

Exploiting the Multi-Family Opportunity

to Enhance Portfolio Income, Appreciation and Diversification

A *White Paper* from GreenLite Holdings, LLC



Why it works, what to look for in an investment, and how to invest

In addition to diversifying the portfolio, multi-family investments can reduce portfolio volatility, provide steady income and offer tax advantages few investments can match. In this paper, we attempt to explain the benefits and risks of multi-family investments as well as the options individuals and institutions have to invest in multi-family properties.



GREENLITE
— HOLDINGS —
MOMENTUM IN MULTI-FAMILY

ANSWERING THE CHALLENGE OF INCOME, APPRECIATION AND DIVERSIFICATION

There are only two ways to make money: by working and/or by having your assets work for you, providing appreciation in value and income.

Returns on the traditional investment vehicles from interest on bank deposits to purchasing stocks and bonds have become increasingly vulnerable to non-financial factors. Manipulation of interest rates has resulted in below inflation returns for bank deposits and growing risks for stock and bond returns. Stocks prices have benefited from low interest rates while bonds are yielding record low returns, benefiting issuers at the expense of investors. When interest rates increase, as they inevitably must, stock and bond portfolios will experience substantial changes, many to the disadvantage of investors.

Where can individuals and institutions allocate their portfolios to achieve stable income and minimize vulnerability to negative volatility in the stock and bond markets? Multi-family investments have become one answer.

In addition to diversifying the portfolio, multi-family investments have the potential to reduce portfolio volatility, provide steady income and offer tax advantages few investments can match. In this paper, we attempt to explain the benefits and risks of multi-family investments as well as the opportunities individuals and institutions have to invest in multi-family properties.

Understanding Multi-Family

A multi-family development is a building or collection of buildings designed to house several different families in separate housing units. The most common type of multi-family housing is an apartment building. Duplexes, quadruplexes, and townhomes also qualify as multifamily housing. The entire building or development may be owned by an individual, an entity, or, as is the case with condominiums, by individuals who have purchased units.

Multi-family developments typically benefit from economies of scale in several aspects, reaching their highest yields when properties exceed 100 units. Costs to build are lower due to common walls, roofs and other savings that come from building multiple units in one location. Historically, apartment construction costs have averaged 30% less per square foot per unit than comparable single family homes. Economies of scale also affect the ongoing operation of a multi-family complex. Grouping multiple units in one location lowers the expense per unit for:

- ◆ Management
- ◆ Security
- ◆ Maintenance, repairs and upkeep
- ◆ Capital expenditures
- ◆ Finishes and fixtures
- ◆ Taxes
- ◆ Financing costs

Multiple units also amplify the effect of increasing income and offset the financial impact of vacancies when additional units continue to generate income to cover operating costs and provide cash flow. A \$25 per month rent increase for a 250-unit property will increase annual rental income by up to \$75,000, which in turn drives higher property valuations. Operators also tend to find it more cost-efficient to attract new tenants when offering multiple units and common amenities.

Classes of Multi-Family Properties

Multi-family properties are classified as A, B or C properties. A fourth Class, D, includes government subsidized projects. Each property classification reflects a different risk and return. While there is no precise formula by which properties are placed into classes A, B, or C, classification tends to fall within the following guidelines:

Class A: These are the highest quality buildings in the surrounding submarket. They are generally newer properties built within the last 15 years with little or no deferred maintenance issues. Rents are high, resulting high-income earning tenants. Typically, Class A properties are professionally managed.

Class B: One step down from Class A, these properties are generally older than Class A, tend to have lower income tenants and may or may not be professionally managed. Rental income is commonly lower than Class A and there may be some deferred maintenance issues. Class B properties can be a “value-add” investment opportunity if, through renovation and common area improvements, the property can be upgraded to Class A or a Class B+. These properties are typically sold at a higher capitalization (cap) rate than a comparable Class A property because they are viewed as riskier than Class A.*

Class C: Class C properties are typically more than 20 years old and/or in less desirable locations. The property is generally in need of renovation, including updating the building infrastructure. As a result, Class C buildings tend to have the lowest rental rates in a market with other Class A or Class B properties and sell at a higher rate than A or B properties.

