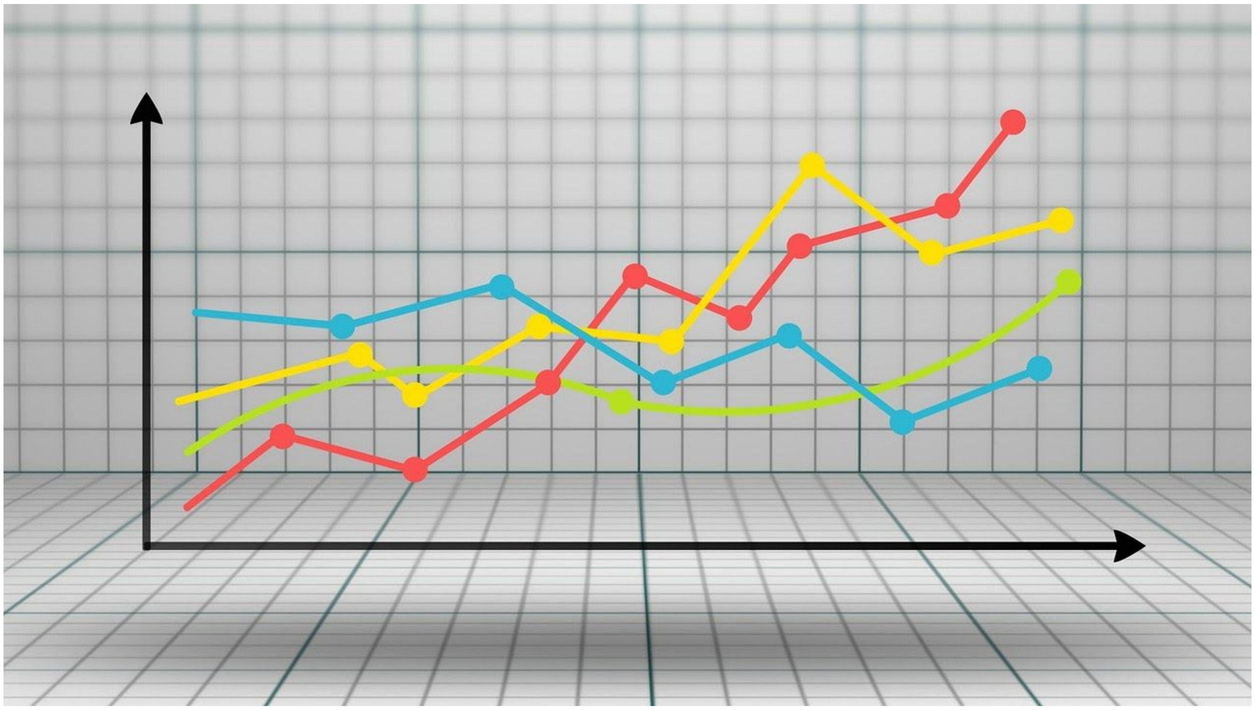
What Is the Safest Real Estate Investment?



Every investment carries some risk. Investment properties are no different. However, the level of risk can vary dramatically from one property type to another. Some types of real estate are inherently riskier than others based on where their cash flow comes from, who the target market is, and how they are capitalized.

By identifying the risks of real estate investment ahead of time, you can look for the right property to meet your needs while planning ahead on how to mitigate the associated risks.

Real Estate Investment Risk Factors

Some common risk factors for real estate investments include:

1. Tenant Issues

Tenants are the ones paying you rent. Any disruption can cause major cash flow issues, whether that's from inconsistent payments, extended vacancies, damaging behaviors, or any number of other situations.

Managing tenants is vital to the success of your investment. Tenant issues can cause major losses, but you can insulate your investment to some extent.

2. Cash Flow Problems

The largest gains in real estate investments usually come from cash the property generates. While the long-term capital gains can also be significant, positive cash flow is vital to maintaining a good real estate investment.

Cash flow can be destabilized by a number of different things. Anything from periods of high vacancy, unexpected costs, or an improper rental strategy.

3. Short-Term Volatility

Real estate markets can exhibit a high level of volatility in the short-term, even if they tend to see long-term growth overall. Most investors get more out of long-term holds than short-term or speculative holds.

