

Real Estate Investing

FOR

DUMMIES®

2ND EDITION

by Eric Tyson and Robert S. Griswold



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Introduction

Welcome to *Real Estate Investing For Dummies*, 2nd Edition! We're delighted to be your tour guides. Throughout this book, we emphasize three fundamental cornerstones that we believe to be true:

- ✔ Real estate is one of the three time-tested ways for people of varied economic means to build wealth (the others are stocks and small business). Over the long-term (decades), you should be able to make an annualized return of at least 8 to 10 percent per year investing in real estate.
- ✔ Investing in real estate isn't rocket science but does require doing your homework. If you're sloppy doing your legwork, you're more likely to end up with inferior properties or to overpay. Our book clearly explains how to buy the best properties at a fair (or even below-market value!) price. (Although we cover all types of properties, this book concentrates more on residential investment opportunities, which are more accessible and appropriate for nonexperts.)
- ✔ Although you should make money over the long-term investing in good real estate properties, you *can* lose money, especially in the short-term. Don't unrealistically expect real estate values to increase every year. As many folks experienced in the late-2000s, they don't! When you invest in real estate for the long-term, which is what we advocate and practice ourselves, the occasional price declines should be merely bumps on an otherwise fruitful journey.

How This Book Is Different

If you expect us (in infomercial-like fashion) to tell you how to become an overnight multimillionaire, this is definitely not the book for you. And please allow us to save you money, disappointment, and heartache by telling you that such hucksters are only enriching themselves through their grossly overpriced tapes and seminars.

Real Estate Investing For Dummies, 2nd Edition, covers tried and proven real estate investing strategies that real people, just like you, use to build wealth. Specifically, this book explains how to invest in single-family homes;

detached and attached condominiums; small apartments including duplexes, triplexes, and multiple-family residential properties up to 20 to 30 units; commercial properties, including office, industrial, and retail; and raw (undeveloped) land. We also cover indirect real estate investments such as real estate investment trusts (REITs) that you can purchase through the major stock exchanges or a real estate mutual fund.

We've always relied on tried-and-true methods of real estate investing and our core advice is as true today as it was before the real estate downturn in the late-2000s. Our book is an especially solid reference in a down economy and will help you position yourself for the rebound.

Unlike so many real estate book authors, we don't have an alternative agenda in writing this book. Many real estate investing books are nothing more than infomercials for high priced DVDs or seminars the author is selling. The objective of our book is to give you the best crash course in real estate investing so that if you choose to make investments in income-producing properties, you may do so wisely and confidently.

Here are some good reasons why we — Eric Tyson and Robert Griswold — are a dynamic duo on your side:

Robert Griswold has extensive hands-on experience as a real estate investor who has worked with properties of all types and sizes. He is also the author of *Property Management Kit For Dummies* (Wiley) and is the author of two popular syndicated real estate newspaper columns. He has appeared for over 15 years as the NBC-TV on-air real estate expert for Southern California. And for nearly 15 years, he was the host of the most popular and longest running real estate radio show in the country — *Real Estate Today! with Robert Griswold* on Clear Channel Communications.

Robert also holds the titles Counselor of Real Estate (CRE), Certified Commercial Investment Member (CCIM), Professional Community Association Manager (PCAM), and Certified Property Manager (CPM) designations. He earned a bachelor's degree and two master's degrees in real estate and related fields from the University of Southern California's Marshall School of Business.

Eric Tyson is a former financial counselor, lecturer, and coauthor of the national bestseller *Home Buying For Dummies* (Wiley), as well as the author or coauthor of four other bestselling books in the *For Dummies* series: *Personal Finance*; *Investing*; *Mutual Funds*; and *Taxes*.

Eric has counseled thousands of clients on a variety of personal finance, investment, and real estate quandaries and questions. A former management consultant to Fortune 500 financial service firms, Eric is dedicated to teaching

people to better manage their personal finances. Over the past 25 years, he has successfully invested in real estate and securities and started and managed several businesses. He earned an MBA at the Stanford Graduate School of Business and a bachelor's degree in economics at Yale.

Foolish Assumptions

Whenever an author sits down to write a book, he has a particular audience in mind. Because of this, he must make some assumptions about who his reader is and what that reader is looking for. Here are a few assumptions we've made about you:

- ✔ You're looking for a way to invest in real estate but don't know what types of properties and strategies are best.
- ✔ You're considering buying an investment property, be it a single-family home, a small apartment complex, or an office building, but your real estate experience is largely limited to renting an apartment or owning your own home.
- ✔ You may have a small amount of money already invested in real estate, but you're ready to go after bigger, better properties.
- ✔ You're looking for a way to diversify your investment portfolio.

If any of these descriptions hit home for you, you've come to the right place.

How This Book Is Organized

We've organized *Real Estate Investing For Dummies*, 2nd Edition, into five parts. Here's what you find in each:

Part I: Stacking Real Estate Up Against Other Investments

In this part, we explain how real estate compares with other common investments, how to determine whether you've got what it takes to succeed as a real estate investor, how much money you need to invest in various types of real estate, and the tax advantages of real estate. We also cover how to fit real estate investments into your overall financial and personal plans.

We discuss the range of real estate investments available to you — not only common ones (such as single-family homes and small apartments) but also the more unusual (such as foreclosures and probate sales). An entire chapter is devoted to passive real estate investments, including real estate investment trusts, tenants in common, triple net properties, notes and trust deeds, limited partnerships, and tax lien certificate sales. We also cover the allure of property flipping and buying with no or little money down. Finally, you want to work with the best professionals that you can, so we also detail how to interview and secure top agents, lawyers, and other real estate pros.

Part II: How to Get the Money: Raising Capital and Financing

You can't play if you can't pay. This part details how and where to come up with the dough you need to buy property. We also explain the common loans available through lenders and how you may be able to finance your real estate investment through the seller of the property. Finally, we share all of our favorite strategies for finding and negotiating the best deals when you need a mortgage.

Part III: Finding and Evaluating Properties

This section gets down to the brass tacks of helping you decide where and what to buy. We explain how to value and evaluate real estate investment properties: From choosing the best locations to projecting a property's cash flow, we have you covered. Finally, we walk you through the negotiation process, plus all of the ins and outs of purchase agreements, inspections, and closing on your purchase.

Part IV: Operating the Property

After you own a property, you have lots of opportunities to improve its value and manage it well. For starters, this important part covers how to be a landlording genius, find and keep the best tenants, and sign solid lease contracts. We also reveal many proven methods for boosting (legally, of course) a property's return and value. We don't let tax headaches get you down as we walk you through how to account for the annual cash flow on your property and

how the tax advantages of depreciation allow you to legally pay lower taxes. Last but not least, we share strategies for deciding when and how to sell, including how to defer taxation on your sales' profits while expanding your real estate holdings if you so desire.

Part V: The Part of Tens

This part contains other important chapters that didn't fit neatly into the rest of this book. Topics that we cover in this section include ten steps to real estate success and ten ways to increase a property's return.

Appendix

This book is comprehensive, but it isn't a book of forms. The purchase and sale of real estate is complicated, and specific legal issues and practices vary throughout the country. We do include a purchase agreement in the appendix to illustrate some of the key points. However, we recommend that you contact local real estate professionals for the forms that are specifically drafted for your area.

Icons Used in This Book

Throughout this book, you can find friendly and useful icons to enhance your reading pleasure and to note specific types of information. Here's what each icon means:



This icon points out something that can save you time, headaches, money, or all of the above!



Here we're trying to direct you away from blunders and boo-boos that others have made when investing in real estate.



This icon alerts you to hucksters, biased advice, and other things that can really cost you big bucks.



Here we point out potentially interesting but nonessential (skippable) stuff.



We use this icon to highlight when you should look into something on your own or with the assistance of a local professional.



This icon flags concepts and facts that we want to ensure you remember as you make your real estate investments.

Where to Go from Here

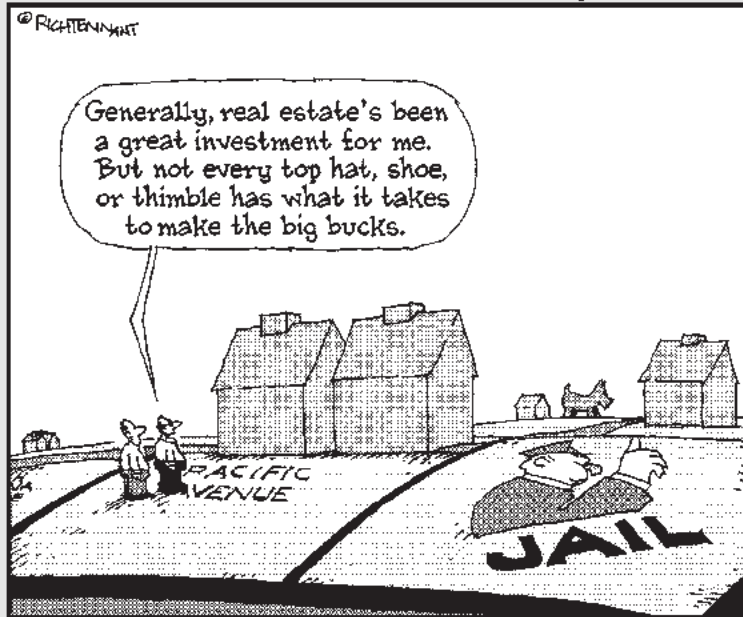
If you have the time and desire, we encourage you to read this book in its entirety. It provides you with a detailed picture of how to maximize your returns while minimizing your risks in the real estate market. But you may also choose to read selected portions. That's one of the great things (among many) about *For Dummies* books. You can readily pick and choose the information you read based on your individual needs.

Part I

Stacking Real Estate Up Against Other Investments

The 5th Wave

By Rich Tennant



In this part . . .

