BREAKWATER 1031

Multifamily Property Investments

Investing in residential real estate can be an excellent opportunity for investors to generate a steady stream of passive income. Investors can choose from various residential real estate investments, including senior housing student housing. Another option is multifamily properties, which allow investors to collect multiple rental income streams from a single property. If you're interested in learning more about multifamily real estate investing for beginners, you must first understand what a multifamily investment is and what to know before buying a multifamily property. This guide to multifamily real estate investment can help potential investors as they consider this investment.

What Is a Multifamily Property?

A multifamily property is a building containing multiple housing units. Compared to a single-family residence (SFR), a multifamily property includes two or more separate dwelling units. Properties with five or more units are considered commercial property. The IRS defines dwelling units as spaces with accommodations like a sleeping area, cooking facilities, and a bathroom. The IRS considers real estate residential if it derives at least 80% of its yearly rental income from dwelling units.

Before investing, real estate investors may find it helpful to consider the pros and cons of multifamily properties. The benefits of multifamily investing can potentially outweigh the risks, depending on an individual's situation. Here are a few multifamily investment pros and cons to consider:

Pros of Investing in Multifamily Properties

Here are some of the top advantages of investing in multifamily properties:

Cash Flow: One of the most significant benefits of multifamily investing is the opportunity for passive cash flow from rent. People always need a place to live, making monthly rental payments a potentially steady income stream. Multifamily properties have an advantage over single-family homes because of their potential for multiple rental income streams. A multifamily property could have two, three, or more tenants paying rent every month. Even with one vacant unit, investors will still have a reliable source of rental income. The rental market for multifamily properties has historically been robust. The demand for multifamily rental housing increased across several areas in the country in late 2021. In that same period, the value of multifamily lending was the highest in over 15 years, at $487.3 billion.

Another potentially good sign for investors is that the multifamily property vacancy rate has decreased steadily over the last decade. As long as multifamily property investors have a reliable flow of tenants and can easily re-rent units as they become vacant, they have the opportunity to make predictable rental income. Even if one unit in a multifamily property stays vacant for some time, the burden is mitigated across the other units since they still produce cash flow. Since millennials rent for longer than previous generations at a similar age, multifamily property owners may be able to fill vacancies faster.

As with other real estate investing opportunities, multifamily investments are one avenue for generating passive income. Investors in multifamily properties may be able to hire a property manager to oversee their properties. This strategy can provide the benefits of real estate investment while lessening the burden of property management. Since multifamily properties can provide passive cash flow, investing in these types of properties can bring significant, consistent returns.

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Tax Benefits: Investing in multifamily properties can provide investors with several tax benefits. The first tax benefit for investors is depreciation. The IRS allows investors and property owners to depreciate the cost of rental property. Depreciation enables investors to regain the value of the property's physical structure and reduce their yearly tax liability. The amount an investor can depreciate depends on three factors — the investor's cost basis in the property, the depreciation method used, and the property's recovery period.

According to the IRS's Modified Accelerated Cost Recovery System (MACRS), the recovery period for residential rental property is 27.5 years. If an investor holds a multifamily property for 27.5 years, they may be able to recover the cost of the property. Investors can begin to depreciate their multifamily properties when they put them in service and stop depreciating when they've recovered the cost or take them out of service. The more an investor can depreciate in a year, the greater the potential tax benefit. Investors in multifamily real estate may also be allowed to deduct expenses like mortgage interest, property tax, operating expenses, and repairs from their taxes. These tax benefits can help offset the costs of managing a multifamily property, which is a significant advantage for investors.