*The capitalization rate, often referred to as the cap rate, is the ratio of Net Operating Income (NOI) to property asset value. If a property was listed for \$1,000,000 and generated NOI of \$100,000, the cap rate would be \$100,000/\$1,000,000, or 10%.

Each class of multi-family properties represents a different level of risk and reward.

Class A properties are less likely to require further capital expenditures, but more vulnerable to economic downturns. These properties tend to perform best at the top of the economic cycle in markets with higher income tenants.

With Class B and C properties, investors assume the additional risks of an older property with lower income tenants, or potentially a property in a less desirable neighborhood, but have lower correlation to traditional investments in economic downturns. During more difficult economic conditions, demand for lower price rental accommodations typically increases. B and C properties also have more opportunity for add-on appreciation, where property improvements drive increased rental rates and improved values.

MULTI-FAMILY ADVANTAGES FOR THE INVESTOR

Unlike a stock or bond investment, an income property investment requires ongoing management and maintenance. Multi-family developments are essentially individual businesses, generating income, expenses, employee management and debt.

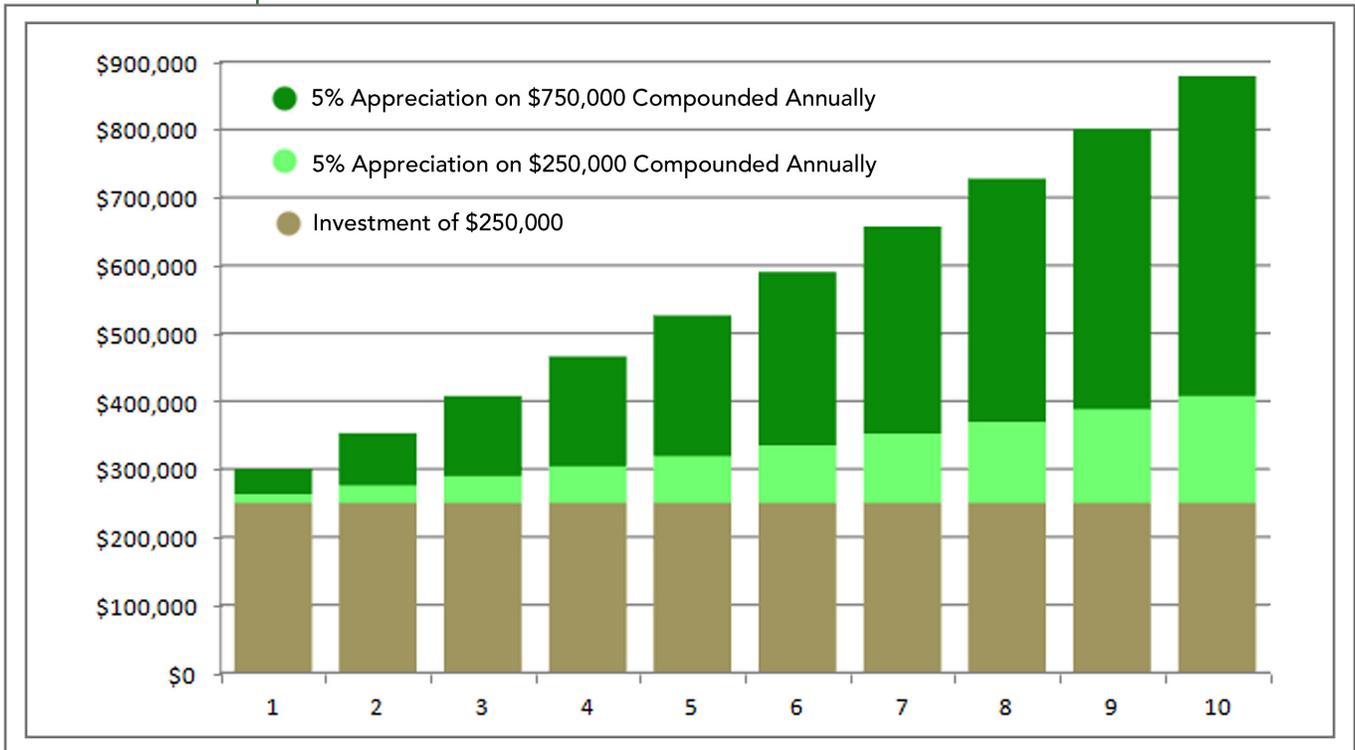
A well managed multi-family property offers five major advantages over equity investments:

