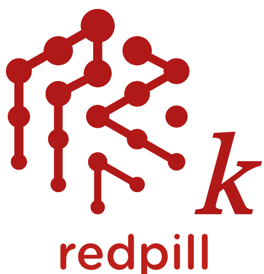
Why multifamily? Asymmetrical Yield.

I often get asked: Why did I pick multifamily as one of the major places where I invest? It's the yield. There's an asymmetrical yield that occurs in multifamily, and let me explain why. I'm an opportunistic commercial real estate investor, and I prefer mid- to large-size multifamily for a very specific reason.



Real estate is the most powerful way to accumulate wealth. More people have become millionaires through real estate than any other means. We know how to find the property, create a plan for improving the cashflow, negotiate the deal, and manage the asset. Your passive investment provides you with the opportunity to earn an income without the nine to five. We create a unique business strategy that fits your financial and investment goals. Get the financial freedom you need to do more of what you love. **We are Red Pill Kapital, with a K.**

What we do?

We leverage data. We take all the data that we can find, and we apply it to the real-world experience. What we figure out is how to get a dependable passive income investing cashflow, and we look at tax-advantaged, commercial real estate. We look at doing value-adds to improve net operating income in our passive commercial real estate. When we do that, we're able to significantly enhance the value proposition. We're densely research and data-driven, and what we're trying to achieve is asymmetrical returns, returns far greater than what one would expect for a particular risk ratio. I keep in mind that all real estate is local. It's hyper-local. It's driven by demographics and the local investment environment.

Each individual asset performance is based upon the skill of the management. It's the management team that will determine the success of a project. The fundamentals of the real estate, the dirt, the building, and things of that nature have little to do with the outcome. The asset is probably 10 percent of the job. Managing the asset and doing it correctly determines the performance of the investment, and what's really interesting is, in real estate, you, as an investor, can have a massive impact on the outcome--should you choose to.

Our core competencies

- We find and validate projects.
- We look for untapped potential.
- We look for the local growth drivers.
- We look for upside potential.
- We trust what people tell us, but we verify each and every single fact that's verifiable.
- We acquire real estate, we stabilize real estate, we value add it, we improve it.
- We have a goal to exit in four to seven years.

Now that may change in the near future because there are a lot of changes coming in inflation, and there are a lot of changes coming in interest rates, and so we keep our eye on the horizon. We're trying to predict what's going to happen five, seven, ten years from now, knowing that the farther out we look, the less predictable it is.

Our goal is to maximize cashflow, to drive the net operating income, and ultimately increase the realized sale value of a property.

We prefer mid- to larger-sized real estate because

You can leverage the systems inside a single campus. What that means is your maintenance, your overhead, your leasing costs, your branding, your unit mix, your ability to release, and your ability to communicate in social media is maximized, because it's all one single campus. You're not trying to rent 100 units over 20 square miles. You're renting 100 units on one city block, and you can put your arms around it.

- Systems leveraged inside a single campus
- Maintenance
- Overhead
- Leasing costs
- Branding
- Unit mix and ability to rapidly lease after vacancy

I prefer real estate that's multifamily because it's logic-based. It's not subjective; it's not emotional. It's math.

Take the net operating income, divide by the cap rate, and that gives you the value. The cap rate for a particular asset, for a particular grade, is pretty well defined. So my goal is to affect net operating income. Net operating income is essentially income minus expenses. Can I increase the income? Can I reduce the expenses? If I can do that, I've increased the value. That's called forced appreciation. It's called a value add. Any increase in net operating income increases the value dramatically.

$$\frac{NOI}{\%Cap} = \textit{Value}$$

Let's just say that you invest $1,000 in the property, and you get a $4,000 to $5,000 increased income net operating annualized. Assume that the cap rate is 5 percent. So a $4,000 change in net operating income from a $1,000 investment at a five cap results in an $80,000 increase in value. That's amazing because you can't get that in a house or a single-family residence, because single-family residences and houses are based on comparative value—the value of that similar house in the market in the same neighborhood—and they're highly subjective.

Let's take a worst-case scenario. Let's say that your $1,000 investment only increased $1,000 net operating income. Even at a five cap, $1,000 increase in net operating income for a $1,000 cap times the expenditure still gave you a $20,000 equity gain. You can't do that in a house. When you increase or put money into a housing situation, you usually will not get the money out. Very rarely will you get a dramatic increase in equity gain in a standard house.

There's a lot **less competition to buy** in commercial real estate, and the reason is because it takes more money, it takes more knowledge, and there's way more fear about it. Everybody knows how to buy a house, but I bet you in the population in general, 1 percent know how to buy commercial real estate. In that 1 percent, it's probably half of a percent that's very good at it.

Money

Knowledge

Fear

Depreciation is your secret weapon.

Taxes are the single biggest drag on wealth accumulation. You have to realize that taxes are merely an incentive by the federal government to get you to do something that they themselves can't do efficiently. They need people to develop housing, because there's a tremendous difficulty for the federal government to develop housing. In fact, it costs the federal government. There was an interesting study done in California where they built section eight housing. The per unit cost of section eight housing for the federal government combined with the state to build it was over $300,000 per unit. That's ridiculous. Anybody else could have come in and built that for $120,000 per unit.

So, the government looks to the private sector by modifying the tax rates, creating incentives to have them do the work that the federal government can't do, and realize that depreciation is a phantom loss. It's not a real loss. What it is, is the federal government says this thing is going to devalue over this amount of time, and as it devalues, you're going to have to replace it. It's about three and a half percent per year for most structures. When you have this phantom loss, it goes against your income, and so it reduces your taxable income. Now with the recent tax law changes with accelerated and bonus depreciation, it has completely eliminated most of my K-1 distribution taxes that I've had to do on passives. It's a secret weapon that most people don't pay attention to, and it's a huge equity kicker on rate of return that you can never get in the stock market.

Why not just buy a portfolio of single-family rentals?

Well, you can't find property managers. It's really hard to find them. Maintenance is incredibly difficult, because it typically takes my folks 30 minutes to an hour to get to a site, evaluate the site, look at the system, figure out what they need, then go to the hardware store, get what they need there, and put it in. A simple toilet repair, on average, takes about four hours on a single-family residence. That same toilet repair on our multifamilies takes under 30 minutes. Those parts are in stock in our multifamily; they're all standardized. You don't have to go and travel. There's not a trip fee. You don't have to go look at the particular gasket or that particular item that you need, the flapper valve that's unique to that particular toilet.

