Determine Your Investment Criteria

After you've chosen your market(s), it's time to define your investment criteria. Knowing what you will focus on in your search will help you stay focused on a specific target. Also, a sponsor with solid investment criteria will gain stronger credibility with brokers, sellers, and passive investors. It also helps you become an expert in your market.

There are six investment criteria aspects you should take into consideration:

Investment Criteria #1: Deal Size

The number of units you want to purchase and the deal volume. Generally speaking, multifamily properties are divided into:

a. Small MF deals – 5 to 100 units
b. Middle Market MF deals – 100 to 400 units
c. Large MF deals – 400+ units

When it comes to multifamily, lenders require syndicators to have net worth that is equal to the loan amount, which is about 30%-40% of the purchase price. If you don't want to limit the deal size to your net worth, you'll need to find someone who will have that net worth and will be willing to sign on the loan for a piece of equity (more about that in Module 11: Financing).

A word of caution: small is not necessarily safe. When I started investing in real estate, I jumped right into the middle market tier, since I understood the danger of going small: if you buy a 10-unit apartment building and have 3 vacant units, your vacancy rate is 30% and you are most likely to have a negative cash flow. But if you buy a 70-unit apartment building, 3 and even 10 vacant units are not a huge threat to your bottom line.

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Investment Criteria #2: Vintage

"Vintage" is a fancier word for year of construction. Buildings that were built before the 70s are generally speaking cheaper, but they require more frequent and more expensive maintenance. On the other hand, new buildings are more expensive to purchase. When you choose your vintage, you can do that by deciding on a range (for instance: 1980 -2000).

Investment Criteria #3: Asset Class

Building classes are often tied to vintage, but it's important to make the distinction. As we covered in Module 1:

- Class A: New construction, high-end buildings that are well maintained and have luxury amenities.
- Class B: 10 to 15-year-old buildings, well maintained, and have little deferred maintenance.
- Class C: 15 to 30-year-old buildings, showing signs of aging, and usually have some deferred maintenance.
- Class D: 30+ year-old property, no amenities, low occupancy, needs extensive work.

Class A buildings usually have lower returns, but many times you can find them in strong areas, while Class D buildings have higher returns but are in the worst areas of town. Choosing the building type should correlate with your appetite for risk.

Investment Criteria #4: Risk Profile/Investment Strategy

Generally speaking, there are 4 investment strategies in real estate: Core, Core Plus, Value Add and Opportunistic.

A **Core investment** has low risk and low returns. Investments are usually high-end class A buildings in a major city. Leverage is very low and can be up to 30%. The cash flow from that opportunity is pretty much known and is predictable. Most syndicators don't go with core investments due to low potential returns. **Core Plus** is a Core investment with higher leverage (up to 50%).

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In a **Value-Add** deal, the syndicator is looking for a way to increase the property's profitability and can do that by either lowering expenses or increasing income. Increasing income can be done by renovating the exterior of the building (such as painting), adding or renovating amenities and renovating the unit interiors. Lowering expenses can be done by running the property in a more efficient way. This strategy is medium to high risk (depending on the opportunity) and medium to high returns, and leverage is usually between 50% and 75%. Many Value-Add deals are properties that were built in the 90s or in older years. Syndicators buy the property, improve it, and sell it for a higher price.

Value Add is my favorite investment type and the one that most syndicators favor as well.

Opportunistic is an investment strategy for investors with high appetite for risk. It is high risk high return strategy. Opportunistic properties need "heavy lifting" meaning an extensive renovation and rehab plan and a large amount of capital expenditure for deferred maintenance. Leverage is around 50% for this type of investment.

Again, it's perfectly fine to invest in several strategies, as long as you understand the difference between them and are comfortable with both.

Self-evaluation question: Are you conservative or aggressive?

Investment Criteria #5: Value-Add or Turn-Key

Turn-key property is a fully renovated apartment building, while value-add deals are buildings that require some work. In a value-add deal, the buyer is looking for a way to increase the property's profitability and can do that by either lowering expenses or increasing income. Lowering expenses can be done by running the property in a more efficient way. Increasing income can be done by renovating the exterior of the building (such as painting), adding or renovating amenities and renovating the unit interiors. For more information about value add vs. turn-key deals, read the next chapter.

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Here's an example for defined investment criteria: 100-250 units, 1980-2000 vintage, Class B and C, value add deals.

It's important that you stick to your investment criteria and not deviate from it for two main reasons:

1. It will give you more credibility when you communicate to brokers what you look for in an investment.
2. Sticking to a specific investment criterion will help you stay focused and specialize in a specific class asset.

Investment Criteria #6: Hold Period

You should ask yourself; what is the ideal hold period I feel comfortable with? Are you looking for a short 2-3 years hold period? Or 5-7? Or perhaps longer? Most syndications hold properties for 5-7 years, though in some cases syndicators decide to sell the property after 3 or 4 years, if the market allows them to sell the property sooner and still receive the returns they presented to their investors.

Investment Criteria #7: Returns

At this point, you should have a clear idea of the type of assets you are looking for. Now, you'll need to focus on the ideal returns you're focused on. When it comes to returns, the main two metrics are CoC and IRR. The exact CoC and IRR returns very based on the market, vintage, asset class, and investor's personal preferences.

As a rule of thumb, you should look at investments that yield:

15%-18% IRR, and

6%-10% CoC

Over a hold period of 5-7 years

Of course, returns change over time, based on where we are in the cycle.

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It’s important that you stick to your investment criteria and not deviate from it because it will help you stay focused and save you time in considering investments that don’t even fit your criteria.

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