Scalable: Investing in a multifamily property could scale an investor's portfolio by two or more units at a time, allowing investors to boost their cash flow opportunities. When an investor can scale their portfolio quickly, it enables them to grow their wealth faster than they could with a property that only brought one source of rental income. Another consideration to keep in mind is that maintenance on a multifamily property is easier than owning multiple single-family dwellings in different locations. Multifamily homes are also physically scalable. Whereas single-family homes only provide investors with one source of rental income, investors may be able to add more dwelling units to a multifamily property and increase their income. For example, an apartment complex may have land nearby or other properties the investor can convert into additional units. Another opportunity could be when an investor owns a three-story duplex. The investor could reconfigure this property into a dwelling on each story, resulting in the chance to collect three monthly rent payments instead of two.

Cons of Investing in Multifamily Properties

Here are a few of the risks of multifamily property investment:

Market Risks: Investing in multifamily properties can also bring a few unique risks. One of the top cons of multifamily investing is the presence of market risks. Factors like local rental demand and vacancies, population growth, supply of competing properties, and current rental rates may impact an investor's rental income. Other considerations regarding the larger economy include unemployment, interest rates, and inflation. Investors must thoroughly research the market and location of a multifamily property before investing in it. Part of the risk of a market downturn on multifamily homes is that many tenants could be involved in the same industry, which could be popular in that location. If that industry experiences a slump, a multifamily property could lose multiple tenants. Investors may reduce risk by investing in a property in an area with a diverse local economy where sudden downturns in a specific field might not impact all tenants equally. There are also risks associated with investing in multifamily properties for commercial purposes, as the financial investment is typically larger and the property may be more difficult to liquidate. Finding a buyer for an apartment complex could be a greater challenge than finding one for an SFR.

Financial Risks: The cost of investment can be a significant barrier in real estate. Multifamily homes are typically significantly more costly to acquire than single-family homes, depending on the location. Investors may need to save more money as a down payment for a multifamily property or find alternative investment vehicles, such as Delaware Statutory Trusts (DSTs). Investors in multifamily homes might over-leverage a property and acquire too much debt compared to the property's cash flow. This financial risk could occur if a property fails to generate enough monthly rental income to cover loan payments and operating expenses. Over-leverage could lead to the investor defaulting on the loan and the lender foreclosing. A multifamily property also poses a financial risk if the investor wants to sell. Buyers for multifamily properties are usually more scarce than for single-family homes, and if the investor can't find another buyer, the property could be challenging to sell.

Despite these risks, securing a loan for a multifamily property may be less complicated than expected. A bank could potentially see a multifamily property as having less foreclosure risk and less financial risk since a vacancy doesn't impact the income stream as much as a vacancy in a single-family home. However, the loan approval process for multifamily properties with five or more units is different since these properties are considered commercial.

Asset Risks: Another con of investing in multifamily properties is asset risk, which is the risk associated with purchasing the asset. A significant aspect of asset risk is the need for capital improvements. Capital improvements include renovations and updates to the property's structure and key systems, such as its plumbing and electrical systems. Owners of multifamily properties periodically need to complete renovations and repairs that, if left undone, could negatively impact their rental income. There may also be additional repair costs if tenants damage the unit. Managing asset risk requires researching the asset and determining whether the risk is worth the potential return.

Investors might compare the cost of purchasing and renovating the property with the potential rental income it could generate. Factoring in the possible cost of future replacements and repairs can also help investors better understand the property's asset risk. Ultimately, these risks are an unavoidable part of real estate investing that investors can manage but not eliminate. Deciding whether to invest in a particular multifamily property comes down to whether the investor considers the risk worth the potential reward.

GENERAL DISCLOSURE

Not an offer to buy, nor a solicitation to sell securities. Information herein is provided for information purposes only, and should not be relied upon to make an investment decision.

All investing involves risk of loss of some or all principal invested. Past performance is not indicative of future results. Speak to your finance and/or tax professional prior to investing.

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1031 RISK DISCLOSURE

- There is no guarantee that any strategy will be successful or achieve investment objectives;
- Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;
- Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- Potential for foreclosure – All financed real estate investments have potential for foreclosure;
- Illiquidity – Because 1031 exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions; Impact of fees/expenses
- Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits

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