Single-family residences are incredibly market sensitive. If you looked at the 2008 recession, single-family residences had much higher vacancies than did the cheaper apartments and the value-add apartments, and so they had a much greater loss of capital. Single-family residences are highly dependent upon the general economy, because they're comparative market approach to valuation rather than cashflow valuation. Single-family residence is defined by comp rates, not by net operating income, so if you increase the rental rate by $500 per month at a 7 percent cap on a multifamily, it increases the value by $7,142 per unit. On the single-family residence, it wouldn't matter. What we'd have to do is compare that single-family residence to something else that looked similar – similar architectural style, and whether somebody would want to buy it in that same neighborhood and based upon the schools, and a whole host of other factors that are highly subjective and completely out of your control. I don't invest in single-family rentals. There's too much hassle, there's too much friction, and it's too subjective for me.

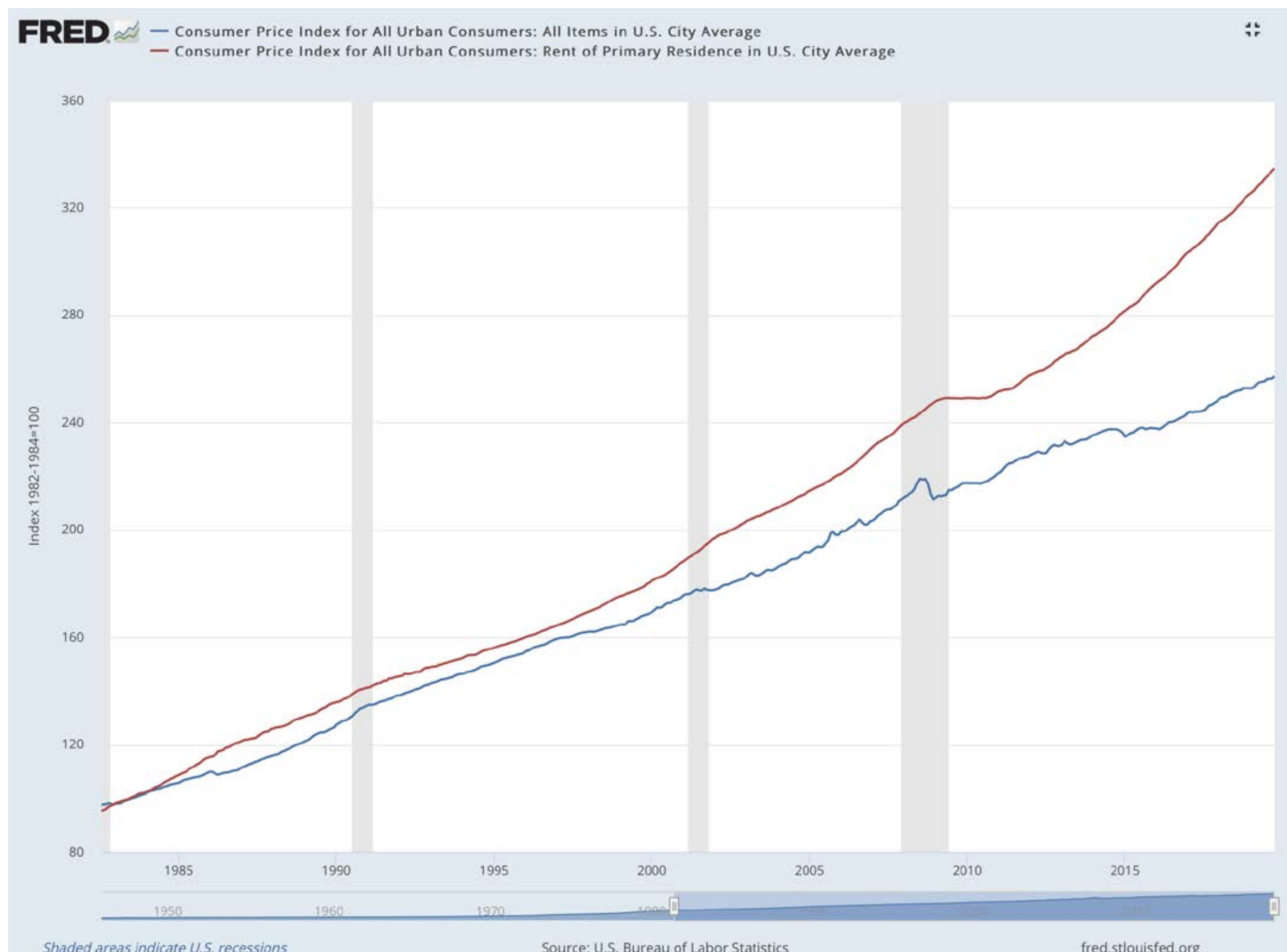
There's a stability of income even during a recession. You know, people think that a recession is coming, the recession is coming.

I don't really care.

The sky may be falling, but it's about cashflow.

Cashflow determines your success during any recessionary period.

If you looked at the numbers from the St. Louis Fed, and you looked at consumer price index for all urban consumers, and you looked at in the blue line the index for the average consumer of goods versus the consumer of residences. The red line shows what the cost is for rental, and the blue line shows just a general inflation rate or general cost. If you look at that and you look at the gray bars, which indicate recessionary periods, you'll notice something interesting. The inflation rate ticks up but has a significant drop during the recession. The actual housing cost doesn't shift, and this is specifically for multifamily. It really doesn't make any difference. It may stabilize or it may flatten for a period of a few months, but then it continues to creep back up. The reason why, is that this is demographic driven. This is driven by the number of people, and unless we dramatically reduced the population in the United States, that average rental rate is going to continue to climb.

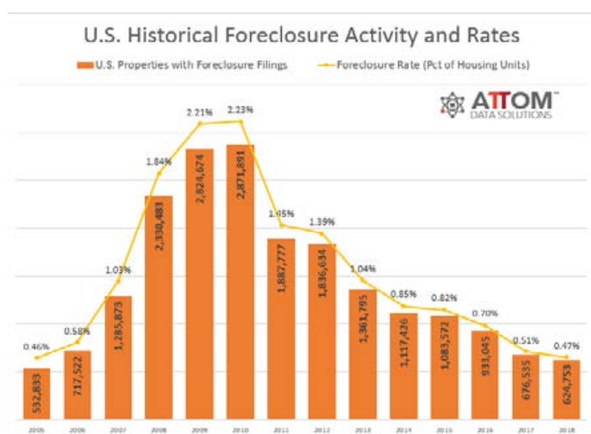


Foreclosure is exceedingly rare in multifamily, and the reason why is because of the stable income and the high demand.