4. Active Management

Real estate is not a passive investment like a bond or ETF. Someone has to be monitoring it to keep up with maintenance, tenant management, and market changes. Without active management, real estate investments can lose value, fall behind the market, and degrade over time.

On a strong cashflow property, you can outsource property management.

5. Illiquidity

In tough times, it's difficult to liquidate your real estate investments. You can't liquidate an investment property on short notice, even when market demand is very strong. Real estate sales always take time.

When you're considering the safest real estate investment types, these risks are always taken into account. How well does a certain type of real estate reduce risk? How stable is the investment during ups and downs in the economic cycle?

These are the 3 safest types of real estate for investors:

1. Multi-Family

Out of all the investment real estate types, multi-family is considered to be one of the safest asset classes. Multi-family has a few things going for it.

First, multi-family properties tend to be highly resistant to economic downturns and poor market conditions. No matter how hard things get, people always need a place to live and will usually turn to rentals, especially if they don't have the the required down payment or credit score necessary to get a favorable mortgage. The catch is that this only applies with low-to-middle income housing, not luxury apartments.

When you're renting out multi-family units, you also have a lot of separate tenants. This means that even if there is a high tenant turnover rate or you experience long vacancies on some units, the other tenants will help keep the property afloat. It's unlikely that you will lose all your tenants at once, so you should be able to weather times of high vacancy more comfortably.

Related: Mitigating Recession Downside with Multifamily Investing

The downside to having many individual tenants is the need to manage them all. Many multi-family investors tend to work with property managers who help find, vet, and sign on tenants.

Finally, new real estate investors and veterans alike can jump into the multi-family space without a lot of hassle. Financing for multi-family tends to be simpler than financing for other large classes of CRE.

It's easier to get financing, loans tend to have a lower interest rate, and there are a wide variety of market options with varying capital requirements. Whether through syndication deals, partnerships, or direct purchase, investors can get into the market alone or with other experienced investors.

Pros

- Vacancy risk spread over many units
- Steady demand
- Tax benefits for investors
- Potential for passive involvement
- Long-term upward market momentum
- Smaller capital requirements
- Simpler loan structures
- Lower barriers to entry for new investors

Cons

- Less stable tenants, usually shorter-term contracts
- More direct management needed
- Competitive buying environments

2. Industrial

Industrial real estate is known best for having long-term contracts with large, individual tenants. With the right type of facility, you can expect to rent out the whole building to a single tenant for 10+ years.

This is great for investment stability. Top that with the potential for triple-net leases that pass through most of the property expenses to the tenant, and you're looking at a very low maintenance investment overall.

The biggest problem that comes along with that model is that you're relying on a single tenant (or just a few, at most) for your entire cash flow. If the tenant starts having financial troubles and can't pay the rent on time, you're not going to make any money from that property at all.

Even with a triple-net lease, where the tenant is responsible for maintaining the property and paying other expenses, you might end up in hot water if the tenant is not caring for the property as they're supposed to or is neglecting certain required payments.

The other problem with industrial real estate that makes it riskier than multi-family is the fact that periods of vacancy can last a long time. If you're in between tenants, there can be a long negotiation period while you wait for the tenant to decide to sign the lease. Even after that, tenant improvements may require time and money before the tenant starts paying rent.

Industrial can be a lucrative class of real estate for investors, especially once a tenant settles into a long-term lease. However, high initial capital requirements and the risk of long vacancy periods between tenants makes it less accessible to new investors or anyone without an already solid portfolio.

Pros

- Long-term tenants
- Low volatility
- Strong growth projections
- Low maintenance

- High potential ROI

Cons

- Long vacancies significantly increase risk
- High capital investment requirements

3. Office

Like industrial properties, office buildings exclusively rent to tenants with revenue-generating operations. You may have a mix of large, corporate tenants who take up multiple floors of the building and small business tenants, freelance contractors, etc.

The good thing about working with these tenants is that they tend to prefer longer leases. Businesses need a consistent location, so they're often willing to sign 5-, 7-, 10-, or 15-year leases. Small businesses may seek out shorter 3-year leases, but you probably won't be dealing with month-to-month or 1-year leases at all.

