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A Bull Market in Rental Housing

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Five years into the real-estate bust, the market for single-family homes seems weaker than ever. According to the most recent S&P/Case-Shiller housing data, prices fell 3.3% nationwide in February from a year earlier.

The ongoing malaise, paradoxically, is only boosting the opportunities for investors in multiunit rental properties.

The days of buying and flipping a property for quick profit are long gone. But investors who purchase apartment buildings, perhaps as part of a retirement portfolio or estate plan, are seeing better deals now than at any time in the past decade, says Dan Fasulo, managing director at Real Capital Analytics, a real-estate research-and-consulting firm. On the cost side, housing prices are low and falling in many areas, while mortgage rates are near historic lows. On the income side, apartment rents are near all-time highs.

"As an asset class, it looks awfully attractive," Mr. Fasulo says.

Brian Stauffer

Nationwide, rents now average $991, compared with $930 in 2006, and are expected to rise to about $1,025 by 2012, according to Reis Inc., which tracks rental-performance data. In part, that is because there are fewer units: The national vacancy rate for apartments dropped to 6.2% during the first quarter of 2011, from 8% a year ago.

Rental demand should remain strong for several years, experts say. The housing-market crash and shaky job market have made more would-be homeowners gun-shy about buying, says Paula Poskon, a senior research analyst at R.W. Baird, a wealth-management company.

Demographic trends also are favorable. Roughly 3 million young adults had been living with family during the past five years, according to data from the Census and real-estate investment brokerage firm Marcus & Millichap, and housing experts estimate that they now generate about one-third of rental demand.

Still other renters have no alternative. Some 2.8 million homes were foreclosed on since 2008, with another 5 million expected to enter foreclosure or be repossessed by the banks by the end of 2012, according to RealtyTrac.com. Many of those former homeowners will have to rent until their credit score recovers, which typically takes seven years.

Such factors have sparked a bull market: Sales of multifamily units priced at $500,000 or above surged by 28% in the first quarter of 2011 from a year earlier, according to Marcus & Millichap. The dollar volume surged 44% to $11.2 billion.

The key for investors, of course, is to find a property that generates enough rent to cover the operating costs. Annual expenses, including property taxes, insurance, water, heat, maintenance and occasional repairs, shouldn't eat up more than 40% of a property's annual rental income, says Jim Scofield, senior investment adviser at Apartment REP, a multifamily brokerage and advisory firm in Raleigh, N.C.

Factoring in maintenance costs and other variables, an investment property should produce at least a 6% return on the initial cash investment in the first year after it is purchased, Mr. Scofield says. For example, an investor who puts down $250,000 in cash on a $750,000 property would need to clear at least $15,000 in the first year.

There are, to be sure, drawbacks to this kind of investing, from repairs to delinquent tenants. Laws vary by state, but typically tenants could end up staying for up to four months without paying rent before the eviction process is completed, says Hessam Nadji, managing director of research and advisory services at Marcus & Millichap.

Investors who don't want to fix a broken toilet on a Saturday night can pay a property-management company to handle everything from leasing apartments to making repairs. Fees, which generally run about 5% to 6% of total annual rents, often decrease as the number of units increases, says Tony Drost, president of the National Association of Residential Property Managers.

The big payoff from property investing comes when the mortgage is paid off. For a conservative investor, assuming a 15-year mortgage, the influx of extra income could arrive just in time to subsidize retirement, rising health-care costs or children's college tuition.

That has been William King's strategy for some time now. The 43-year-old owner of an audiovisual production company in Morrisville, N.C., has used real-estate investments to save for college tuition for his two children, ages 9 and 13, accumulating more than 20 properties.

Five Promising Markets

Regions with good long-term upside, based on property costs and rental income potential.

Cities	VACANCY RATE	RENT GROWTH	MEDIAN PRICE*
New York	2.4%	6.9%	$118,700
Minneapolis	2.9	3.4	66,300
San Diego	3.4	4.6	116,100
Portland, Ore.	3.5	4.8	67,200
Austin, Texas	5.6	5.0	50,700

*Per unit in multi-unit residential property.

Note: Vacancy rate and rent growth based on 2011 projections; rent growth based on effective rents; median price based on 2010 data.

Source: Marcus & Millichap

In March, Mr. King dipped into his savings to buy a $550,000 multi-unit dwelling nearby, this time with an eye on retirement. The property generates about $50,000 a year after expenses and financing, and Mr. King plans to own it outright before he is 60. At that point, he says, it will probably yield about $80,000 at today's rate.

For investors who want exposure to income-producing properties without getting their hands dirty, there are alternatives. Real-estate investment trusts, or REITs, pass along at least 90% of their taxable income, typically rent from tenants, to shareholders in the form of dividends. They perform better when the rental market picks up—in 2010, the average REIT returned 27.5%—and during inflationary periods, since rents tend to increases with inflation.

Investors also can pool their money—the minimum investment required is typically $250,000—into private-equity groups that in turn buy large properties, many of which are distressed, and hold them for five to 10 years with the aim of selling at a profit, says Jack McCabe, a housing analyst in Deerfield Beach, Fla., and consultant to private-equity groups.

But these options don't offer leverage. An investor can buy a property outright with a mortgage and a down payment of around 25% to 30% in cash. Any capital appreciation magnifies the returns on that investment.

"You can't beat the real-estate angle right now," Mr. King says. "I'm more excited about it than I've ever been."

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