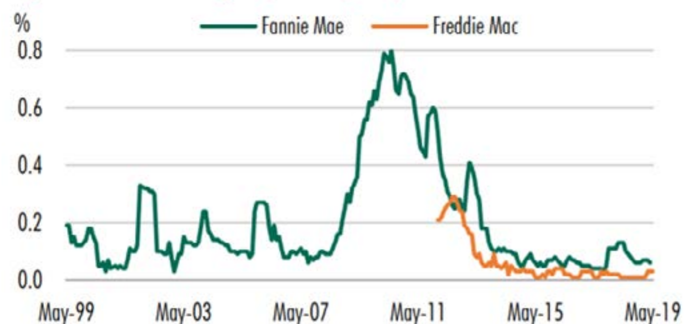
It’s a cashflow-based asset that the banks will stress test before they give you a loan on it, and the banks love lending for it because they know that you’re not going to go into foreclosure. If you look at single-family residences, they’re foreclosed on three times more often than multifamily. Even in good times, they’re five times more likely to be foreclosed than a multifamily property. Lenders love multifamily because the asset is stable. They can deploy a lot more capital, and there’s less potential for human factors to get in the way.

This is a chart of single-family foreclosures during the recessionary period: 2008, 2009, 2010. This is compared to the same period for Freddie Mac and Fannie Mae loans, which were commercial multifamily. If you notice, the historic average of rates of foreclosure is 0.46 to 0.47, and it jumps to 2.23 for single-family. The historic rate for multifamily is about 0.1 to 0.2, and it jumps up to a little bit below 0.8, then it drops immediately back down to 0.1, 0.2. Single-family foreclosures peak at 2.23 percent of the entire real estate market, and even at the peak of the financial crisis, multifamily was only 0.8 percent. That’s a huge, huge difference.

Single family foreclosure



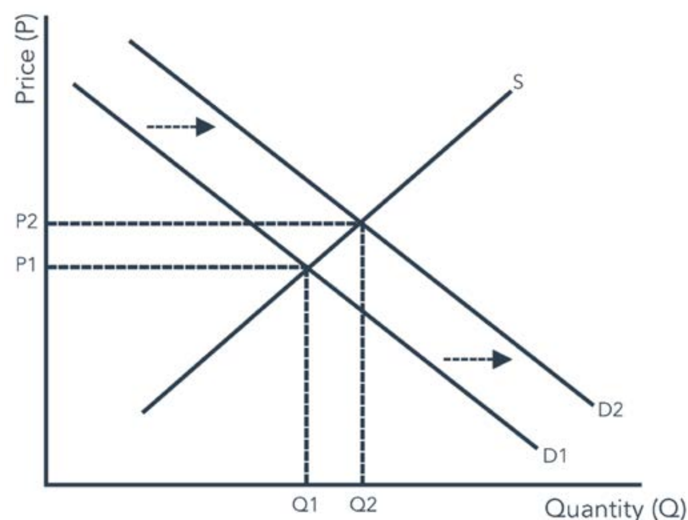
Multifamily delinquency rate



It’s about supply and demand.

So I’m going to throw something at you. Demographics is what happens to populations, and populations determine value. The more people that want a particular thing, the higher the price. The less people that want that particular thing, the lower the price. In real estate, supply of real estate and utilization of real estate is fixed as in terms of land. Certainly you can increase the supply of real estate by building, but what is easier to change is demographics – the number of people coming into a community. If you have a bunch of people coming into the community, you’re shifting your demand curve from D1 to D2. You have people coming in, and your supply is remaining linear, then what ends up happening is your price has to go up. But let’s say that instead, you’re in a community that is at D2 and you’re losing population. Your price is going to go down and your supply is essentially the same. Demographics are incredibly sensitive indicators as in terms of what happens to price.

I look at demographics as a headwind or a tailwind. If you’re flying a plane, and you’re going 500 miles per hour, and you have a 200 mile per hour headwind, you’re going to take longer to get there because your net rate is 300 or you’re going to burn more energy to get there. But if you’re flying that plane and you have a 200 mile per hour tailwind, you’re going to get there a lot faster, or you’re going to have a lot less energy burned to get to the same place. It’s almost the exact same thing. **Demographics are headwinds and tailwinds, and the economics of the issue of price and demand.**