R real estate is just one of many available investment options, so in this part, we compare and contrast real estate investing with alternatives you may consider. We discuss the realities of investing in and managing rental properties (both the pros and the cons) and how to fit real estate into your overall personal financial plans. We also cover the gamut of real estate investments you have to choose from and how to begin to assemble a team of competent professionals to assist you with the process.

Chapter 1

Evaluating Real Estate as an Investment

In This Chapter

- ▶ Getting started
 - ▶ Contrasting real estate with other financial options
 - ▶ Deciding whether real estate is really for you
 - ▶ Arranging your overall investment and financial plans to include real estate
-

When Robert first entered the real estate field while attending college decades ago, his father, a retired real estate attorney, advised that he use his monthly income primarily to pay day-to-day living expenses and allocate money each month into long-term financial investments like real estate. This solid advice has served Robert well over the years.

It's never too early or too late to formulate your own plan into a comprehensive wealth-building strategy. For many, such a strategy can help with the challenges of funding future education for children and ensuring a comfortable retirement.

The challenge involved with real estate is that it takes some real planning to get started. Contacting an investment company and purchasing some shares of your favorite mutual fund or stock is a lot easier than acquiring your first rental property. Buying property isn't that difficult, though. You just need a financial and real estate investment plan, a lot of patience, and the willingness to do some hard work, and you're on your way to building your own real estate empire!

In this chapter, we give you some information that can help you decide whether you have what it takes to make money *and* be comfortable with investing in real estate. We compare real estate investments to other investments. We provide some questions you need to ask yourself before making any decisions. And finally, we offer guidance on how real estate investments can fit into your overall personal financial plans. Along the way, we share

our experience, insights, and thoughts on a long-term strategy for building wealth through real estate that virtually everyone can understand and actually achieve.

Understanding Real Estate's Income- and Wealth-Producing Potential



Compared with most other investments, good real estate can excel at producing current income for property owners. So in addition to the longer-term appreciation potential, you can also earn income year in and year out. Real estate is a true growth *and* income investment.



The vast majority of people who don't make money in real estate make easily avoidable mistakes, which we help you avoid.

The following list highlights the major benefits of investing in real estate:

✓ **Tax-deferred compounding of value:** In real estate investing, the appreciation of your properties compounds *tax-deferred* during your years of ownership. You don't pay tax on this profit until you sell your property — and even then you can roll over your gain into another investment property and avoid paying taxes. (See the “Tax advantages” section later in this chapter.)

✓ **Regular cash flow:** If you have property that you rent out, you have money coming in every month in the form of rents. Some properties, particularly larger multiunit complexes, may have some additional sources, such as from coin-operated washers and dryers.

When you own investment real estate, you should also expect to incur expenses that include your mortgage payment, property taxes, insurance, and maintenance. The interaction of the revenues coming in and the expenses going out is what tells you whether you realize positive operating profit each month.

✓ **Reduced income tax bills:** For income tax purposes, you also get to claim an expense that isn't really an out-of-pocket cost — depreciation. Depreciation enables you to reduce your current income tax bill and hence increase your cash flow from a property. (We explain this tax advantage and others later in the “Tax advantages” section.)

✓ **Rate of increase of rental income versus overall expenses:** Over time, your operating profit, which is subject to ordinary income tax, should rise as you increase your rental prices faster than the rate of increase for your property's overall expenses. What follows is a simple example to show why even modest rental increases are magnified into larger operating profits and healthy returns on investment over time.



Suppose that you're in the market to purchase a single-family home that you want to rent out and that such properties are selling for about \$200,000 in the area you've deemed to be a good investment. (**Note:** Housing prices vary widely across different areas but the following example should give you a relative sense of how a rental property's expenses and revenue change over time.) You expect to make a 20 percent down payment and take out a 30-year fixed rate mortgage at 6 percent for the remainder of the purchase price — \$160,000. Here are the details:

Monthly mortgage payment	\$960
Monthly property tax	\$200
Other monthly expenses (maintenance, insurance)	\$200
Monthly rent	\$1,400

In Table 1-1, we show you what happens with your investment over time. We assume that your rent and expenses (except for your mortgage payment, which is fixed) increase 3 percent annually and that your property appreciates a conservative 4 percent per year. (For simplification purposes, we ignore depreciation in this example. If we had included the benefit of depreciation, it would further enhance the calculated returns.)

Table 1-1 **How a Rental Property's Income and Wealth Build Over Time**

<i>Year</i>	<i>Monthly Rent</i>	<i>Monthly Expenses</i>	<i>Property Value</i>	<i>Mortgage Balance</i>
0	\$1,400	\$1,360	\$200,000	\$160,000
5	\$1,623	\$1,424	\$243,330	\$148,960
10	\$1,881	\$1,498	\$296,050	\$133,920
20	\$2,529	\$1,682	\$438,225	\$86,400
30	\$3,398	\$1,931	\$648,680	\$0
31	\$3,500	\$1,000	\$674,625	\$0

Now, notice what happens over time. When you first buy the property, the monthly rent and the monthly expenses are about equal. By year five, the monthly income exceeds the expenses by about \$200 per month. Consider why this happens — your largest monthly expense, the mortgage payment, doesn't increase. So, even though we assume that the rent increases just 3 percent per year, which is the same rate of increase assumed for your non-mortgage expenses, the compounding of rental inflation begins to produce larger and larger cash flow to you, the property owner. Cash flow of \$200 per month may not sound like much, but consider that this \$2,400 annual income is from an original \$40,000 investment. Thus, by year five, your rental property

is producing a 6 percent return on your down payment. (And remember, if you factor in the tax deduction for depreciation, your cash flow and return are even higher.)

In addition to the monthly cash flow from the amount that the rent exceeds the property's expenses, also look at the last two columns in Table 1-1 to see what has happened by year five to your *equity* (the difference between market value and mortgage) in the property. With just a 4 percent annual increase in market value, your \$40,000 in equity (the down payment) has more than doubled to \$94,370 (\$243,330 – \$148,960).

By years 10 and 20, you can see the further increases in your monthly cash flow and significant expansion in your property's equity. By year 30, the property is producing more than \$1,400 per month cash flow and you're now the proud owner of a mortgage-free property worth more than triple what you paid for it!

After you get the mortgage paid off in year 30, take a look at what happens to your monthly expenses (big drop) and therefore your cash flow in year 31 and beyond (big increase).

Recognizing the Caveats of Real-Estate Investing

Despite all its potential, real-estate investing isn't lucrative at all times and for all people — here's a quick outline of the biggest caveats that accompany investing in real estate:



- ✓ **Few home runs:** Your likely returns from real estate won't approach the home runs that the most accomplished entrepreneurs achieve in the business world.
- ✓ **Upfront operating profit challenges:** Unless you make a large down payment, your monthly operating profit may be small or nonexistent in the early years of rental property ownership. During soft periods in the local economy, rents may rise more slowly than your expenses or even fall. That's why you must ensure that you can weather financially tough times. In the worst cases, we've seen rental property owners lose both their investment property and their homes. Please see the section "Fitting Real Estate into Your Financial Plans" later in this chapter.

- ✔ **Ups and downs:** You're not going to earn an 8 to 10 percent return every year. Although you have the potential for significant profits, owning real estate isn't like owning a printing press at the U.S. Treasury. Like stocks and other types of ownership investments, real estate goes through down as well as up periods. Most people who make money investing in real estate do so because they invest and hold property over many years.
- ✔ **Relatively high transaction costs:** If you buy a property and then want out a year or two later, you may find that even though it has appreciated in value, much (if not all) of your profit has been wiped away by the high transaction costs. Typically, the costs of buying and selling — which include real estate agent commissions, loan fees, title insurance, and other closing costs — amount to about 15 percent of the purchase price of a property. So, although you may be elated if your property appreciates 15 percent in value in short order, you may not be so thrilled to realize that if you sell the property, you may not have any greater return than if you had stashed your money in a lowly bank account.
- ✔ **Tax implications:** Last, but not least, when you make a profit on your real estate investment, the federal and state governments are waiting with open hands for their share. Throughout this book, we highlight ways to improve your after-tax returns. As we stress more than once, the profit you have left after Uncle Sam takes his bite (not your pretax income) is all that really matters.

These drawbacks shouldn't keep you from exploring real estate investing as an option; rather, they simply reinforce the need to really know what you're getting into with this type of investing and whether it's a good match for you. The rest of this chapter takes you deeper into an assessment of real estate as an investment as well as introspection about your goals, interests, and abilities.

Comparing Real Estate to Other Investments

Surely you've considered or heard about many different investments over the years. To help you appreciate and understand the unique characteristics of real estate, we compare and contrast real estate's attributes with those of other wealth building investments like stocks and small business.

How leverage affects your real estate returns

Real estate is different from most other investments in that you can typically borrow (finance) up to 70 to 80 percent or more of the value of the property. Thus, you can use your small down payment of 20 to 30 percent of the purchase price to buy, own, and control a much larger investment. (During market downturns, lenders tighten requirements and may require larger down payments than they do during good times.) So when your real estate increases in value (which is what you hope and expect), you make money on your investment as well as on the money that you borrowed. That's what we mean when we say that the investment returns from real estate get magnified due to *leverage*.

Take a look at this simple example. Suppose you purchase a property for \$150,000 and make a \$30,000 down payment. Over the next three years, imagine that the property appreciates 10 percent to \$165,000. Thus, you have a profit (on paper) of \$15,000 (\$165,000 – \$150,000) on

an investment of just \$30,000. In other words, you've made a 50 percent return on your investment. (**Note:** We ignore *cash flow* — whether your expenses from the property exceed the rental income that you collect or vice versa, and the tax benefits associated with rental real estate.)

Remember, leverage magnifies all of your returns, and those returns aren't always positive! If your \$150,000 property decreases in value to \$135,000, even though it has only dropped 10 percent in value, you actually lose (on paper) 50 percent of your original \$30,000 investment. (In case you care, and it's okay if you don't, some wonks apply the terms *positive leverage* and *negative leverage*.) Please see the "Understanding Real Estate's Income- and Wealth-Producing Potential" section earlier in this chapter for a more detailed example of investment property profit and return.