Stable tenants are useful because they act as guaranteed cash flow. Having strong tenants with long-term contracts can even positively impact the valuation of your property. The lower turnover also means you don't need to worry about finding new tenants all the time, which is good because office tenants generally take longer to sign a lease.

Tenants looking for office space may request improvements to be made in order for them to make the best use of the space. This is normal practice with office buildings. Some tenant improvements may be paid for by the tenant if they are signing a short lease, but the longer the lease, the more the tenant is going to expect you to do to prepare the space for them.

Office buildings are great for their stability when you have solid tenants. However, the reliance on strong economic conditions and the tendency to have long vacancy periods makes office real estate a bit riskier than industrial and multifamily.

Pros

- Mostly long-term, stable clients
- Less tenant turnover
- High likelihood of tenants renewing leases
- Potential to pass some operating costs through to tenants
- Different class options for portfolio diversification

Cons

· Tenant improvements may cut into profits

· Highly dependent on market conditions

· Vacancies tend to be long

Honorable Mentions

Smaller subsets of CRE are also worth mentioning because of recent investment trends. Here are a few other places to look if you need a little more market stability.

Mobile Home Parks

Mobile homes parks are a subset of multifamily. The big difference is the owner of a mobile home park is generally not responsible for the units themselves, just the property that each unit is located on.

Practically speaking, this means a lot less capital is needed to invest in a mobile home park and your regular maintenance is a lot simpler. Whereas apartment buildings and residential real estate need building maintenance and groundskeeping, mobile home parks only need groundskeeping and small infrastructure maintenance.

The market for mobile home parks as investment properties is not overcrowded with investors. It will likely be easier for you to find and purchase a property from an individual owner rather than an investment company or an LLC.

With mobile home parks, one of the biggest downfalls is the risk involved in finding a property to purchase. There's a lot that goes into the due diligence process. If, for example, you get a property in a poor location, it might be difficult for you to turn that property around for a decent ROI.

If you can find a property with no major defects in a solid location, mobile home parks are a fantastic investment with a high ROI compared to other multifamily assets.

Self-Storage Facilities

2020 was a turbulent year for many CRE markets, but self-storage came out as a clear winner through the chaos. This is a very resilient real estate type. When multifamily has supply issues, self-storage may experience growth.

As people move or downsize, they often need a place to store their things. When a transition is temporary, such as students waiting for university to open again, storage helps people to keep their stuff safe in a convenient location for the interim. It's a lot cheaper to pay a small self-storage fee than to pay for rent for months of non-use of a property.

Even in a bad market, self-storage has consistent returns. It's low maintenance, has minimal staffing, and can provide steady cash flow.

One of the main downsides to self-storage is the specific market conditions that make or break a property. You need a great location to get the best returns and no market can handle too much competition on this front. It's a fairly low volume real estate class, so you may have trouble getting in if you're not already connected.

Tenants can be problematic for self-storage as well. The nature of self-storage facilities means that your tenants will likely be short-term. Some may only rent for a month before moving their stuff out. You'll have a lot of people coming and going. Cash flow may be relatively stable, but it's not always a sure thing that you'll have new tenants walk through your doors when others leave.

Final Thoughts

Having been in the multi-family investment space for years now, my opinion is that multi-family is generally the safest option for commercial real estate investment. With the steady market demand, large and increasing numbers of rent-paying tenants, and lower capital requirements, you can get a great ROI.

The best way to lower your risk is to perform a thorough due diligence before you make any investments. If you get connected with the right group of experienced syndicators, or you find a viable property that aligns with your risk tolerance, you're more likely to get a better outcome than if you jump into a deal unprepared.

No real estate investment can ever be 100% safe, but by planning ahead and choosing the right type of real estate to invest in, you can successfully hedge yourself against a big portion of the risks.

About the Author

Ismael "Rey" Reyes has been actively investing in residential real estate since 2005 and has focused exclusively on multifamily since 2016. He has led MI Real Estate in investing in 11 multifamily properties in Alabama, Florida, and Tennessee, totaling 401 units, and valued at over $28 million. Rey also provides independent consulting to multifamily investors and is the international bestselling author of BLUF: The Bottom Line Up Front about Passively Investing in Multi-family Properties.