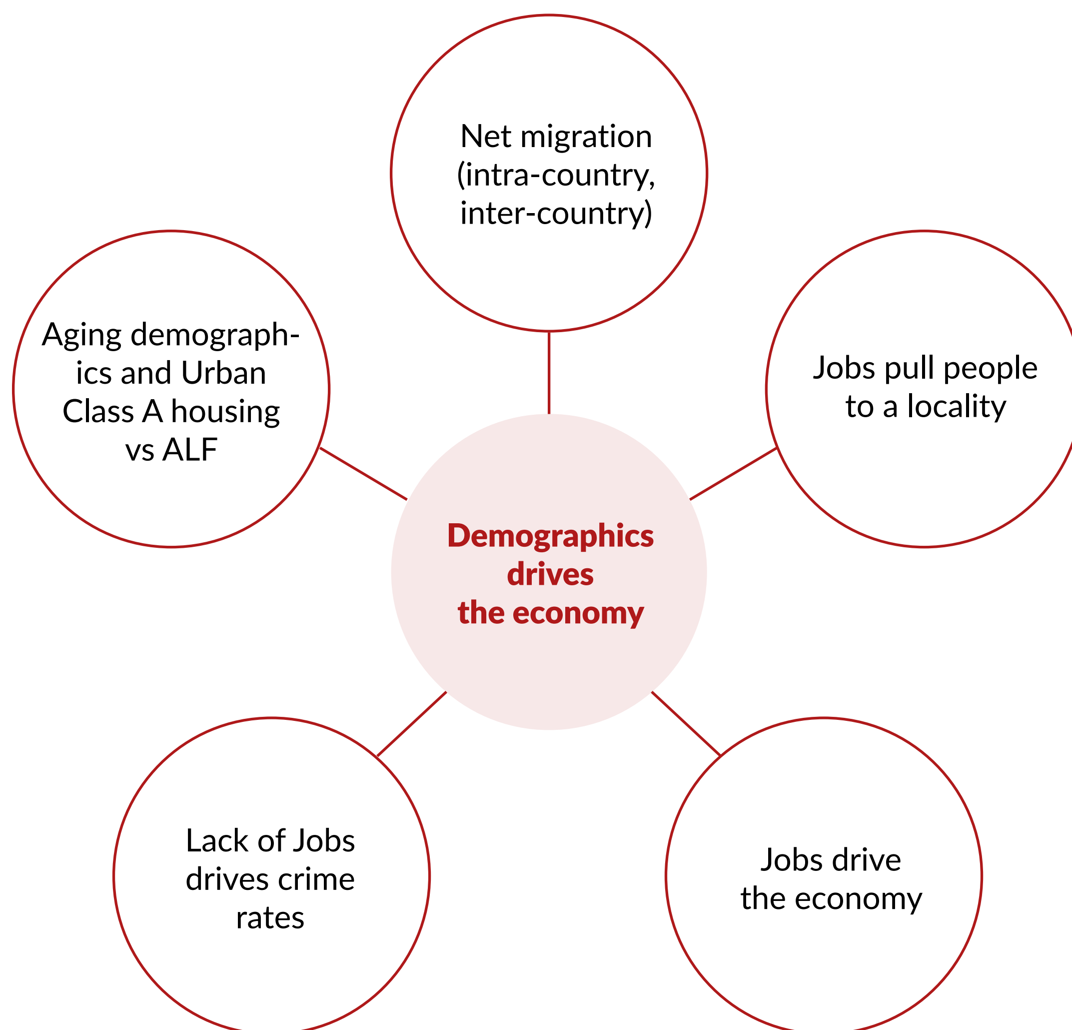


Demographics drive the economy

It's all based off of population statistics, so there are a couple of things that you should be aware of. America's birthrate is really low, and we have not been producing enough babies for the generations to replace themselves. We have to have a steady influx of people coming into the country, because if we don't, we're not going to have enough people to maintain our demand levels. If our demand levels start to drop, our prices are going to start to drop. Certainly, I know that **real estate is a fixed total supply, but the reality is if your demand drops in a fixed total supply, your price goes down, and so it's just something that we have to be aware of.** Now there are other factors, and part of those factors are as that population ages, they live longer. So the demand may go up as an aging population goes up. But, we have to be very careful what economics they have, and what they're willing to buy and not buy, so I use the demographics to help predict what happens to price and supply in a particular asset class.

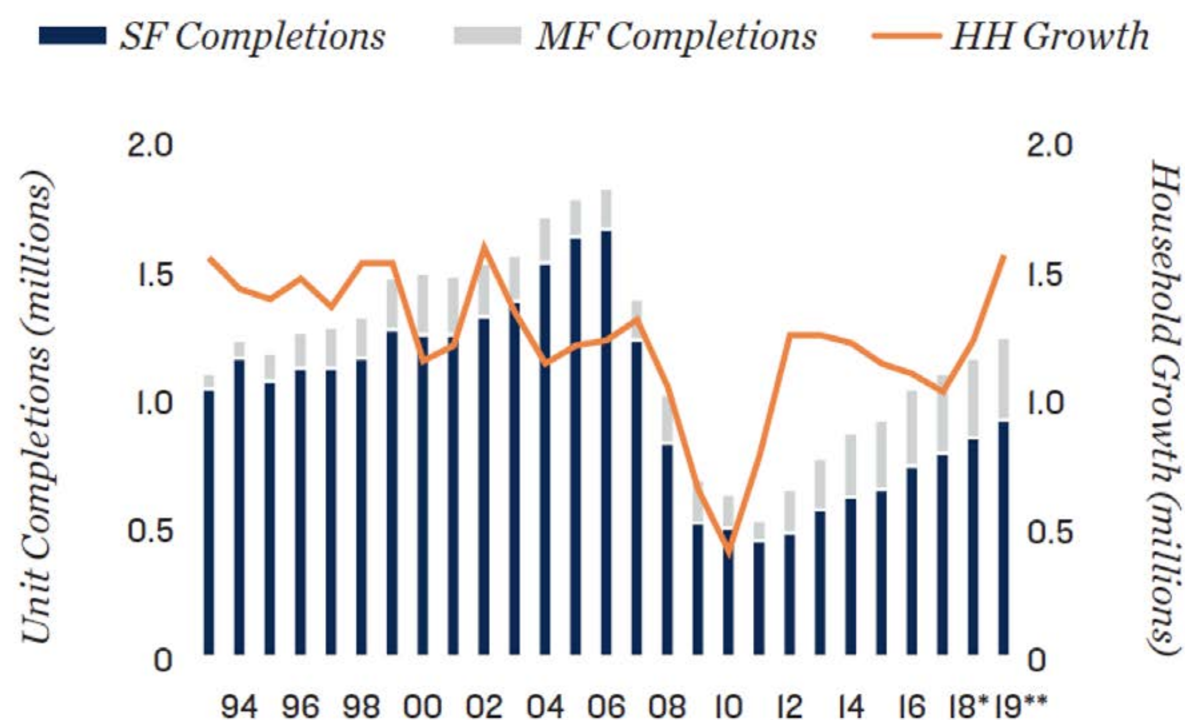
It's a combination of net migration, intra-country and inter-country. So let's say that I'm going to buy something in an area that's losing population quickly. I'll give you an example: Detroit. Detroit continues to lose population. No matter what you do, your population is leaving, so you have headwinds there. You're not going to be able to increase price over time, because you don't have the demand and your population is leaving. Whereas, let's say you compare that to Orlando or Tampa where a lot of people are moving in no matter what. That same real estate, that same asset that's at that location, is going to have a higher demand, and there's not more of it, so the price goes up.

Jobs pull people to a locality. People don't move to a locality because they want to move there. The vast majority of people move to a locality because they're able to work. Jobs drive the economy, and a lack of jobs drives crime rate. This combination of stuff poses some interesting thoughts on what the future of real estate investing is – assisted living facilities, skilled nursing facilities. What happens to the millennials? What happens to retirement? There's a whole host of things that I'll be discussing in other modules that we'll look more closely at, just that demographics. This is really meant to be an overview.