Returns

Clearly, a major reason that many people invest in real estate is for the healthy total *returns* (which include ongoing profits and the appreciation of the property). Real estate generates robust long-term returns because, like stocks and small business, it's an *ownership investment*. By that, we mean that real estate is an asset that has the ability to produce income *and* profits.

Our research and experience suggest that total real estate investment returns are comparable to those from stocks — about 8 to 10 percent annually. Interestingly, the average annual return on real estate investment trusts (REITs), publicly traded companies that invest in income producing real estate such as apartment buildings, office complexes, and shopping centers has been about 10 percent. See our discussion of REITs in Chapter 4.

And you can earn returns better than 10 percent per year if you select excellent properties in the best areas and manage them well.

Risk

Real estate doesn't always rise in value — witness the decline occurring in most parts of the U.S. during the late 2000s. That said, market values for real estate don't generally suffer from as much volatility as stock prices do. You may recall how the excitement surrounding the mushrooming of technology and Internet stock prices in the late 1990s turned into the dismay and agony of those same sectors' stock prices crashing in the early 2000s. Many stocks in this industry, including those of leaders in their niches, saw their stock prices plummet by 80 percent, 90 percent, or more.

Keep in mind (especially if you tend to be concerned about shorter-term risks) that real estate can suffer from declines of 10 percent, 20 percent, or more. If you make a down payment of say, 20 percent, and want to sell your property after a 10 to 15 percent price decline, you may find that all (as in 100 percent) of your invested dollars (down payment) are wiped out after you factor in transaction costs. So you can lose everything.



You can greatly reduce and minimize your risk investing in real estate through buying and holding property for many years (seven to ten or more).

Liquidity

Liquidity — the ease and cost with which you can sell and get your money out of an investment — is one of real estate's shortcomings. Real estate is relatively *illiquid*: You can't sell a piece of property with the same speed with which you whip out your ATM card and withdraw money from your bank account or sell a stock with a phone call or click of your computer's mouse.

We actually view this illiquidity as a strength, certainly compared with stocks that people often trade in and out of because doing so is so easy and seemingly cheap. As a result, many stock market investors tend to lose sight of the long-term and miss out on the bigger gains that accrue to patient buy-and-stick-with-it investors. Because you can't track the value of investment real estate daily on your computer, and because real estate takes considerable time, energy, and money to sell, you're far more likely to buy and hold onto your properties for the longer-term.

Although real estate investments are generally less liquid than stocks, they're generally more liquid than investments made in your own or someone else's small business. People need a place to live and businesses need a place to operate, so there's always demand for real estate (although the supply of such properties can greatly exceed the demand in some areas during certain time periods).

Capital requirements

Although you can easily get started with traditional investments such as stocks and mutual funds with a few hundred or thousand dollars, the vast majority of quality real estate investments require far greater investments — usually on the order of tens of thousands of dollars. (We devote an entire part of this book — Part II, to be precise — to showing you how to raise capital and secure financing.)



If you're one of the many people who don't have that kind of money burning a hole in your pocket, don't despair. We present you with lower cost real estate investment options. Among the simplest low-cost real estate investment options are real estate investment trusts (REITs). You can buy these as exchange traded stocks or invest in a portfolio of REITs through an REIT mutual fund (see Chapter 4).

Diversification value

An advantage of holding investment real estate is that its value doesn't necessarily move in tandem with other investments, such as stocks or small-business investments that you hold. You may recall, for example, the massive stock market decline in the early 2000s. In most communities around America, real estate values were either steady or actually rising during this horrendous period for stock prices.

However, real estate prices and stock prices, for example, *can* move down together in value (as happened in most parts of the country during the 2007–2008 stock market slide). Sluggish business conditions and lower corporate profits can depress stock and real estate prices.

Opportunities to add value

Although you may not know much about investing in the stock market, you may have some good ideas about how to improve a property and make it more valuable. You can fix up a property or develop it further and raise the rental income accordingly. Perhaps through legwork, persistence, and good negotiating skills, you can purchase a property below its fair market value.

Relative to investing in the stock market, persistent and savvy real estate investors can more easily buy property in the private real estate market at below fair market value. You can do the same in the stock market, but the scores of professional, full-time money managers who analyze the public market for stocks make finding bargains more difficult. We help you identify properties that you can add value to in Part III.

Tax advantages

Real estate investment offers numerous tax advantages. In this section, we compare and contrast investment property tax issues with those of other investments.

Deductible expenses (including depreciation)

Owning a property has much in common with owning your own small business. Every year, you account for your income and expenses on a tax return. (We cover all the taxing points about investment properties in Chapter 18.) For now, we want to remind you to keep good records of your expenses in purchasing and operating rental real estate. (Check out Chapter 17 for more information on all things accounting.) One expense that you get to deduct for rental real estate on your tax return — depreciation — doesn't actually involve spending or outlaying money. *Depreciation* is an allowable tax deduction for buildings, because structures wear out over time. Under current tax laws, residential real estate is depreciated over 27½ years (commercial buildings are depreciated over 39 years). Residential real estate is depreciated over shorter time periods because it has traditionally been a favored investment in our nation's tax laws.

Tax-free rollovers of rental property profits

When you sell a stock or mutual fund investment that you hold outside a retirement account, you must pay tax on your profits. By contrast, you can avoid paying tax on your profit when you sell a rental property if you roll over your gain into another like-kind investment real estate property.

The rules for properly making one of these 1031 exchanges are complex and usually involve third parties. We cover 1031 exchanges in Chapter 18. Make sure that you find an attorney and/or tax advisor who is an expert at these transactions to ensure that everything goes smoothly (and legally).

If you don't roll over your gain, you may owe significant taxes because of how the IRS defines your gain. For example, if you buy a property for \$200,000 and sell it for \$550,000, you not only owe tax on that difference, but you also owe tax on an additional amount, depending on the property's depreciation. The amount of depreciation that you deduct on your tax returns reduces the original \$200,000 purchase price, making the taxable difference that much larger. For example, if you deducted \$125,000 for depreciation over the years that you owned the property, you owe tax on the difference between the sale price of \$550,000 and \$75,000 (\$200,000 purchase price – \$125,000 depreciation).

Deferred taxes with installment sales

Installment sales are a complex method that can be used to defer your tax bill when you sell an investment property at a profit and you don't buy another rental property. With such a sale, you play the role of banker and provide

financing to the buyer. In addition to collecting a competitive interest rate from the seller, you only have to pay capital gains tax as you receive proceeds over time from the sale. For details, please see Chapter 18.

Special tax credits for low-income housing and old buildings

If you invest in and upgrade low-income housing or certified historic buildings, you can gain special tax credits. The credits represent a direct reduction in your tax bill from expenditures to rehabilitate and improve such properties. These tax credits exist to encourage investors to invest in and fix up old or run-down buildings that likely would continue to deteriorate otherwise. The IRS has strict rules governing what types of properties qualify. See IRS Form 3468 to discover more about these credits.

Determining Whether You Should Invest in Real Estate

We believe that most people can succeed at investing in real estate if they're willing to do their homework, which includes selecting top real estate professionals. In the sections that follow, we ask several important questions to help you decide whether you have what it takes to succeed and be happy with real estate investments that involve managing property.

Do you have sufficient time?

Purchasing and owning investment real estate and being a landlord is time consuming. If you fail to do your homework before purchasing property, you can end up overpaying or buying real estate with a mess of problems. Finding competent and ethical real estate professionals takes time. (We guide you through the process in Chapter 6.) Investigating communities, neighborhoods, and zoning also soaks up plenty of hours (information on performing this research is located in Chapter 10), as does examining tenant issues with potential properties (see Chapter 11).

As for managing a property, you can hire a property manager to interview tenants and solve problems such as leaky faucets and broken appliances, but doing so costs money and still requires some of your time.



If you're stretched too thin due to work and family responsibilities, real estate investing may not be for you. You may want to look into the less time-intensive real estate investments discussed in Chapters 3 and 4.

Can you deal with problems?

Challenges and problems inevitably occur when you try to buy a property. Purchase negotiations can be stressful and frustrating. You can also count on some problems coming up when you own and manage investment real estate. Most tenants won't care for a property the way property owners do.

If every little problem (especially those that you think may have been caused by your tenants) causes you distress, at a minimum, you should only own rental property with the assistance of a property manager. You should also question whether you're really going to be happy owning investment property. The financial rewards come well down the road, but you live the day-to-day ownership headaches immediately.

Does real estate interest you?

In our experience, some of the best real estate investors have a curiosity and interest in real estate. If you don't already possess it, such an interest and curiosity *can* be cultivated — and this book may just do the trick.

On the other hand, some people simply aren't comfortable investing in rental property. For example, if you've had experience and success with stock market investing, you may be uncomfortable venturing into real estate investments. Some people we know are on a mission to start their own business and may prefer to channel the time and money into that outlet.

Can you handle market downturns?

Real estate investing isn't for the faint of heart. Buying and holding real estate is a whole lot of fun when prices and rents are rising. But market downturns happen, and they test you emotionally as well as financially.

Consider the real estate market price declines that happened in most communities and types of property in the late 2000s. Such drops can present attractive buying opportunities for those with courage and cash.

None of us has a crystal ball though so don't expect to be able to buy at the precise bottom of prices and sell at the precise peak of your local market. Even if you make a smart buy now, you'll inevitably end up holding some of your investment property during a difficult market (recessions where you have trouble finding and retaining quality tenants, where rents may fall rather than rise, where your property falls in value). Do you have the financial wherewithal to handle such a downturn? How have you handled other investments when their values have fallen?