(1) Leverage – The ability to finance real estate investments amplifies the outcome of the deal or transaction. Good investments can become great investments. While buying stocks on margin can provide the equity investor with leverage, that leverage is limited to 50%, has higher interest rates and is subject to margin calls. With over-leveraged derivative investment vehicles, such as options and futures, in a loss situation the investor may owe significantly more than original principal. Through non-recourse multi-family financing (typically available on loans in excess of \$3 million), the multi-family investors' risk can be limited to the principal investment.

The following example shows a hypothetical investment in a \$1 million multi-family property with 25% down and the remaining \$750,000 of the purchase financed. If the property appreciates at 5% annually, the value of the original investment increases from \$250,000 to \$878,000 by year 10. The caveat is that the property has also incurred interest charges during this period. The goal of a multi-family investment would be to assure that interest and operating costs are more than covered by rental income, providing cash flow to the investor.

Increase in Investment Value Based on 5% Annual Appreciation

\$1 Million Multi-Family Property - \$250,000 down / \$750,000 financed



(2) Investor control – The owner of a multi-family property has the ability to directly increase the value of the property through physical improvements, increased rents, greater operating efficiencies, reduced vacancies, etc. Properties with value-add opportunities can force appreciation.

(3) Lower volatility – Real estate prices are far less volatile than equities. While a stock price might fall based on market activity halfway across the world, multi-family properties are valued primarily on the basis of net operating income. A property well managed and fully leased that provides stable cash flow is not going to see a rapid, much less daily, change in value.

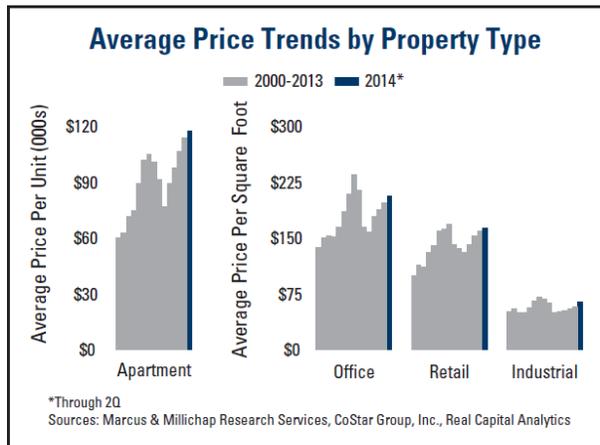
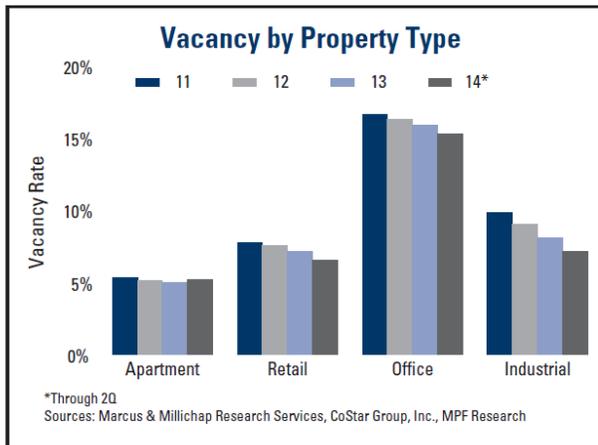
(3) Tax advantages - Interest payments, property taxes, management costs and other operating expenses are fully deductible. In addition, real estate investors have the ability to take depreciation on an investment property, further reducing taxable income. By using a 1031 Tax-Deferred Exchange when selling and buying a new investment property, investors are able to defer all taxable gains into the new property. By deferring capital gains taxes, the investor has more funds to invest in a new project, further leveraging long-term returns.