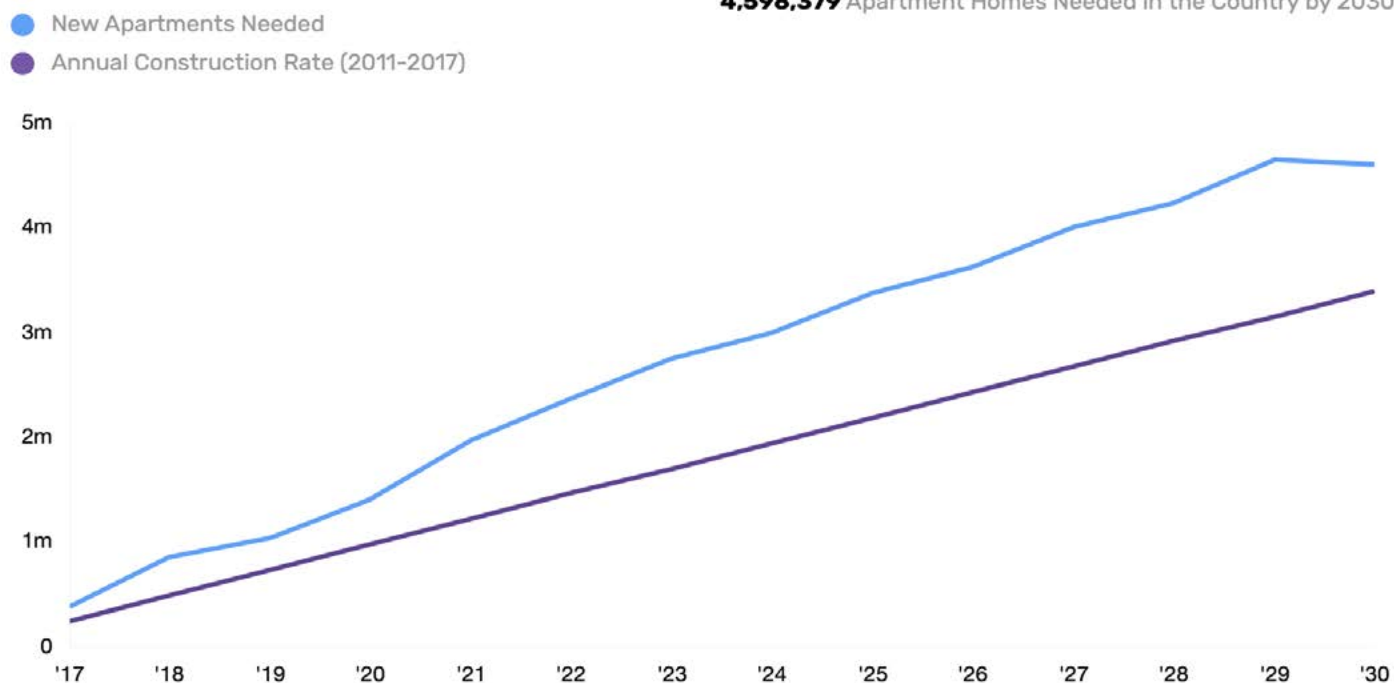


As you get more new households formed, then rental demand goes up, and the thing is that the vast majority of household formation, new people coming into households, they're really looking for B and C quality property. But the only thing we're building is A quality property, because it's almost impossible to build B or C. It's too expensive, and so B and C properties actually have reduced production and high demand, and A properties have high production and reduced demand. What do you think is going to happen to the price on these things?

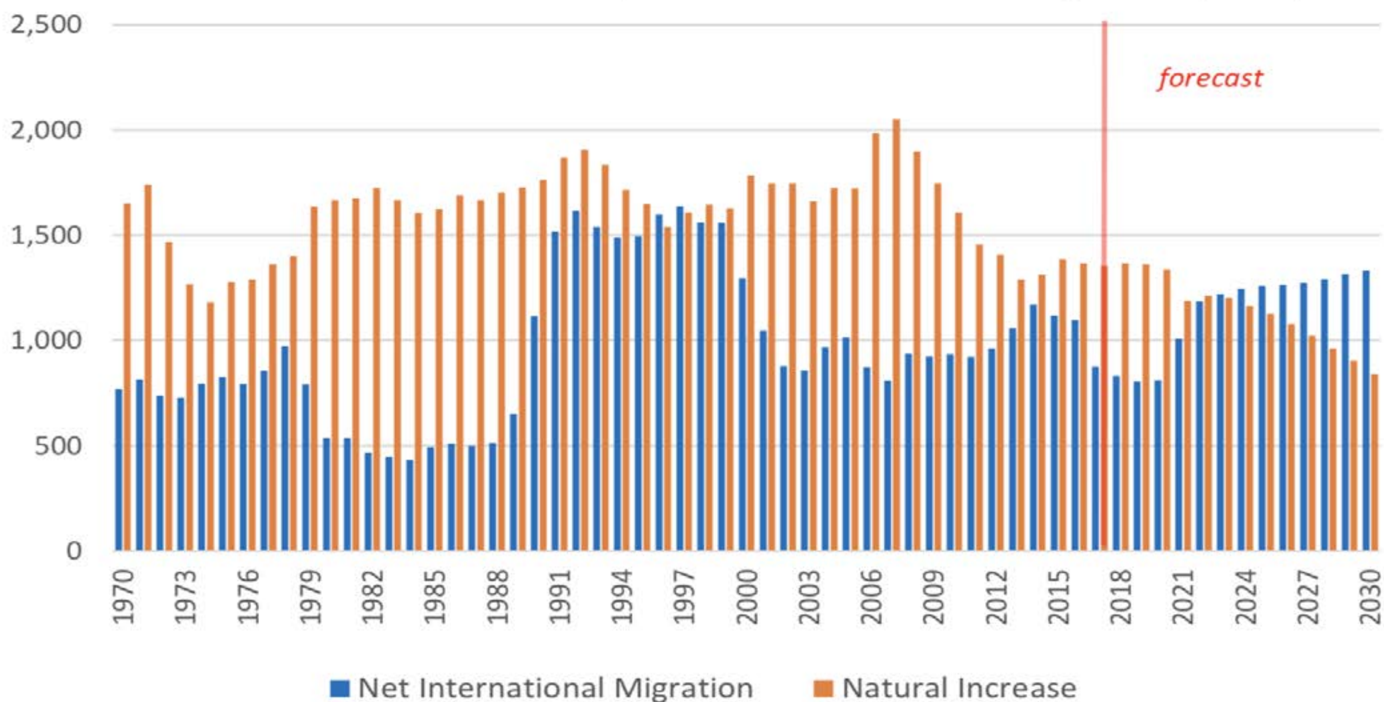
This is just a simple display of household demand, household growth, and what's happening over time. Household formation is far exceeding the completion rate of multifamilies, and if you look at it a little bit closer, you're going to find out that the multifamily completion is in class A facilities, but the vast majority of household formation is B and C.



If you look prospectively—if you look at the future—the number of new apartments needed far exceeds the construction rate that we have available, and we'll have a deficit of probably 2 million units by the year 2030.