Fitting Real Estate into Your Financial Plans

For most nonwealthy people, purchasing investment real estate has a major impact on their overall personal financial situation. So, before you go out to buy property, you should inventory your money life and be sure your fiscal house is in order. This section explains how you can do just that.

Ensure your best personal financial health

If you're trying to improve your physical fitness by exercising, you may find that eating lots of junk food and smoking are barriers to your goal. Likewise, investing in real estate or other growth investments such as stocks while you're carrying high-cost consumer debt (credit cards, auto loans, and so on) and spending more than you earn impedes your financial goals.



Before you set out to invest in real estate, pay off all your consumer debt. Not only will you be financially healthier for doing so, but you'll also enhance your future mortgage applications.

Eliminate wasteful and unnecessary spending; analyze your monthly spending to identify target areas for reduction. This practice enables you to save more and better afford making investments including real estate. Live below your means. As Charles Dickens said, "Annual income twenty pounds; annual expenditures nineteen pounds; result, happiness. Annual income twenty pounds; annual expenditure twenty pounds; result, misery."

Protect yourself with insurance

Regardless of your real estate investment desires and decisions, you absolutely must have comprehensive insurance for yourself and your major assets, including

- ✓ **Health insurance:** Major medical coverage protects you from financial ruin if you have a big accident or illness that requires significant hospital and other medical care.
- ✓ **Disability insurance:** For most working people, their biggest asset is their future income-earning ability. Disability insurance replaces a portion of your employment earnings if you're unable to work for an extended period of time due to an incapacitating illness or injury.

- ✔ **Life insurance:** If loved ones are financially dependent upon you, term life insurance, which provides a lump sum death benefit, can help to replace your employment earnings if you pass away.
- ✔ **Homeowner's insurance:** Not only do you want homeowner's insurance to protect you against the financial cost due to a fire or other home-damaging catastrophe, but such coverage also provides you with liability protection. (After you buy and operate a rental property with tenants, you should obtain rental owner's insurance. See Chapter 16 for more information).
- ✔ **Auto insurance:** This coverage is similar to homeowner's coverage in that it insures a valuable asset and also provides liability insurance should you be involved in an accident.
- ✔ **Excess liability (umbrella) insurance:** This relatively inexpensive coverage, available in million dollar increments, adds on to the modest liability protection offered on your home and autos, which is inadequate for more-affluent people.

Nobody enjoys spending hard-earned money on insurance. However, having proper protection gives you peace of mind and financial security, so don't put off reviewing and securing needed policies. For assistance, see the latest edition of Eric's *Personal Finance For Dummies* (Wiley).

Consider retirement account funding

If you're not taking advantage of your retirement accounts (such as 401(k)s, 403(b)s, SEP-IRAs, and Keoghs), you may be missing out on some terrific tax benefits. Funding retirement accounts gives you an immediate tax deduction when you contribute to them. And some employer accounts offer "free" matching money — but you've got to contribute to earn the matching money.

In comparison, you derive no tax benefits while you accumulate your down payment for an investment real estate purchase (or other investment such as for a small business). Furthermore, the operating profit or income from your real estate investment is subject to ordinary income taxes as you earn it. To be fair and balanced, we must mention here that investment real estate offers numerous tax benefits, which we detail in the "Tax advantages" section earlier in this chapter.

Think about asset allocation

With money that you invest for the longer-term, you should have an overall game plan in mind. Fancy-talking financial advisors like to use buzzwords such as *asset allocation*, a term that indicates what portion of your money

you have invested in different types of investment vehicles, such as stocks and real estate (for growth) or lending vehicles, such as bonds and CDs (which produce current income).



Here's a simple way to calculate asset allocation: Subtract your age from 110. The result is the percentage of your long-term money that you should invest in ownership investments for appreciation. So, for example, a 40-year-old would take 110 minus 40 equals 70 percent in growth investments such as stocks and real estate. If you want to be more aggressive, subtract your age from 120; a 40-year-old would then have 80 percent in growth investments.

As you gain more knowledge, assets, and diversification of growth assets, you're in a better position to take on more risk. Just be sure you're properly covered with insurance as discussed earlier in the section "Protect yourself with insurance."



These are simply guidelines, not hard-and-fast rules or mandates. If you want to be more aggressive and are comfortable taking on greater risk, you can invest higher portions in ownership investments.

As you consider asset allocation, when classifying your investments, determine and use your *equity* in your real estate holdings, which is the market value of property less outstanding mortgages. For example, suppose that prior to buying an investment property, your long-term investments consist of the following:

Stocks	\$150,000
Bonds	\$50,000
CDs	\$50,000
Total	\$250,000

So, you have 60 percent in ownership investments (\$150,000) and 40 percent in lending investments (\$50,000 + \$50,000). Now, suppose you plan to purchase a \$300,000 income property making a \$75,000 down payment. Because you've decided to bump up your ownership investment portion to make your money grow more over the years, you plan to use your maturing CD balance and sell some of your bonds for the down payment. After your real estate purchase, here's how your investment portfolio looks:

Stocks	\$150,000
Real estate	\$75,000 (\$300,000 property – \$225,000 mortgage)
Bonds	\$25,000
Total	\$250,000

Become your own landlord

Many real estate investors are actually involved in other activities as their primary source of income. Ironically, many of these business owners come to realize the benefits of real estate investing but miss the single greatest opportunity that is right before their eyes — the

prospect of being their own landlord. Robert has advised many business owners that they should purchase the buildings occupied by their own businesses and essentially pay the rent to themselves. If you own a business that rents, do yourself a favor — become your own landlord!

Thus, after the real estate purchase, you've got 90 percent in ownership investments (\$150,000 + \$75,000) and just 10 percent in lending investments (\$25,000). Such a mix may be appropriate for someone under the age of 50 who desires an aggressive investment portfolio positioned for long-term growth potential.

Chapter 2

Covering Common Real Estate Investments

In This Chapter:

- ▶ Keeping your investments close to home
 - ▶ Looking at residential properties
 - ▶ Getting to know commercial real estate
 - ▶ Studying undeveloped land
-

If you lack substantial experience investing in real estate, you should avoid more esoteric and complicated properties and strategies. In this chapter, we discuss the more accessible and easy-to-master income-producing property options. In particular, *residential income property*, which we discuss in the next section, can be an attractive real estate investment for many people. Residential housing is easier to understand, purchase, and manage than most other types of property, such as office, industrial, and retail property. If you're a homeowner, you already have experience locating, purchasing, and maintaining residential property.

In addition to discussing the pros and cons of investing in residential income property, we add insights as to which may be the most appropriate and profitable for you and touch on the topics of investing in commercial property as well as undeveloped land.

The Various Ways to Invest in Residential Income Property

The first (and one of the best) real estate investments for many people is a home in which to live. In this section, we cover the investment possibilities inherent in buying a home for your own use, including potential profit to be had from converting your home to a rental or fixing it up and selling it. We also give you some pointers on how to profit from owning your own vacation home.

Buying a place of your own

During your adult life, you're going to need a roof over your head for many decades. And real estate is the only investment that you can live in or rent out to produce income. A stock, bond, or mutual fund doesn't work too well as a roof over your head!



Unless you expect to move within the next few years, buying a place probably makes good long-term financial sense. (Even if you need to relocate, you may decide to continue owning the property and use it as a rental property.) Owning usually costs less than renting over the long haul and allows you to build *equity* (the difference between market value and mortgage loans against the property) in an asset.

Under current tax law, you can also pocket substantial tax-free profits when you sell your home for more than you originally paid plus the money you sunk into improvements during your ownership. Specifically, single taxpayers can realize up to a \$250,000 tax-free capital gain; married couples filing jointly get up to \$500,000. In order to qualify for this homeowner's *gains tax exemption*, you (or your spouse if you're married) must have owned the home and used it as your primary residence for a minimum of 24 months out of the past 60 months. The 24 months doesn't have to be continuous. Additionally, the IRS now provides for pro-rata (proportionate) credit based on hardship or change of employment. Also note that the full exemption amounts are reduced proportionately for the length of time you rented out your home over the five-year period referenced above.

Some commentators have stated that your home isn't an investment, because you're not renting it out. We respectfully disagree: Consider the fact that many people move to a less costly home when they retire (because it's smaller and/or because it's in a lower cost area). Trading down to a lower priced property in retirement frees up equity that has built up over many years of homeownership. This money can be used to supplement your retirement income and for any other purpose your heart desires. Your home is an investment because it can appreciate in value over the years, and you can use that money toward your financial or personal goals. *Home Buying For Dummies* (Wiley), which Eric cowrote with residential real estate expert Ray Brown, can help you make terrific home buying decisions.

Converting your home to a rental

Turning your current home into a rental property when you move is a simple way to buy and own more properties. This approach is an option if you're already considering investing in real estate (either now or in the future), and

you can afford to own two properties. Holding onto your current home when you're buying a new one is more advisable if you're moving within the same area so that you're close by to manage the property. This approach presents a number of positives:

- ✔ You save the time and cost of finding a separate rental property, not to mention the associated transaction costs.
- ✔ You know the property and have probably taken good care of it and perhaps made some improvements.
- ✔ You know the target market because the house appealed to you.



Some people unfortunately make the mistake of holding onto their current home for the wrong reasons when they buy another. This situation often happens when homeowners must sell their homes in a depressed market. Nobody likes to lose money and sell their home for less than they paid for it. Thus, some owners hold onto their homes until prices recover. If you plan to move and want to keep your current home as a long-term investment (rental) property, you can. If you fully convert your home to rental property and use it that way for years before selling it, after you do sell you can either take advantage of the lower long-term capital gains rates or do a tax deferred exchange. For tax purposes, you get to deduct depreciation and all of the write-offs during the ownership and you can shelter up to \$25,000 in income from active sources subject to income eligibility requirements. (Please see Chapter 18 for more details.)

