments.

As boomers fret about the source and adequacy of their retirement incomes, increasing numbers will recognize the advantages of income properties. As more investors search for cash flow properties, they will bid prices up further. Although over time rent levels will continue to inflate, property prices will inflate at even greater rates. Relative to property prices, cash flows (rent collections) will not keep pace. We can see this trend in New York, London, Sydney, Dubai, and San Francisco. In these and other high-priced locations, speculators in appreciation potential have pushed most cash flow investors out of the market.

LoopNet has listed a six-unit property in San Francisco for $1.2 million. Rent collections for this property total just $7,200 a month. This price-rent relationship (the gross rent multiplier) came in at 166. With 20 percent down, the rents would barely cover the mortgage payments (debt service).

Either investors must come up with a higher down payment or go out-of-pocket each month to pay for property taxes, insurance, maintenance, and repairs. An all-cash purchase of this property would have netted an annual yield of just 4.7 percent (not counting appreciation, which, of course, is where the buyers would hope to make their money).

Too much money is chasing too few cash flow investments.

Fortunately, many commercial and multifamily properties still offer reasonable cash flows *and* potential for appreciation. But don't wait. Given that government and corporate bond interest rates offer low returns and yields from stock dividends average less than 2 percent, income properties stand superior to all other popular investments. Yet, with too much money chasing too few good cash flow investments, you must act now. Absent general economic collapse, five years from now the selling prices of small income properties will have climbed significantly, and positive cash flows (under historically normal terms of financing) will be found in fewer and fewer locations. Affordability will diminish.

What Yields Are Reasonable? Throughout the 1990s, many stock market investors received capital gains of 12 to 20 percent a year. By the turn of the century, surveys revealed that investors believed that such high returns would continue long into the future.

As people now realize, these grandiose expectations defied reality. Because the U.S. economy grows (on average) just 2 to 4 percent a year, it will prove impossible for stock prices to consistently grow three or four times faster than GDP. Stock hypesters have now muted their rhetoric. Even that great bull Jeremy Siegel (*Stocks for the Long Run,* McGraw-Hill, 3rd ed., 2002) tells stock investors to prepare for stock market returns of no better than 7 percent a year for at least the next decade. And that 7 percent is before deductions for brokerage fees, mutual fund expenses, and income taxes.

As of early 2008, the DJIA had barely passed its year 2000 peak. Total DJIA returns since 2000 have averaged less than 5 percent a year—actually less total yield than government bonds.

Implications for Real Estate With dividend yields (positive cash flows) on stocks of less than 2 percent a year and total pretax, preexpense returns of 5 to 7 percent, investors need higher yields. Yet, only income properties offer investors those double-digit (total) returns that stocks experienced for one brief and exceptional moment in history.

Most people fail to recognize this opportunity. They cling to the false hope that stocks will rebound and replay their glory days. Others have pushed money into risky hedge funds or they merely sit on the sidelines and hold their cash in low-return CDs and money market funds.

Another problem: Those headlines that scream every day about crashing home values do not distinguish the investment property market from the spec-built home market. Fear due to lack of information immobilizes many potential property investors.

This mass misunderstanding and misallocation of investment dollars won't persist. Every few weeks, I see financial planners quoted in personal finance magazines fretting over the broken nest egg dilemma.

Property prices will go up as investors search for inflation-protected retirement income.

The *broken nest egg* refers to the fact that people who fill their retirement portfolios with stocks won't receive enough income from those stocks to pay their retirement living expenses. A million-dollar diversified stock portfolio pays (under current yields) about $12,000 to $20,000 per year, depending on the specific stock holdings. To survive at above subsistence levels, most so-called stock market retirees must draw down their savings (i.e., break their nest eggs).

But since these retirees do not know how many years they will survive after they retire, they cannot reasonably estimate a safe withdrawal rate. Their dilemma is to live well and face the risk of running out of money or live like misers and forgo the material pleasures that a lifetime of saving and investing was supposed to bring.

Twenty years ago, fewer than 10 million Americans seriously saved and invested for retirement, for their kids' college educations, and for other longer-term financial goals. Today, that number has grown to more than 50 million people.

It doesn't take Einstein to figure out that the middle class has joined the moneyed class in pursuit of high-yield investments. Cash yields must continue to fall. It defies reason to believe that 50 million Americans can find safe investments that will yield total returns of 10 or 12 percent a year. We all can't get rich with stocks and bonds.

All investment returns yields will continue to fall.

This is why I urge you to start investing in income property—now. Even though cash flow returns today don't look as good as they did 5 or 10 years ago, they look better today than they will look 5 or 10 years into the future. The number of investors who want high yields has grown much faster than the capacity of the economy to generate high investment returns. Mathematically, a majority of investors must end up disappointed.

Search Time

Compared to single-family houses, you can build wealth with investment properties with less search time. Even in high-cost areas, a $5 million or $10 million portfolio of houses would (or at least should) include at least 15 to 20 properties. In lower-priced areas, a portfolio of this amount might include 50 properties. To buy that many houses would require several thousand hours to find houses, look at houses, evaluate neighborhoods, negotiate purchase contracts, and apply for loans.