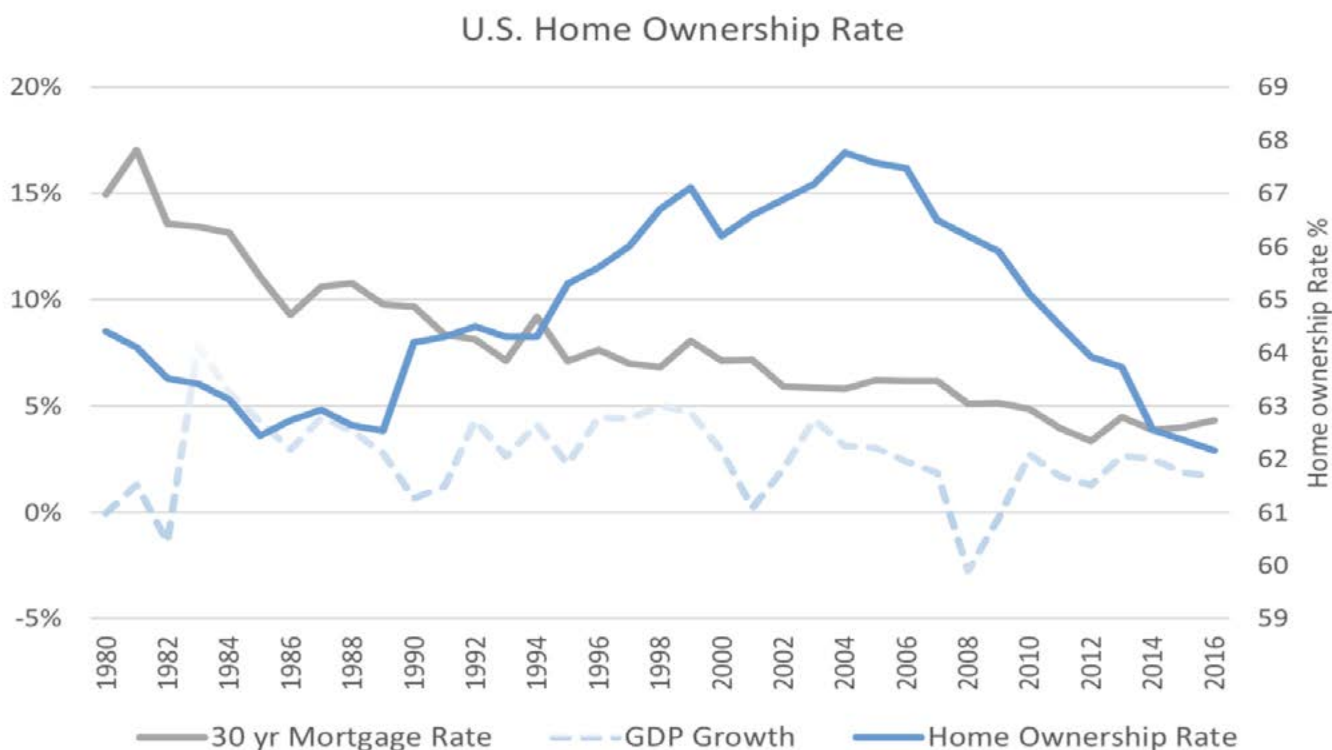
As the population continues to increase, whether it's by net migration in, or by intrinsic population increase, that combination will maintain a demographic growth rate. Now that demographic growth rate is hyper-local. It's not going to be all over the country. It's going to be in urban areas. It's going to be in a core area that has a lot of benefits for the local community. What we're noticing is that even the people that have retired are now moving to more urban areas so that they can have more access to amenities and health care, and the millennials are also moving to these more urban areas so they can have more access to entertainment venues. What's interesting is, there's very few construction opportunities in these areas, so they're having to rent.



We've converted to a renter nation

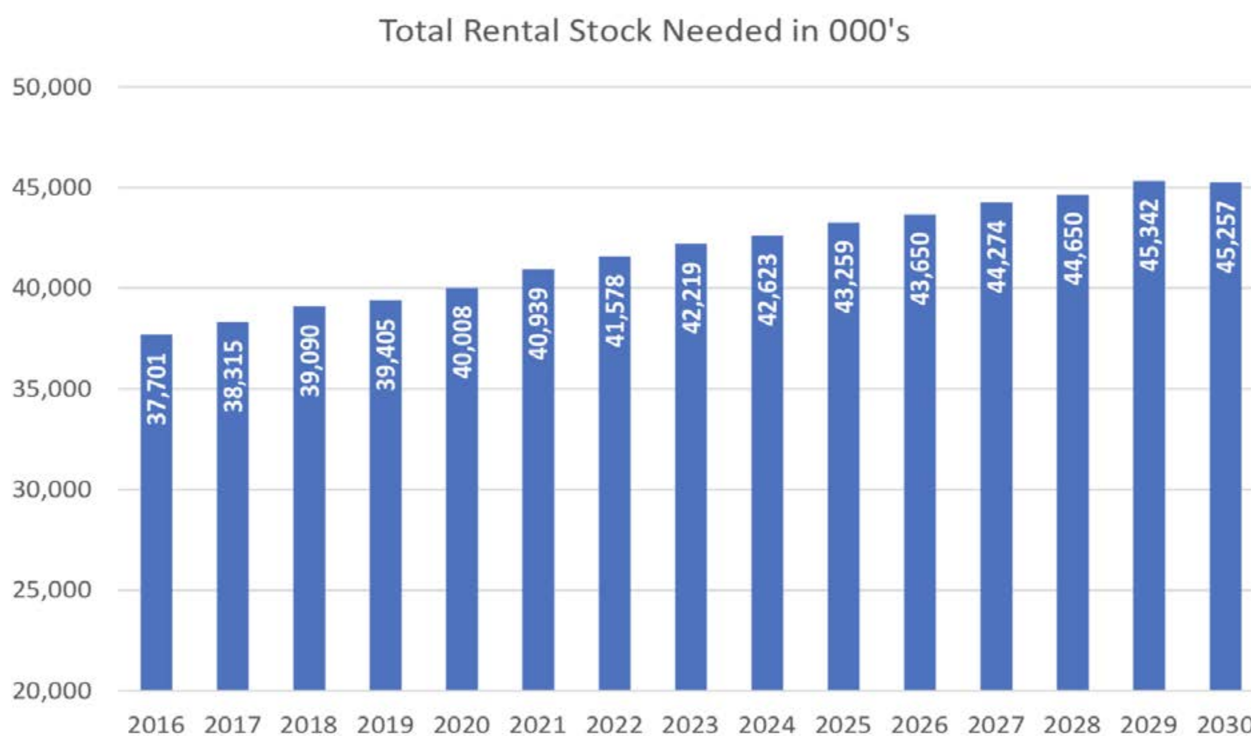
People have been disillusioned by the housing bubble crisis of 2007 to 2010, and a lot of homeowners had total equity destruction. They've given up on owning houses. Younger households look for mobility. They have a tremendous amount of student debt. They're postponing home ownership, or choosing to have the flexibility of renting. It's the Uberization of housing. We're looking more at the use of an object rather than the ownership of the object, and the tighter underwriting standards have resulted in a significant reduction in supply of multifamily and single-family housing, especially on the coastal markets.