Turning your home into a *short-term* rental, however, is usually a bad move because:

- ✔ You may not want the responsibilities of being a landlord, yet you force yourself into the landlord business when you convert your home into a rental.
- ✔ You owe tax on the sales' profit if your property is classified for tax purposes as a rental when you sell it and don't buy another rental property. (You can purchase another rental property through a 1031 exchange to defer paying taxes on your profit. See the discussion in Chapter 18.)

Effective tax year 2009, you lose some of the capital gains tax exclusion if you sell your home and you had rented it out for a portion of the five year period prior to selling it. For example, if you rented your home for two of the last five years, you may only exclude 60 percent of your gain (up to the maximums of \$250,000 for single taxpayers and \$500,000 for married couples filing jointly), whereas the other 40 percent is taxed as a long-term capital gain. Also be aware that when you sell a home previously rented and are accounting for the sale on your tax return, you have to recapture the depreciation taken during the rental period.

Investing and living in well-situated fixer-uppers

Serial home selling is a variation on the tried-and-true real estate investment strategy of investing in well-located fixer-upper homes where you can invest your time, sweat equity, and materials to make improvements that add more value than they cost. The only catch is that you must actually move into the fixer-upper for at least 24 months to earn the full homeowner's capital gains exemption of up to \$250,000 for single taxpayers and \$500,000 for married couples filing jointly (as we cover in the "Buying a place of your own" section earlier in this chapter).



Be sure to buy a home in need of that special TLC in a great neighborhood where you're willing to live for 24 months! But if you're a savvy investor, you would've invested in a great neighborhood anyway.

Here's a simple example to illustrate the potentially significant benefits of this strategy. You purchase a fixer-upper for \$275,000 that becomes your principal residence, and then over the next 24 months you invest \$25,000 in improvements (paint, landscaping, appliances, decorator items, and so on) and you also invest the amount of sweat equity that suits your skills and wallet. You now have one of the nicer homes in the neighborhood, and you can sell this home for a net price of \$400,000 after your transaction costs. With your total investment of \$300,000 (\$275,000 plus \$25,000), your efforts have earned you a \$100,000 profit completely tax-free. Thus, you've earned an average of \$50,000 per year, which isn't bad for a tax-exempt second income without strict office hours. (Note that many states also allow you to avoid state income taxes on the sale of your personal residence, using many of the same requirements as the federal tax laws.)



Now, some cautions are in order here. This strategy is clearly not for everyone interested in making money from real estate investments. We recommend that you bypass this strategy if any of the following apply:

- ✔ You're unwilling or reluctant to live through redecorating, minor remodeling, or major construction.
- ✔ You dislike having to move every few years.
- ✔ You're not experienced or comfortable with identifying undervalued property and improving it.
- ✔ You lack a financial cushion to withstand a significant downturn in your local real estate market as happened in numerous parts of the country during the mid- to late-2000s.
- ✔ You don't have the budget to hire a professional contractor to do the work, and you don't have the free time or the home improvement skills needed to enhance the value of a home.



One final caution: Beware of transaction costs. The expenses involved with buying and selling property — such as real estate agent commissions, loan fees, title insurance, and so forth — can gobble up a large portion of your profits. With most properties, the long-term appreciation is what drives your returns. Consider keeping homes you buy and improve as long-term investment properties.

Purchasing a vacation home

Many people of means expand their real estate holdings by purchasing a *vacation home* — a home in an area where they enjoy taking pleasure trips. For most people, buying a vacation home is more of a consumption decision than it is an investment decision. That's not to say that you can't make a profit from owning a second home. However, potential investment returns shouldn't be the main reason you buy a second home.

For example, we know a family that lived in Pennsylvania and didn't particularly like the hot and humid summer weather. They enjoyed taking trips and staying in various spots in northern New England and eventually bought a small home in New Hampshire. Their situation highlights the pros and cons that many people face with vacation or second homes. The obvious advantage this family enjoyed in having a vacation home is that they no longer had the hassle of securing accommodations when they wanted to enjoy some downtime. Also, after they arrived at their home away from home, they were, well, home! Things were just as they expected — with no surprises, unless squirrels had taken up residence on their porch.



The downsides to vacation homes can be numerous, as our Pennsylvania friends found, including

- ✔ **Expenses:** With a second home, you have the range of nearly all of the costs of a primary home — mortgage interest, property taxes, insurance, maintenance, utilities, and so on.
- ✔ **Property management:** When you're not at your vacation home, things can go wrong. A pipe can burst, for example, and the mess may not be found for days or weeks. Unless the property is close to a kind person willing to keep an eye on it for you, you may incur the additional expense of paying a property manager to watch the property for you.
- ✔ **Lack of rental income:** Most people don't rent out their vacation homes, thus negating the investment property income stream that contributes to the returns real estate investors enjoy (see Chapter 1). If your second home is in a vacation area where you have access to plenty of short-term renters, you or your designated property manager can rent out the property. However, this entails all of the headaches and hassles of having many short-term renters. (But you do gain the tax advantages of depreciation and all expenses as with other rental properties.)



- ✔ **Obligation to use:** Some second homeowners we know complain about feeling forced to use their vacation homes. Oftentimes in marriages, one spouse likes the vacation home much more than the other spouse (or one spouse enjoys working on the second home rather than enjoying the home itself).

Before we close out this section on vacation homes, we want to share a few tax tips, as found in the current tax code:

- ✔ If you retain your vacation home or secondary home as personal property, forgoing the large income streams and tax write-offs for depreciation and operating expenses associated with rental properties, you can still make a nice little chunk of tax-free cash on the side. The current tax code permits you to rent the property for up to 14 days a year — and that income is *tax-free!* You don't have to claim it. Yes, you read that right. And you can still deduct the costs of ownership, including mortgage interest and property taxes, as you do for all other personal properties.
- ✔ If you decide to maintain the property as a rental (you rent it out for more than 14 days a year), you, as the property owner, can still use the rental property as a vacation home for up to 14 days a year, or a maximum of 10 percent of the days gainfully rented, whichever is greater, and the property still qualifies as a rental. Also, all days spent cleaning or repairing the rental home don't count as personal use days — so that's why you paint for a couple of hours every afternoon and spend the morning fishing!

Before you buy a second home, weigh all the pros and cons. If you have a spouse or partner with whom you're buying the property, have a candid discussion. Also consult with your tax advisor for other tax-saving strategies for your second home or vacation home. And please see Chapter 18 for more tax related information on rental properties.

Paying for condo hotels and timeshares

Timeshares, a concept created in the 1960s, are a form of ownership or right to use a property. A more recent trend in real estate investing is condo hotels, which in many ways are simply a new angle on the old concept of timeshares. A condo hotel looks and operates just like any other first-class hotel, with the difference that each room is separately owned. The guests have no idea who owns their room.

Both timeshares and condo hotels typically involve luxury resort locations with amenities such as golf or spas. The difference between the traditional timeshare and condo hotel is the interval that the unit is available — condo hotels are operated on a day-to-day availability, and timeshares typically rent in fixed intervals such as weeks.

Some of the most popular projects have been the branded condo hotels such as Ritz Carlton, Four Seasons, Trump, W, Westin, and Hilton located in the high profile vacation destinations like Hawaii, Las Vegas, New York, Chicago, and Miami. You can also find many foreign condo hotel properties in the Caribbean and Mexico, and the concept is expanding to Europe, the Middle East, and Asia.

Two types of individuals are attracted to investing in condo hotels and timeshares. One group is investors who believe that the property will appreciate like any other investment. The other group is people who use the condo hotel or timeshare for personal use and offset some of their costs.

From an investment standpoint, the fundamental problem with timeshares is that they're overpriced, and like a condominium, you own no land (which is what generally appreciates well over time). For example, suppose that a particular unit would cost \$150,000 to buy. When this unit is carved up into weekly ownership units, the total cost of all those units can easily approach four to five times that amount!

To add insult to injury, investors find that another problem with timeshares is the high maintenance or annual service fees. Is it worth buying a slice of real estate at a 400 to 500 percent premium to its fair market value and pay high fees on top of that? We don't think so.

Many owners of timeshares find that they want to vacation at a different location or time of year than what they originally purchased. To meet this need, several companies offer to broker or sell timeshare slots. However, timeshare availability and desirability have so many variables — including location, time of year, and quality of the particular resort — that it has been difficult to fairly value and trade timeshares. As a result, resort rating systems have been developed (Resorts Condominiums International and Interval International are two of the most well known) to compare resort location, amenities, and quality.

The developers and operators of condo hotels love the concept because one of the most consistently successful principles of real estate is increasing value by fractionalizing interests in real estate. As with timeshares, the developers are able to sell each individual hotel room for much more than they could get for the entire project.

Condo hotel operators are able to generate additional revenue from service and maintenance fees to cover their costs of operations. Often the owners' use of their own rooms doesn't negatively impact the overall revenues of the property because the rooms would have sometimes been vacant anyway. Condo hotels allow their owners to stay in their units but often impose limits on the amount of personal usage.

Still interested in a timeshare? Read on.

Timeshares are packaged in a multitude of ways — some resorts offer fixed units where you vacation at the exact same unit every year either on set dates or set numbered weeks (though the actual calendar date may vary). Some timeshares are available as *biennial* (every other year) so you can have some variety. Some offer fixed weeks, where you have the same week every year but may be in a different unit.

Timeshares aren't just a one-time purchase; they also have monthly or annual service or maintenance fees. These funds are established each year by the homeowner's association or resort management company. There are different types of ownership for timeshare interests, with fee simple, right of use, and leasehold being the primary options:

- ✔ **Fee simple** ownership is an estate in real estate that provides the absolute ownership subject to state and local laws and government powers such as taxation, eminent domain, police power, and so on.
- ✔ **Right-to-use** are occupancy rights for a given number of years but no actual ownership interest in the property. Some states and many foreign countries don't allow the fee simple ownership of timeshares so they offer long-term lease or right-to-use agreements that can be from 20 to 99 years. The actual fee simple title of the real estate remains with the resort developer or management company.