With income properties, you can work up to a $5 million or $10 million portfolio with as few as four to eight acquisitions. Even

Build unlimited wealth with income properties, yet allocate less time and effort.

if each deal takes three to four times as long to complete as one single-family purchase, you still save search time. As you move up to a $20 million, $30 million, or $50 million portfolio of properties (should you plan to grow that wealthy), a comparable sum devoted to single-family houses would prove impossible to acquire and manage. If you want a life (not a job), investment properties provide more return for each hour spent in property acquisitions and negotiations.

Management

If you own 15 or 20 houses, you own 15 or 20 roofs, electrical and plumbing systems, and yards to oversee. If you own two or three investment properties instead, you reduce the number of components that will, at some point, need attention. Although maintaining an investment property can cost more per building, it costs less per unit, in terms of both dollars and time.

If you choose, you can also own net lease investment properties. *Net lease* office buildings, shopping centers, and free-standing retail stores shift responsibility (in varying degrees, depending on specific lease terms) for maintenance, repairs, property taxes, and insurance to the tenants.

You can operate multifamily apartment buildings under a master lease (likewise for office and retail). With a master lease, one master lessee (tenant) pays you and assumes responsibility for leasing out individual units (spaces) and paying expenses.

As another alternative, employ an on-site manager who attends to day-to-day concerns that arise. Compensate your on-site manager(s) with a nominal amount of rent reduction. On-site people can perform some maintenance and repairs, address most tenant problems or concerns, and prepare and lease vacancies as they occur.

Trade Up Tax Free

To build wealth avoid paying taxes. For owners of investment properties, the Internal Revenue Code offers a generous advantage. As you acquire larger and larger properties, the law permits you to pyramid your wealth-building tax free through a Section 1031 tax-deferred exchange.

When you *sell* a property, you pay a tax on your capital gain. The amount you can reinvest in a larger property is reduced by the amount of taxes owed. With a Section 1031 exchange, you preserve your gain, and your total accumulated equity counts toward your down payment on the larger property. No income taxes are due.

Never pay tax on capital gains.

Exchanges Don't Require Two-Way Trades Because many real estate investors do not understand tax-free exchanges, they believe that to use this tax benefit, they must find a seller who will accept one or more of their currently owned properties in a direct trade. Although this possibility represents one way to complete a tax-free exchange, it does not represent the most commonly used exchange technique. Most exchanges involve at least three investors.

The Three-Party Exchange Three-party exchanges outnumber two-party trade-in exchanges because it's usually difficult to find someone who owns a property you want who will accept the property you plan to trade. It's sometimes possible to persuade an unwilling seller to accept your property in trade. But to do so may cause you to waste negotiating capital that you could otherwise devote to issues such as a lower price or owner-will-carry (OWC) financing.

Exchanges usually involve several property owners who simultaneously buy and sell.

Instead, most real estate pros arrange a three-party exchange through the following three steps: (1) Locate a buyer for the property you want to trade; (2) locate a property you want to buy; and (3) set up an escrow whereby you deed your property to your buyer, the buyer pays your seller, and your seller conveys that property to you. No property has really been exchanged for another property.

Exchanges Are Complex but Easy Most transactions that involve federal tax laws activate a web of rules. Section 1031 exchanges prove no exception. However, even though exchange rules are complex, exchange transactions are relatively easy to carry out when you work with a tax pro who is experienced in administering tax-free exchanges.

The fees (including attorney and escrow) for conducting an exchange should range between $750 and $2,000.

Caveat: A majority of certified public accountants (CPAs) and real estate attorneys know little about Section 1031 exchanges. Unless your accountant or lawyer has mastered this area of law, find someone else who has this expertise. If you live in at least a midsized city, there's probably an exchange club whose members include investors and commercial real estate brokers who can recommend exchange experts.

Upward exchanges do not result in taxable gains.

Are Tax-Free Exchanges Really Tax Free? Some people quibble over the term *tax-free exchange.* They say that an exchange doesn't eliminate taxes but only defers payment to a later date. This view errs in five possible ways:

1. The exchange itself is tax free if you follow the rules.
2. Whether you pay taxes at a later date depends on how you divest yourself of the property. If you hold it until death, the property passes into your estate free of capital gains taxes.
3. As another alternative, you can arrange a sale in a later year in which you have tax losses that you can use to offset the amount of your capital gain.

4. You can withdraw your equity through a tax-free cash-out refinance.
5. If we get lucky, the United States may adopt the policies of many other countries and abolish taxes on capital gains.

Exchanges eliminate capital gains in the year you dispose of an income property by trading up. Whether you pay in future years depends on how wisely you develop your tax-avoidance strategies and on future tax laws. By exchanging, you eliminate a definite tax liability in the year of sale and accept an uncertain and contingent tax liability. That's a tax trade-off you should make.

Single-Family Houses Technically, you can use a Section 1031 tax-deferred exchange to avoid taxes when you acquire more expensive investment houses or to trade up from a single-family house to a multi-unit property. Though a practical matter, owners of commercial and multifamily properties use this technique more often than do owners of rental houses. Experienced investors readily enter into such agreements and are well acquainted with the 1031 advantages. Owners of single-family residences are less likely to understand exchanges and tend to reject the unfamiliar.