(4) Inflation hedge – Multi-family properties, with their ability to increase rents on an annual basis, maintaining capitalization rates and property values, provide an important hedge against inflation for investors. Inflation also increases the

costs of replacement properties, providing existing properties with substantial economic advantages and potential appreciation.

Multi-family investments may also offer advantages over other forms of investment real estate. Multi-family was the first sector to fully recover from real estate losses in the Great Recession. On the national level, by 2013 multi-family values had fully recovered, according to Real Capital Analytics (RCA). Office, retail and hotel sectors were still below the pre-recession peak. While retail, travel and business may falter in difficult economic conditions, the need for housing remains relatively constant.

The following graphics and data are from the [Marcus & Millichap Fall 2014 Special Research Capital Markets Report](#) and illustrate the lower vacancy rates and positive price trends for multi-family properties in the recent economic recovery.



FACTORS IMPACTING THE DEMAND FOR MULTI-FAMILY HOUSING

The health of the multi-family market is directly related to employment opportunities and demographics and their impact on the demand for rental housing.

In its **2014 Multifamily Outlook**, the Federal Home Loan Mortgage Corporation (Freddie Mac) cites favorable conditions for the multi-family market.

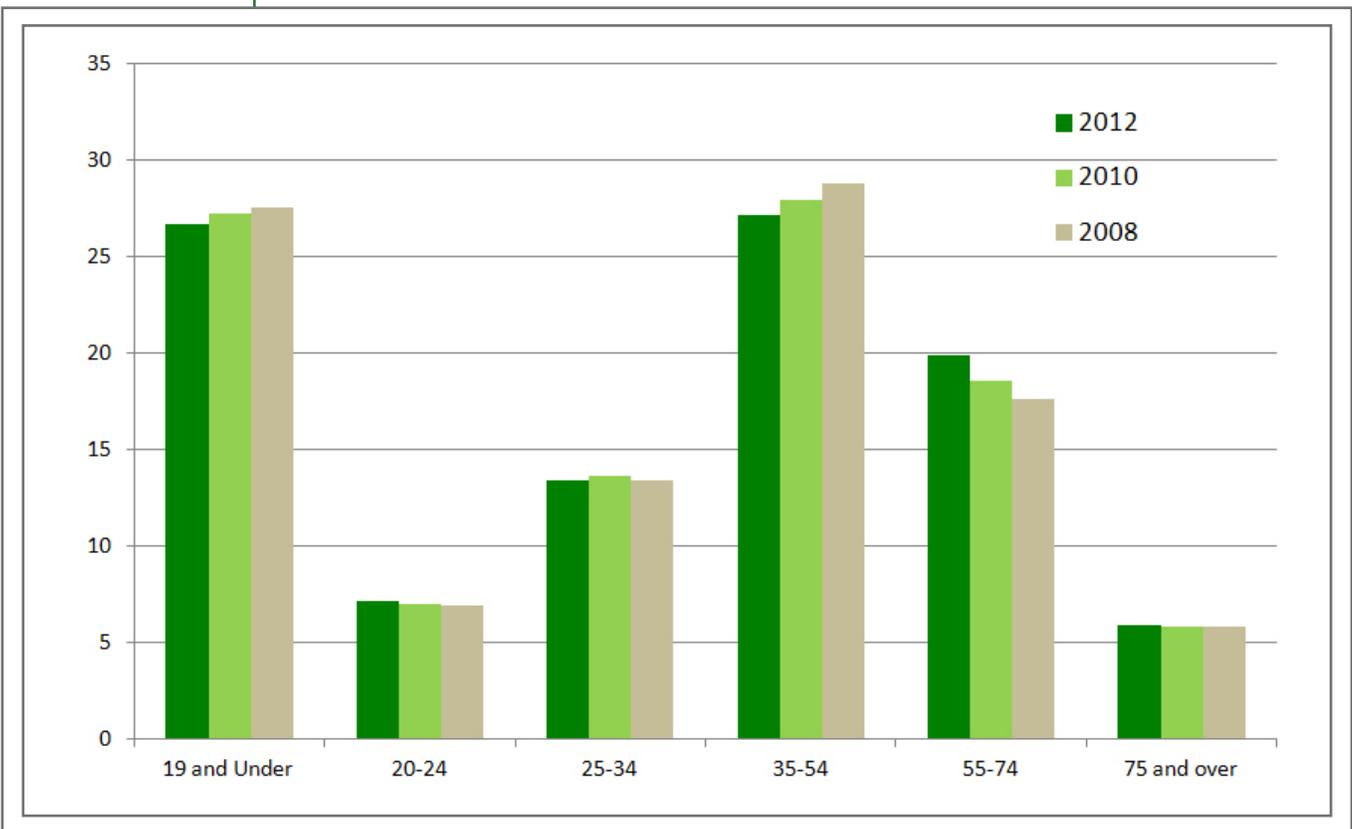
“...while employment levels remain below the previous peak, apartment fundamentals are strong. Occupancy rates have been above long-run averages for a couple of years and rent growth has been robust. At the same time, debt and equity capital flows to multifamily have been more favorable than to other sectors, leading to relatively strong property valuations.”