The day-to-day operations of timeshares are typically handled by the homeowner's association or a resort management company.

- ✔ **Leasehold** is an agreement between the lessee (tenant) and lessor (owner or landlord) specifying the lessee's right to use the leased property for a given purpose and given time at a specified rental payment.

If you're interested in buying a timeshare, you can talk with the developer directly; this method may make sense if you're looking for a particular time of the year in the high season. The timeshare industry typically uses a color-coded pricing system to denote the seasonal demand for a particular timeshare property. Although the concept is pretty consistent, the designation of particular colors can vary from one resort to another. In general, the demand is broken down into three categories:

- ✔ Red for the prime or high demand
- ✔ Yellow or white for intermediate or medium season
- ✔ Green or blue for off-season or low demand

If you're looking for a week in the green or blue season, you can often find much better pricing from reputable resellers. The *reputable* is a key and elusive term here. Among companies to consider for reselling timeshares are RCI, Interval International, and Trading Places International

The purchaser of the condo hotel unit sees this type of investment as an option to direct ownership of a second home and likes the ability to generate income. The professional management is another one of the attractions to investors. The owners don't pay a management fee to the hotel operator unless their room is rented, and then the collected revenue is split.

These properties are often hyped, and the expectations of the condo hotel investor are often much greater than the reality. Investors are lured to condo hotels by the potential for appreciation and cash flow as well as professional management. Many investors find themselves being pressured into pre-sale offering presentations even before the units are built. These events can be tempting, but savvy investors need to do their own due diligence. So when you hear a sales pitch indicating that your proposed investment in a condo hotel unit will provide significant income from hotel rentals and cover most or all of your mortgage and carrying costs, that's the time to grab your wallet and find the nearest exit.

Many investors' first experiences with timeshares are tempting offers of a free meal, a great discount offer to a theme park, or even a free one or two night stay at the resort, with the catch that they have to spend some time listening to an informational presentation. These offers usually come from individuals contacting you in known tourist locations or when you check into a hotel that just happens to offer condos as well. Robert remembers his first exposure to timeshares was as a child in the early '70s on a family vacation to Florida, when his parents got a free camera just for attending a seminar on timeshares near Orlando. Even as a teenager, Robert didn't like the obvious pressure sales tactics he observed.



However, timeshares may make sense for you if you like to vacation at the same resort around the same time every year and if the annual service or maintenance fees compare favorably to the cost of simply staying in a comparable resort. Remember, though, that if the deal seems too good to be true, it *is* too good to be true. As with timeshares, the only folks who generally make money with condo hotels are the developers, not the folks who buy specific days of ownership.

Surveying the Types of Residential Properties You Can Buy

If you've been in the market for a home, you know that in addition to single-family homes, you can choose from numerous types of attached or shared housing including apartment buildings, condominiums, townhomes, and co-operatives. In this section, we provide an overview of each of these properties and show how they may make an attractive real estate investment for you.



From an investment perspective, our top recommendations are apartment buildings and single-family homes. We generally don't recommend attached-housing units. If you can afford a smaller single-family home or apartment building rather than a shared-housing unit, buy the single-family home or apartments.



Unless you can afford a large down payment (25 percent or more), the early years of rental property ownership may financially challenge you: With all properties, as time goes on, generating a positive cash flow gets easier because your mortgage expense stays fixed (if you use fixed rate financing) while your rents increase faster than your expenses. Regardless of what you choose to buy, make sure that you run the numbers on your rental income and expenses (see Chapter 12) to see if you can afford the negative cash flow that often occurs in the early years of ownership.

Single-family homes



As an investment, single-family detached homes generally perform better in the long run than attached or shared housing. In a good real estate market, most housing appreciates, but single-family homes tend to outperform other housing types for the following reasons:

- ✓ Single-family homes tend to attract more potential buyers — most people, when they can afford it, prefer a detached or stand-alone home, especially for the increased privacy.
- ✓ Attached or shared housing is less expensive and easier to build *and to overbuild*; because of this surplus potential, such property tends to appreciate more moderately in price.



Because so many people prefer to live in detached, single-family homes, market prices for such dwellings can sometimes become inflated beyond what's justified by the rental income these homes can produce. That's exactly what happened in some parts of the United States in the mid-2000s and led in part to a significant price correction in the subsequent years. To discover whether you're buying in such a market, compare the monthly cost (after tax) of owning a home to monthly rent for that same property. Focus on markets where the rent exceeds or comes close to equaling the cost of owning and shun areas where the ownership costs exceed rents.

Single-family homes that require just one tenant are simpler to deal with than a multiunit apartment building that requires the management and maintenance of multiple renters and units. The downside, though, is that a vacancy means you have no income coming in. Look at the effect of 0 percent occupancy for a couple of months on your projected income and expense statement! By contrast, one vacancy in a four-unit apartment building (each with the same rents) means that you're still taking in 75 percent of the gross potential (maximum total) rent.

With a single-family home, you're responsible for all maintenance. You can hire someone to do the work, but you still have to find the contractors and coordinate and oversee the work. Also recognize that if you purchase a

single-family home with many fine features and amenities, you may find it more stressful and difficult to have tenants living in your property who don't treat it with the same tender loving care that you may yourself.



The first rule of being a successful landlord is to let go of any emotional attachment to a home. But that sort of attachment on the tenant's part is favorable: The more they make your rental property their home, the more likely they are to stay and return it to you in good condition — except for the expected normal wear and tear of day-to-day living. (We discuss the proper screening and selection of tenants in Chapter 15.)



Making a profit in the early years from the monthly cash flow with a single-family home is generally the hardest stage. The reason: Such properties usually sell at a premium price relative to the rent that they can command (you pay extra for the land, which you can't rent). Also remember that with just one tenant, you have no rental income when you have a vacancy.

Attached housing

As the cost of land has climbed over the decades in many areas, packing more housing units that are attached into a given plot of land keeps housing somewhat more affordable. Shared housing makes more sense for investors who don't want to deal with building maintenance and security issues.

In this section, we discuss the investment merits of three forms of attached housing: condominiums, townhomes, and co-ops.

Condos

Condominiums are typically apartment-style units stacked on top of and/or beside one another and sold to individual owners. When you purchase a condominium, you're actually purchasing the interior of a specific unit as well as a proportionate interest in the common areas — the pool, tennis courts, grounds, hallways, laundry room, and so on. Although you (and your tenants) have full use and enjoyment of the common areas, remember that the homeowner's association actually owns and maintains the common areas as well as the building structures themselves (which typically include the foundation, roof, plumbing, electrical, and other building systems).

One advantage to a condo as an investment property is that of all the attached housing options, condos are generally the lowest-maintenance properties because most condominium associations deal with issues such as roofing, gardening, and so on for the entire building and receive the benefits of quantity purchasing. Note that you're still responsible for necessary maintenance inside your unit, such as servicing appliances, interior painting, and so on.

Although condos may be somewhat easier to keep up, they tend to appreciate less than single-family homes or apartment buildings unless the condo is located in a desirable urban area.

Condominium buildings may start out in life as condos or as apartment complexes that are then converted into condominiums.



Be wary of apartments that have been converted to condominiums. Although they're often the most affordable housing options in many areas of the country and may also be blessed with an excellent urban location that can't easily be re-created, you may be buying into some not so obvious problems. Our experience is that these converted apartments are typically older properties with a cosmetic makeover (new floors, new appliances, new landscaping, and a fresh coat of paint). However, be forewarned: The cosmetic makeover may look good at first glance, but the property probably still boasts 40-year-old plumbing and electrical systems, poor soundproofing, and a host of economic and functional obsolescence.

Within a few years, most of the owner-occupants move on to the traditional single-family home and rent out their condos. You may then find the property is predominantly renter-occupied and has a volunteer board of directors unwilling to levy the monthly assessments necessary to properly maintain the aging structure. Within 10 to 15 years of the conversion, these properties may well be the worst in the neighborhood.

Townhomes

Townhomes are essentially attached or row homes — a hybrid between a typical airspace-only condominium and a single-family house. Like condominiums, townhomes are generally attached, typically sharing walls and a continuous roof. But townhomes are often two-story buildings that come with a small yard and offer more privacy than a condominium because you don't have someone living on top of your unit.



As with condominiums, you absolutely must review the governing documents before you purchase the property to see exactly what you legally own. Generally, townhomes are organized as *planned unit developments* (PUDs) in which each owner has a *fee simple* ownership (no limitations as to transferability of ownership — the most complete ownership rights one can have) of his individual lot that encompasses his dwelling unit and often a small area of immediately adjacent land for a patio or balcony. The common areas are all part of a larger single lot, and each owner holds title to a proportionate share of the common area.

Co-ops

Co-operatives are a type of shared housing that has elements in common with apartments and condos. When you buy a cooperative, you own a stock certificate that represents your share of the entire building, including usage rights to a specific living space per a separate written occupancy agreement. Unlike a condo, you generally need to get approval from the co-operative association if you want to remodel or rent your unit to a tenant. In some co-ops, you must even gain approval from the association for the sale of your unit to a proposed buyer.



Turning a co-op into a rental unit is often severely restricted or even forbidden and, if allowed, is usually a major headache because you must satisfy not only your tenant but also the other owners in the building. Co-ops are also generally much harder to finance, and a sale requires the approval of the typically finicky association board. Therefore, we highly recommend that you shun co-ops for investment purposes.

Apartments

Not only do apartment buildings generally enjoy healthy long-term appreciation potential, but they also often produce positive *cash flow* (rental income – expenses) in the early years of ownership. But as with a single-family home, the buck stops with you for maintenance of an apartment building. You may hire a property manager to assist you, but you still have oversight responsibilities (and additional expenses).



