Investing in “B” & “C” Class Multifamily Properties

By: George Lintz

The Information Management Network Middle-Market Multifamily Forum (West) took place recently in Santa Monica. The conference was well attended by a nicely balanced mix of Owner/Operators and Service Providers. I participated as a panelist with a group of Owner/Operators and our topic was “An In-Depth Examination of Class “B” & “C” Properties. Here is a recap of the salient points that I conveyed as a panelist.

B & C Class Properties in an economic downturn.

I heard other speakers throughout the conference mention that the lower-class properties are affected more profoundly in a recession than the higher-class properties. Accordingly, some investors seek higher class properties to protect their downside in an economic downturn. My investment philosophy diverges from this conventional wisdom. In a recession, I believe you find much higher vacancy rates in the “luxury” properties than you find in workforce housing. The reason is that people need a place to live at all times during the economic cycle; a cardboard box on the street is not an option for almost everyone. The lower priced apartments only empty out when the population moves out of the area entirely. For most people, who are going to stay in their general area, price will be a major factor in determining where they live. Operators of B & C properties can keep their rents low and keep their buildings full during the recession. This strategy assumes, of course, that the owner is not over-leveraged.

Do New Class A Properties Stress Your Occupancy Rates?

The question is often asked of us by investors and others how we are affected by Class A construction going on in the area of our properties. While it might seem that the additional inventory could put a strain on your occupancy rates, again, I depart from conventional wisdom. Our prospective tenants in workforce housing would generally not be able to afford Class A units. On the other hand, Class A units in the neighborhood of our properties elevate the value of our properties. For example, where we charge $1.00 to $1.20 per square foot for rent, owners of newly constructed Class A properties need to charge a minimum of $2.50 per square foot to earn a profit. If we raise our rents from $1.20 to $1.30 per square foot, we are more than satisfied and we still have plenty of head room before a tenant would compare our facilities to the nearby Class A facilities. Class A construction in the neighborhood of our properties enhances the value of our properties.

Cost/Benefit of Upgrades

It seems that brokers are constantly telling us about prospective properties that they want us to purchase that they have “meat left on the bones”. “All you need to do is upgrade the remaining units and you can raise rents $100 to $150 per month”. It’s not possible that every property has the same value-add potential.

We look for properties that have been held by the seller for more than five years. The longer hold period implies that the seller has a significantly lower cost basis and did not have as much incentive to push rents to the top of the market. The sellers who are “flipping” in 1 to 3 years generally have completed recent upgrades and pushed rents until a point where there is no more room to grow without the market rising on a macro level. We endeavor not to rely on macro level raises in rental rates. We focus on what value-add improvements we can make to the interiors of the apartments and, to a lesser extent, the communal areas on the property in order to bring the rents up to the current market levels.

To summarize, it is important to question “group think” mentality because conventional wisdom is usually a contradiction in terms.