Demand for rental housing has been driven by the downturn in single-family residential properties, culminating in the market collapse in 2008. Foreclosures forced many families into rental housing, while stricter underwriting criteria have limited the ability of individuals and families to purchase homes.

A key driver in the demand for rental housing is also the growth of the 25- to 34-year-old age cohort. Where employment conditions are improving, this age group is contributing to a substantial demand for rental housing. We see this particularly in emerging markets in the southwest United States.

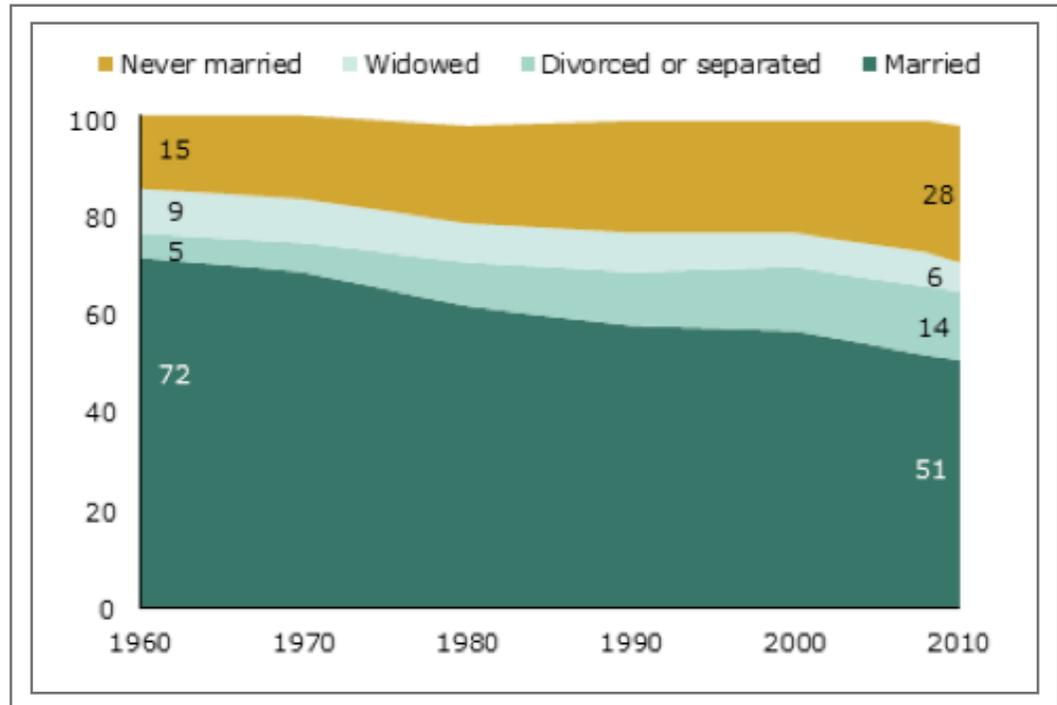
Distribution of Age Cohorts in the U.S.