In the real-estate financing world, apartment buildings are divided into two groups based on the number of units:

- ✓ **Four or fewer units:** You can obtain more favorable financing options and terms for apartment buildings that have four or fewer units because they're treated as residential property.
- ✓ **Five or more units:** Complexes with five or more units are treated as commercial property and don't enjoy the extremely favorable loan terms of the one- to four-unit properties.

Apartment buildings, particularly those with more units, generally produce a small positive cash flow, even in the early years of rental ownership (unless you're in an overpriced market where it may take two to four years before you break even on a before-tax basis).

Easy fixes can yield big bucks

Avoid shared housing units in suburban areas with substantial undeveloped land that enables building many more units. Attached housing prices tend to perform best in fully developed or built-out urban environments.

For higher returns, look for property where relatively simple cosmetic and other fixes may allow you to increase rents and, therefore, the market value of the property. Examples of such improvements may include but not be limited to

- ✓ Adding fresh paint and flooring
- ✓ Improving the landscaping
- ✓ Upgrading the kitchen with new appliances and new cabinet/drawer hardware that can totally change the look
- ✓ Converting five-unit apartment buildings into four-unit buildings to qualify for more favorable mortgage terms (see the “Apartments” section earlier in this chapter)

Look for property with a great location and good physical condition but some minor deferred maintenance. Then you can develop the punch list of items with maximum results for minimum dollars — for example, a property with a large yard but dead grass, a two- or three-car garage but peeling paint or a broken garage door. You can also add a garage door opener to jazz up the property for minimum cost. You can also really add value to a property with a burnt-out, absentee, or totally disinterested owner who is tired of the property.



One way to add value, if zoning allows, is to convert an apartment building into condominiums. Keep in mind, however, that this metamorphosis requires significant research on the zoning front and with estimating remodeling and construction costs.

Considering Commercial Real Estate

Commercial real estate is a generic term that includes properties used for office, retail, and industrial purposes. You can also include self-storage and hospitality (hotels and motels) properties in this category. If you’re a knowledgeable real estate investor and you like a challenge, you need to know two good reasons to invest in commercial real estate:

- ✓ You can use some of the space if you own your own small business. Just as it’s generally more cost-effective to own your home rather than rent over the years, so it is with commercial real estate if — and this is a big *if* — you buy at a reasonably good time and hold the property for many years.
- ✓ Your analysis of your local market suggests that it’s a good time to buy. We discuss more on this point in a moment.



We want to be clear, though, that commercial real estate isn't our first recommendation, especially for inexperienced investors. Residential real estate is generally far easier to understand and also usually carries lower investment and tenant risks.

With commercial real estate, when tenants move out, new tenants nearly always require extensive and costly improvements to customize the space to meet their planned usage of the property. And you usually have to pay for the majority of the associated costs in order to compete with other building owners. Fortunes can quickly change — small companies can go under, get too big for a space, and so on. Change is the order of the day in the business world, and especially in the small business world.

So how do you evaluate the state of your local commercial real estate market? You must check out, over a number of years, the supply and demand statistics. How much total space (and new space) is available for rent, and how has that changed in recent years? What's the vacancy rate, and how has that changed over time? Also, examine the rental rates, usually quoted as a price per square foot. We help you cover this ground in Chapter 8.



One danger sign that purchasing a commercial property in an area is likely to produce disappointing investment returns is a market where the supply of available space has increased faster than demand, leading to higher vacancies and falling rental rates. (This is called *negative absorption*, and what you naturally want is a track record and projections showing *positive absorption* — when the supply of space isn't keeping up with the demand.) A slowing local economy and a higher unemployment rate also spell trouble for commercial real estate prices. Each market is different, so make sure you check out the details of your area.

Buying Undeveloped Land

For prospective real estate investors who feel tenants and building maintenance are ongoing headaches, buying undeveloped land may appear attractive. If you buy land in an area that's expected to experience expanding demand in the years ahead, you should be able to make a tidy return on your investment. This is called *buying in the path of progress*, but of course the trick is to buy before everybody realizes that new development is moving in your direction. (Check out Chapter 8 for a full discussion on the path of progress.)

You may even hit a home run if you can identify land that others don't currently see the future value in holding. However, identifying many years in advance which communities will experience rapid population and job growth isn't easy. Land prices in areas that people believe will be the next hot spot

already sell at a premium price. That's what happened in most major cities with new sports facilities (especially because these decisions often are disclosed well in advance of the municipality leadership vote or the ballot initiative). You don't have much opportunity to get ahead of the curve — or if you guess wrong, you may own some costly land for a long time!



Investing in land certainly has other drawbacks and risks:

- ✓ **Care and feeding:** Land requires ongoing cash to pay the property taxes and liability insurance, and to keep the land clear and free of debris while it most likely produces little or no income. Although land doesn't require much upkeep compared with tenant-occupied property, it almost always does require financial feeding.
- ✓ **Opportunity costs:** Investing in land is a cash drain, and of course, purchasing the land in the first place costs money. If you buy the land with cash, you have the opportunity cost of tying up your valuable capital (which could be invested elsewhere), but most likely you will put down 30 to 40 percent in cash and finance the balance of the purchase price instead.
- ✓ **Costly mortgages:** Mortgage lenders require much higher down payments and charge higher loan fees and interest rates on loans to purchase land because they see it as a more speculative investment. Obtaining a loan for development of land is challenging and more expensive than obtaining a loan for a developed property.
- ✓ **Lack of depreciation:** You don't get depreciation tax write-offs because land isn't depreciable.

The dangers of downzoning

Robert owned raw land for many years in an area where a recent government action effectively downzoned his property from 4 acres to 2 acres. The multi-species conservation act designated huge swaths of undeveloped land as mitigation habitat for "endangered plant and animal species." This ordinance mandated that every parcel that wasn't already fully developed was subject to a development limitation of 2 acres.

Luckily for Robert, he had subdivided the original 20 acres into 4 smaller parcels of 4 to 5 acres each or the entire 20 acres would've only been allowed usage of 2 acres. Still, Robert's 4- to 5-acre parcels are now limited to 2 acres of development unless Robert pays a "mitigation fee" which is currently over \$50,000 per acre! This story illustrates the dangers of buying and owning vacant real estate in areas where conservation activists are prevalent.

On the income side, some properties may be able to be used for parking, storage income, or maybe even growing Christmas trees in the Northwest or grain in the Midwest! (After you make sure you've complied with local zoning restrictions and have the proper insurance in place.)



Although large-scale land investment isn't for the entry-level real estate investor, savvy real estate investors have made fortunes taking raw land and getting the proper entitlements and then selling (or better yet, subdividing and then selling) the parcels to developers of commercial and residential properties (primarily home builders). If you decide to invest in land, be sure that you:

- ✔ **Do your homework.** Ideally, you want to buy land in an area that's attracting rapidly expanding companies and that has a shortage of housing and developable land. Take your time to really know the area. This isn't a situation in which you should take a hot tip from someone to invest in faraway property in another state. Nor should you buy raw land just because you heard that irresistible opening bid price advertised on the radio for the government excess land auction down at the convention center this Saturday.
- ✔ **Know all the costs.** Tally up your annual *carrying costs* (ongoing ownership expenses such as property taxes) so that you can see what your annual cash drain may be. What are the financial consequences of this cash outflow — for example, will you be able to fully fund your tax-advantaged retirement accounts? If you can't, count the lost tax benefits as another cost of owning land.
- ✔ **Determine what improvements the land may need.** Running utility, water, and sewer lines; building roads; landscaping; and so on all cost money. If you plan to develop and build on the land that you purchase, research these costs. Make sure you don't make these estimates with your rose-tinted sunglasses on — improvements almost always cost more than you expect them to. (You need to check with the planning or building department for their list of requirements.)

Also make sure that you have access to the land or the right to enter and leave through a public right-of-way or another's property (known as *ingress* and *egress*). Some people foolishly invest in landlocked properties. When they discover the fact later, they think that they can easily get an *easement* (legal permission to use someone else's property). Wrong!

✔ **Understand the zoning and environmental issues.** The value of land is heavily dependent on what you can develop on it. Never purchase land without thoroughly understanding its zoning status and what you can and can't build on it. This advice also applies to environmental limitations that may be in place or that may come into effect without warning, diminishing the potential of your property (with no compensation).

This potential for surprise is why you must research the disposition of the planning department and nearby communities. Attend the meetings of local planning groups, if any, because some areas that are antigrowth and antidevelopment are less likely to be good places for you to buy land, especially if you need permission to do the type of project that you have in mind. Through the empowerment of local residents who sit on community boards and can influence local government officials, zoning can suddenly change for the worse — sometimes you may find that your property has been *downzoned* — a zoning alteration that can significantly reduce what you can develop on a property and therefore the property's value. See the sidebar “The dangers of downzoning” in this chapter for more details.

Chapter 3

Considering Foreclosures, REOs, Probate Sales, and More

In This Chapter

- ▶ Mastering foreclosures and REOs
 - ▶ Considering short sales
 - ▶ Utilizing lease options
 - ▶ Understanding probate sales and auctions
-

Many real estate investors actually start their real estate portfolio conventionally by buying a home for their own use for a number of years and then purchasing a new home and renting out their first home. Other folks have found that the best way to quickly become a real estate investor is to purchase income-producing properties in a more unconventional manner.

In this chapter, we take a brief look at some of the most common of these methods of acquiring real estate investment properties or participating in the real estate market, and we tell you what we think about whether you should pursue these options. We start off with foreclosures, REOs, and lease options. We also cover some other, even more unusual ways to acquire real estate at below-market prices, such as probate sales and auctions. And besides REITs (discussed in Chapter 4), other avenues allow you to passively invest in real estate, including triple net properties, notes and trust deeds, and limited partnerships, which we also discuss.

Finding Foreclosures and REOs

Would you rather buy real estate at retail or at wholesale prices? Obviously the answer is “wholesale!” Just like in the stock market, the concept of *buy low, sell high* also applies to real estate.