You can also trade up single-family rental houses and condos tax free.

Nevertheless, if you own or plan to own single-family rental houses, explore the possible use of Section 1031 exchanges. To move up from one or more single-family residences to multi-unit buildings, structure your transaction to avoid those equity-slicing taxes on capital gains.

Owner Will Carry Financing (OWC)

In the world of real estate, owner-will-carry (OWC) financing often beats bank financing. Generally, owners structure deals with less red tape; easier qualifying, more flexible (creative) terms; and

Owners often offer seller-assisted financing to investors.

lower closing costs. Owner-sellers frequently accept lower down payments than banks. Although some sellers of single-family houses finance their buyers, the practice is widely accepted with commercial and multifamily investments. Many of my acquisitions have involved at least some seller financing.

Yet, as the late real estate investor and columnist Robert Bruss pointed out, many owners don't volunteer OWC financing. To get it, include OWC as part of your purchase offer. Then explain why it makes sense from the seller's point of view. OWC often helps you close deals with financing terms that would never pass muster with a bank underwriter.

Possibilities to Create Value

Although you can create value through improvements of single-family houses, your possibilities for doing so increase substantially with investment properties. With single-family houses, you bid against homebuyers. Because most homebuyers don't factor a profit margin into their purchase offers, they pay too much for properties in need of work.

Professionals dominate the investment property market. Investors run the numbers. Without profit potential, they turn down the deal. Bidding wars and overpaying result less frequently. To attract a buyer, sellers of investment properties must price their properties (or give other incentives) to persuade investors they can earn a profit.

Income properties multiply your opportunities to create value.

Types of Improvements With single-family houses, tight zoning laws, homeowners association (HOA) rules, the character of the neighborhood, and the prices of nearby houses all conspire to limit your upside potential. With multi-unit properties, value relates directly to the amount of net income the property produces. Anything you can do to boost net income boosts the value of the property. Because investment properties are typically regulated by less restrictive zoning laws, you typically enjoy a wide variety of entrepreneurial, profit-generating possibilities.

Moreover, strategic marketing and management count more toward creating value for investment properties vis-à-vis single-family houses. A house is worth what a house is worth. Strategy plays a less important role. The great majority of people plan to live in the house they buy, not rent it out. With investment properties, strategy controls operating costs, tenant satisfaction, tenant turnover, and rent collections. Together, these and other decisions influence the cash flows that the income property produces and, correspondingly, its value.

Even better (at least in terms of your opportunities), most owners of small income properties manage their buildings poorly. Verify this fact for yourself. Look at some properties. Talk with tenants. You'll nearly always find room for improvement. We'll go over many value-creating techniques in later chapters, but for now, realize that many (if not most) affordable income properties offer potential for turnaround and higher net incomes.

Economies of Scale As with acquisition and strategy, income properties offer economies of scale when it comes to making improvements. To reposition, say, 12 houses, you work with 12 different buildings in 12 different locations. Each property requires its own unique market research, design, repairs, and renovations. In contrast, you can improve one 12-unit property with less time and effort (per rental unit).

Your renovation costs also incorporate economies of scale. One large roof costs much less than 12 individual roofs. To the extent that each of a building's individual units are similar, you can apply one redesign to all units. When you focus on one, two, or even three larger properties instead of a dozen or more smaller properties, you achieve more return for each hour you invest.

Summing Up

As we look in to the years ahead, real estate investors who in previous years would have searched only for single-family houses will switch to income properties. Such investments provide economies of scale; they cost less per unit; they yield higher annual cash flows; and they present greater opportunities to create value, to reposition, and to turnaround through improved operational and strategic management. When compared to stocks, bonds, annuities, or other assets, owners of income properties will produce superior performance. In fact, just as I was completing this book, a feature article in the *Wall Street Journal* ("Investors Considering Retirement Opt for [Commercial] Property Investments," December 18, 2007) essentially promotes the same message that I advocate here. The article quotes a Mr. Larson who says, "With the stock market, you're investing in faith. But with commercial real estate you can quantify everything and even drive by it on Saturday to make sure that it's still there."

Affordable income properties yield superior performance.

The journal goes on to report that "more investors are following Mr. Larson's example. As they're looking to build nest eggs that may need to last 30 to 40 years or more, commercial real estate seems like a stable investment compared to stocks—and it delivers a larger regular income stream. . . . Indeed while the residential markets in some areas continues to struggle, commercial real estate shows solid fundamentals."

But as the article also points out, beginning commercial-multifamily investors must study the local economies where they plan to invest, learn to run the numbers, and figure out target markets. Fortunately, that's the knowledge that you will take away from this book. Although, as noted, I focus primarily on the multifamily side of the commercial real estate market, the world of affordable commercial properties offers a magnificent variety of other choices. I urge you to consider starting here and then move on to other opportunities as you gain experience. But if you do wish to jump right in to retail, offices, self-storage, or other types of commercial properties, you just follow the same fundamental analyses.

I wish you good luck and prosperity with your investing.