U.S. Census Bureau data



Another demographic trend affecting multi-family demand is the number of single individual households versus families. Within solo or single households, there appears to be an increasing preference for rental housing over homeownership.

Current Marital Status, 1960 - 2010



Percent of total population based on adults ages 18 and older. Percents may not total 100% due to rounding. Source: Pew Research Center analysis of Decennial Census (1960 - 2000) and American Community Survey data (2008, 2010), IPUMS.

The impact of emerging markets on the demand for housing is illustrated in the following case study from the Midland Odessa area of Texas.

Emerging Market Case Study: Midland-Odessa

In 2011, drilling started exploding in the Eagle Ford Shale. Four years later, oil and condensate production continues to exceed expectations and the field has attracted more capital investments than any shale field in the United States. In the process, Eagle Ford Shale has generated 160,000 new jobs in the past six years and more than \$87 billion in economic output for Texas in 2013. Rents in the Midland-Odessa area soared with the demand for housing. Some 1,172 units were delivered in the area during 2012 and 2013, with another 1,453 units expected to come on line by the end of 2014, reflecting an 8.2% growth in inventory.

Ownership Options for Multi-Family Investments

There are a number of ways individual investors can participate in the multi-family market without the necessity of acquiring 100% ownership in a property or assuming management responsibilities. The most common ownership forms include real estate investment trusts, tenants in common, and limited liability companies, including single property LLCs.

The most common ownership form is a **Real Estate Investment Trust**, or REIT. A REIT is a company that owns or finances income-producing real estate. Modeled after mutual funds, REITs allow anyone to invest in portfolios of large-scale properties the same way they invest in other industries – through the purchase of stock. REITs are required to distribute at least 90% of net income as dividends to shareholders to qualify for tax breaks. In turn, shareholders pay the income taxes on those dividends. A REIT may be publicly traded on a stock exchange or privately traded, in which case there can be no guarantee of a secondary market. Investors have no involvement in the investment decisions of the REIT and may encounter a lack of transparency as to the actual properties held by the REIT; however, their risk is limited to the amount of their initial investment.

Tenancy in common investments (TIC) is an investment in real estate which is co-owned with other investors. TIC sponsors arrange TIC syndications to comply with the limitations articulated by the IRS which, among other requirements, limits the number of investors to 35. TIC investments are treated by most sponsors as securities; only licensed security dealers may market these investments, however, they have limited liquidity and no established secondary market. Each co-owner in a tenancy-in-common or tenant-in-common owns a divided fractional share of the property. This creates potential lawsuit dangers and allow no creditor protection.

The **limited liability company (LLC)** has become a preferred vehicle for owners of income-producing real estate seeking to easily and inexpensively establish a level of personal liability protection from claims of outsiders and allow flow-through tax treatment. Real estate LLCs typically have a real estate professional as the manager with the property investors being the members. This is referred to as *Manager Managed* versus *Member Managed*. The manager(s) exercises control over all aspects of the project. The members have no management control over day-to-day operations; however, the LLC may be structured to allow members voting rights on major decisions related to the property. Liability exposure is limited to the amount of investment by each member.

Single-Property LLCs provide investors with the greatest discretion over their investment. These LLCs are established to own a specific property and typically have a planned disposition process, giving the investor a liquidity timetable. Single-property LLCs also help to ensure that liability against one property is self-contained.

TIC and LLC investments allow 1031 Exchanges, referring to the section of the Internal Revenue Code that allows for the deferral of gains or losses from the sale of real property when specific guidelines are met and appropriate replacement property is identified and acquired in a specific time period. To use

a 1031 exchange with a REIT, one would have to use an Umbrella Partnership Real Estate Investment Trust, usually referred to as an upREIT.

Regardless of the ownership form, real estate investments are considered highly speculative and involve a high degree of risk. There are inherent risks to real estate investing, whether securitized real estate or un-securitized real estate. Please read the risk disclosure on page 12.

Hypothetical Financial Performance of a Multi-Family Investment

Given the risks of real estate ownership, why would one chose to invest in multi-family properties? The reason is the potential for stable cash flow and a substantial return on the initial investment. There is also the intangible value of investing in real assets that one can see, feel and touch.