Home ownership rates are dropping dramatically despite the fact that our GDP is stable. Despite the fact that our mortgage rates are decreasing, the home ownership rates are decreasing.

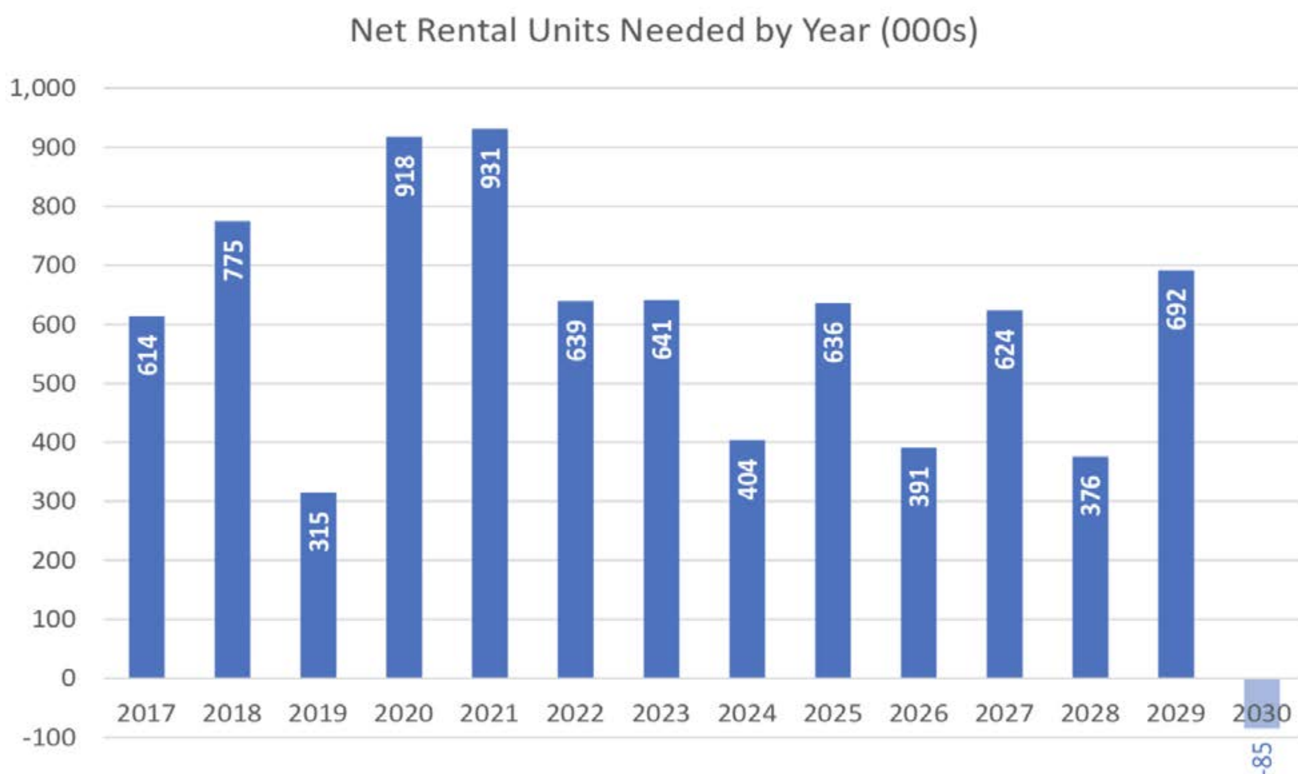


Our expected home ownership rates are going down no matter what you say, no matter what you think. It's going to look bad for ownership of single-family residences going into the future no matter which way you turn.

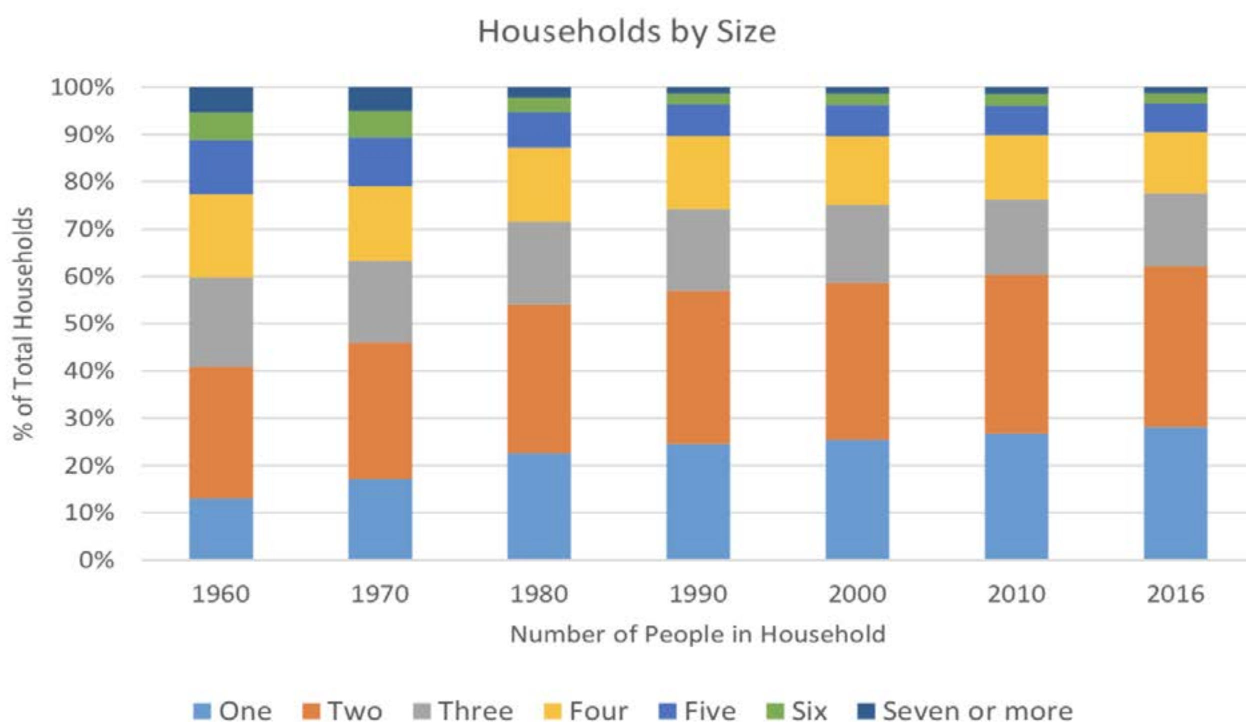
The rental stock needed is very significant, and the availability of that rental stock is diminished.



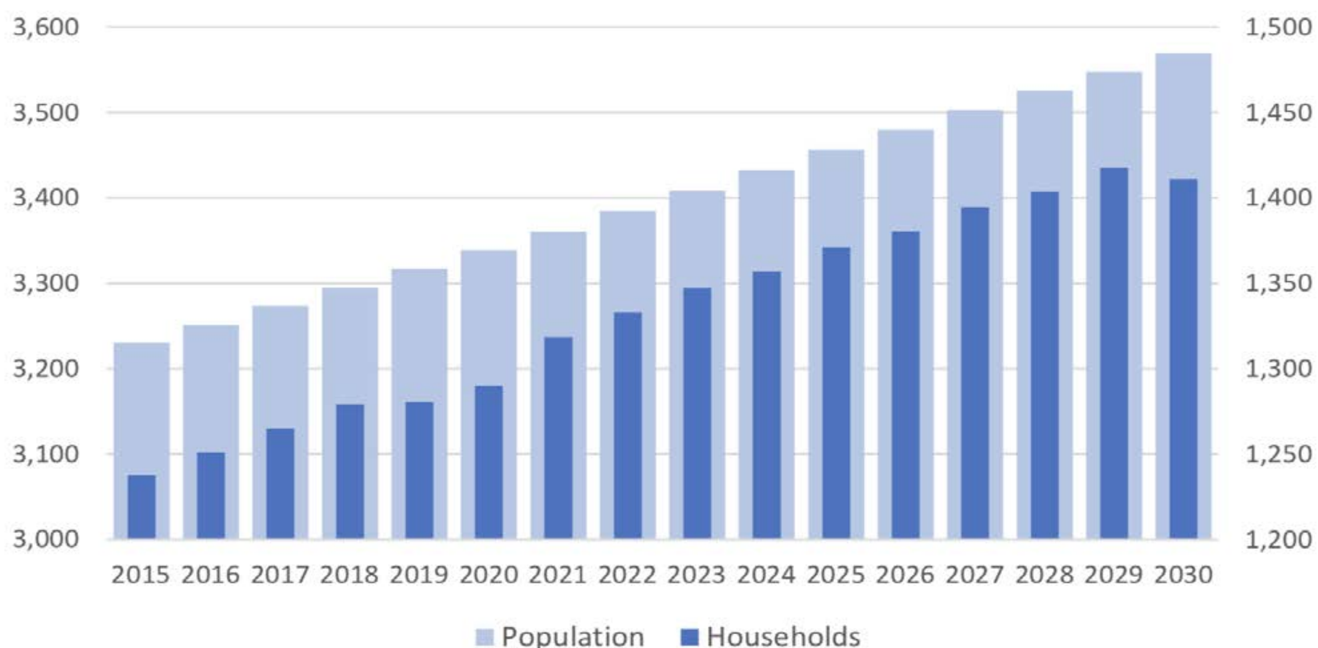
This is a graph indicating the net rental units needed by the year 2030 in comparison to what's available. You only start to see a shift in about 2030, 2030-plus. The reason why you see the shift is that we may have a decrease in net immigration, and if that happens, then by 2030, we won't need as much housing. But all the way to there, we're going to need a significant amount of housing that we cannot build.



If you look at household formations and percentage of households, you'll notice that more and more households are becoming single-family households, and less and less households are becoming multiperson households. What this tells you is that there's an increase in the amount of wealth in each individual household, and household formation is increasing and people are living by themselves or living with just one other person and taking up apartment units, so this is going to put an additional burden on the utilization of the number of apartments rather than large houses.



The U.S. population growth will continue all the way to about 2030, assuming that we've decreased our immigration rates. If our immigration rates go back up, then these numbers will obviously change significantly.



There's more households in the U.S. renting now than any other time in the last 50 years, and the majority of them are millennials.

The largest generation in U.S. history prefers renting over buying. They'd rather use something than own something. It's the Uberization and the sharing economy that are pushing this trend.

Our process

We're a demographic-oriented, first and foremost, company. We identify general areas of interest, but then we quickly narrow our focus to the specific deal and the situation in that specific opportunity in that hyper locality. We acquire assets, but that's just the beginning of the process. The real process is value addition. It's changing the income, reducing the expenses, actively managing the resource, and anticipating the ideal exit time period.

Our market selection is based upon migration rates. It's based upon job creation. Job creation determines the direction of the local economy's future. If you don't have job creation, you don't get net migration in. If you don't get net migration in, you don't get housing build.

So what's Red Pill Kapital?

Red Pill Kapital is a physician-owned, commercial real estate investment and education company. It allows you to invest passively alongside us. We find the property or we find the investment group. We create and validate their plan. We look at how to improve the cash flow. We negotiate the deal. We manage and oversee the asset. Your passive investment provides you with an opportunity to earn an income without the nine to nine, because physicians don't work nine to five. We probably work six to nine. We create a unique business strategy that fits your financial investment goals, because we understand the specific needs of physician professionals.

Is Red Pill Kapital right for you?

Are you looking to enhance your financial wealth and truly live the life that you deserve? Are you an accredited investor who's interested in learning more about passively investing in cashflow and commercial real estate? Are you interested in investing alongside us? Because we don't need your money. What we're trying to do is do bigger projects with more leverage. The bigger the project, the less the risk because the leverage improves. We only make money if you make money. If you have any questions, please email me at **info@redpillkapital.com.** That's Kapital with a K.

We search for value-added real estate for our passive commercial real estate partners, and we actively manage that investment long-term for a successful exit. We are Red Pill Kapital.
Find us at **redpillk.com.**