The following example is based on a 224-unit, Class C+ apartment complex in Arlington, Texas. The complex was offered at \$7,400,000 with a Cap Rate of 9.33% on Cash-on-Cash Returns of 15.73% (T5 income and T12 expenses). The average unit size was 873 square feet. The unit mix consisted of three different floor plans of which 14% were one bedroom, 71% were two bedrooms, and 14% were three bedrooms. This location, near the intersection of Great Southwest Parkway and West Marshall Drive, was isolated with limited competition in the immediate vicinity, which gave the property a competitive advantage with respect to resident retention. The following example shows the potential capital gain at disposition over a holding period of three years:

HYPOTHETICAL MULTI-FAMILY INVESTMENT

Exit Price	\$9,500,000
Sales Expense	4.3% or (\$408,500)
Initial Loan Principal	(\$5,470,000)
Principal Pay-Down	\$275,068
Owner Equity	\$3,896,568
Less Initial Basis	(\$2,533,550)
Owner Equity Creation	\$1,363,018
Less GH Share of Equity	20% = (\$272,603)
Owner Net Equity Share	80% = \$1,090,415

Successful multi-family investment starts with finding the right property in the right market. When seeking a potential property acquisition, GreenLite Holdings, for example, looks for the following criteria:

Minimum Financial Measures

1. 7.5%+ Cap Rate or
2. 9%+ Cash on Cash Return
3. 1.5+ Debt Service Coverage Ratio
4. Priced below replacement cost

These are measures that typically allow us to syndicate the property. There can be no guarantee that all these benchmarks will be met on a property acquisition. Meeting or exceeding these numbers provides a measure of assurance to the investor that the property will cash flow sufficiently to cover debt and operating expenses, and provide an attractive return.

Value-add components offer the potential to force appreciation. This may include under-market rents, vacancies in excess of submarket averages, higher than normal expenses, the need for cosmetic expenditures to enhance the appeal of the property, and substandard marketing of the property to potential tenants.

Finally, market conditions must support the property. At GreenLite Holdings, we target emerging markets (*please see our Emerging Markets whitepaper to better understand this approach*) and properties that meet the needs of the 24- to 35-year-old, middle-class renter.

Multi-family investments, properly structured, have the potential to provide investors with:

- ◆ Diversification from more traditional investments vehicles
- ◆ Passive income during the holding period
- ◆ Capital gains at disposition
- ◆ A high rate of return
- ◆ Hands-off management
- ◆ The opportunity to defer taxes on capital gains
- ◆ A suitable investment for self-directed IRA and 401K plans
- ◆ An tangible investment you can see, feel and touch

But as with all investments there is always the potential for loss as well as gain. Proper due diligence and good management are essential.

Disclosures

The value of a property and the corresponding equity of the owners of a property will fluctuate based on the value of the property and the income the property generates. Though the potential risk of investing in multi-family housing is considered moderate, there is always the potential for owners to lose some or all of their investment by investing in multi-family properties. A property's value and rental income can be affected by many factors, including, but not limited to some of the following risks presented below. You should consider the specific risks presented below before investing.

- ◆ General Risks Prior to Closing on Real Property
- ◆ General Risks of Owning Real Property
- ◆ General Risks of Property Management
- ◆ General Risks of Selling Real Estate
- ◆ Regulatory Risks
- ◆ Environmental Risks
- ◆ Uninsurable Losses
- ◆ Risks of Developing Real Estate or Buying Recently Constructed Properties
- ◆ Appraisal Risks
- ◆ General Risks of Mortgage Loans
- ◆ Use of IRA Fund

Investors should carefully read all information relating to a potential multi-family investment and the ownership structure of the property.

The above information and risks described are for information purposes only and may not apply. GreenLite Holdings, LLC, its subsidiaries, affiliated, officers, employees, and agents may not warrant or representation as to the completeness, accuracy, or content of information and risks described.

For more information on multi-family investing through a single-property LLC, where investors gain transparency and accountability, visit the GreenLite Holdings LLC website at www.greenliteholdings.com or contact our offices at 480-567-9788 – inquiries@greenliteholdings.com.



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