One of the best ways to maximize your chances of earning a good return on your investment is to buy a property at foreclosure or as an REO. Such investments are generally a better value than a conventional purchase (but not without some increased risk)!

And of course, other real estate investors are also scouring your local real estate market for great deals. Clearly, real estate investors flush with cash aren't going to miss this opportunity. As an individual looking to buy just one or two foreclosure homes in your local market, you may be surprised to find that you're competing with very large and sophisticated Wall Street venture funds with tens of millions of dollars that are buying pools of bad loans or foreclosed properties.

Foreclosures are simply properties for which the owner has failed to meet his loan payment or other loan term obligations, forcing the lender, if they want to get some of their money back, to take over legal ownership and control of the property (or foreclose and *take title*). Although more formal in a legal sense and more time consuming, a real estate foreclosure is similar to a lender repossessing the car from an owner who fails to make her monthly car payments.

After completing the foreclosure process, the lender takes title, at which point it owns the property. The lender has to maintain and manage the property, so it turns the property over to asset managers in the lender's in-house real estate owned (REO) department. The asset managers may keep the day-to-day property management in-house as well, but most lenders hire local property management firms to inspect the property, repair any emergency items, and essentially operate the property until the lender can sell it — usually within a few months unless the borrower has redemption rights (see the “Redemption period” section later in the chapter). Some major lenders, like Bank of America, call the department holding their repossessed properties owned real estate operations (OREOs). No matter what the name, the savvy real estate investor willing to do the extensive due diligence required to find the rare diamonds in the rough will be rewarded.

Typically these properties are spruced up and then sold quickly for as close to the appraised value as possible. However, with the number of foreclosures so significant in certain areas of the country, unloading these properties will really hit lenders hard. Robert is seeing a growing trend towards lenders holding on to these properties and hiring local property management firms to not only spruce up the properties but also rent them for one to three years with the expectation that the market will improve and the lenders will recoup much of their loan values. This trend is particularly true with private lenders.

Public lenders, like most banks, don't always have the flexibility of keeping these nonperforming assets on their books for regulatory reasons, but this is a solid strategy. Real estate investors may find fewer fire-sale bargains in

the short run, but actually the recovery will be spread out over several years, and thus there will be a steady supply of reasonably priced rental properties as various lenders spin off some of these held assets.



When considering foreclosures and REOs, be sure to perform the necessary research:

- ✓ Inspect the property and determine the physical condition and the cost of any needed work. Be careful to rule out environmental concerns.
- ✓ Review a preliminary title report to see whether the property has any unpaid tax liens or encumbrances.
- ✓ Appraise the property and establish your target price and a firm maximum bid so that the emotions of bidding don't lead you to overpay.

Foreclosures

The term *foreclosure* actually describes a process by which a lender takes title to a property on which a loan is in default. The two most common high-risk mistakes homeowners make that lead to foreclosure are

- ✓ **Failing to make the mortgage payments as required:** For example, homeowners who overstretched and bought their homes using up to 100 percent financing (they made little or no down payment towards the home's purchase price) and were, in effect, living on the edge.
- ✓ **Borrowing too much when refinancing:** Low interest rates combined with the tremendous increase in real estate values in most parts of the country in the early- to mid-2000s led many homeowners to refinance their properties. Although there's nothing wrong with refinancing, as long as you don't borrow too much, some lenders promoted 110 to 120 percent loans that tempted homeowners to pull all of their equity — and more — out of their homes. The recent trend towards no-documentation or stated-income loans also greatly contributed to the real estate mess of this period.

The flawed theory was that real estate values only increased, so these folks were simply tapping their future equity. However, one slight stumble with a loss of a job or a drop in income, a serious illness, death, or divorce can lead to a missed mortgage payment or two and ultimately, foreclosure. That's what happened to millions of property owners who were overextended with mortgage debt when the real estate market turned against them in the late-2000s. Although some folks couldn't afford to keep up with their payments, others chose to walk away from properties worth less than their outstanding mortgage balance.

More mortgage monkey business

Leading up to the mortgage crisis of 2008, lenders often pushed borrowers toward *piggyback loans*, which are two or more loans (usually from different lenders) used to purchase a property. The three most popular piggyback loan programs are the 80-20-0; the 80-15-5; and the 80-10-10 loans. In each of these loan programs, the first number is an 80-percent first

mortgage, the second number is the amount of the second mortgage, and the last number is the percentage of the purchase price the buyer paid in cash. The 80-10-10 loan (80 percent first, 10 percent second, and 10 percent down) was especially popular because it was designed to save the borrower the added cost of private mortgage insurance (PMI).

But properties can also be subject to foreclosure for other reasons:

- ✔ **Owners fail to meet other loan requirements.** Examples include not maintaining proper insurance coverage or not keeping the property in good physical condition.
- ✔ **Absentee owners are unable to effectively manage the property.** Good property managers regularly visit and inspect their properties. This level of involvement isn't practical from a distance.

This category of foreclosures is extremely prevalent in many of the most popular real estate investment markets for out-of-town speculators such as Las Vegas and Phoenix. If you're in these markets you may be able to pick up some great bargains, but don't make the same mistake that the earlier investors made when they purchased properties out of their comfort zone.

- ✔ **Owners walk away from serious problems.** Some properties fall into foreclosure because the property has serious and irreversible problems that are so bad that the current owner chooses to walk away rather than deal with them. Environmental hazards and serious physical problems where the cost of repair can exceed the value of the property (such as cracked slabs) often top the list. (In Chapter 12, we cover research you can perform to help avoid these types of problems.)



Many foreclosure properties also fall into this category because some real estate investors felt that the market was so strong that literally any property they bought would increase in value. Although this may have been true to a certain extent in some markets for a couple of years, the reality is that investors who bought properties without conducting proper due diligence often found that they had purchased white elephants, or properties that they can't sell for what they paid for them (or even rent out to cover their carrying costs).



Before you pursue foreclosure properties, determine the type of foreclosure process commonly used in your state. Check with your favorite lender, real estate agent, real estate attorney, or title company representative to find this information. Your state falls under one of two categories:

✔ **Deed of trust state:** When a loan is placed in a deed of trust state, the property title is held in the name of a third party or trustee. If the loan payments aren't made as promised or the loan is in default for another reason, the trustee can foreclose or take back the property. No court action is necessary, so a foreclosure in a deed of trust state can happen in 60 to 120 days. This process is referred to as *nonjudicial foreclosure*.

Be sure to check that you have the latest information on federal, state, and even local efforts by legislators and courts that have been quite aggressive in extending the timelines to give borrowers more time to avoid foreclosure.

✔ **Mortgage state:** In a mortgage state, no trustee or third party is named. When a mortgage goes into default for nonpayment or other breach, the holder of the mortgage must go to court and seek legal remedies including *judicial foreclosure*, which can take much longer than a nonjudicial foreclosure.



Foreclosure properties aren't that hard to find. Whether you're in a deed of trust state or a mortgage state, the filing of a Notice of Default (NOD) or a judicial foreclosure lawsuit are matters of public record. An additional public notice announcing a pending foreclosure sale must be published in a local legal newspaper. The timing of the publication prior to the sale varies by state. Many title companies and real estate firms track the Notices of Default and all the steps right through to the actual foreclosure. This information is public record and filed with the county recorder or equivalent, but subscribe to one of the local services offering this information via daily or weekly e-mails or faxes, because gathering this information on your own is time consuming.

Technically, there are four steps, and thus four buying opportunities, for a property subject to the typical foreclosure process. Knowing these steps, which we outline in the following sections, and the techniques or negotiating points necessary at each step to motivate the owner or lender is essential to mastering one of the best strategies of buying real estate at below market or wholesale prices.

Preforeclosure

Every potential foreclosure begins when the owner misses a payment on her debt service or is notified in writing by the lender that a condition or term of her loan isn't being met. The *preforeclosure* stage is the period of time before the lender formally files the Notice of Default, which triggers the legal foreclosure process.



The period of time before the formal foreclosure begins is an important buying opportunity: You can get in ahead of competing investors to identify properties on which the owner is delinquent on mortgage payments or violating other conditions of her loan. The key is to track and locate these defaulting owners.

This is the time when you want to offer a solution to the owner that'll get her out of the property and preserve her credit status so she can purchase property in the future. Also, every owner facing a mortgage delinquency needs some cash to pay for moving and relocation costs. Understanding the motivation of the owner and lender can allow you to formulate an investment strategy that meets everyone's needs and allows you to own a property before it becomes heavily exposed on the local multiple listing service!

Notice of Default

The first formal legal action in the foreclosure process is the filing of a Notice of Default. If the owner wasn't concerned when he first began missing loan payments, the filing of the Notice of Default should be a real wake-up call.

An owner who has received the Notice of Default is likely to be motivated to sell because she knows that the lender has begun the formal steps toward repossessing her property. But not all owners facing foreclosure are aware that the late charges, penalties, and hefty legal fees further erode their shaky financial position. They may not understand the logic that if they can't make their regular monthly payments, they're unlikely to catch up and pay all of the additional costs, which can literally double the delinquent amount.



The 60 to 90 days following the filing of the NOD are a great time to offer solutions to an owner facing a foreclosure. Most owners truly believe that their financial problems are temporary, so make your offer sensitive to the fact that preserving the owner's credit record is a key consideration: If you can buy the property quickly at a discount and then cure the default or pay off the delinquent mortgage, the seller only has the slow payments on his credit report rather than a foreclosure (or possibly a bankruptcy, which is often the only alternative for owners who are unwilling to voluntarily resolve their cash flow problems). Preserving credit has always been a key motivator to owners who are delinquent on their mortgage payments. However, legislative efforts in 2008 to forgive defaults have changed the dynamics significantly, and many homeowners are simply walking away with little concern that their credit will be an obstacle to entering the homeownership ranks at a future date.

Determine the loan balance and the value of the property to ensure that the owner has equity. Generally, the more equity the better, because this equity allows you to provide the owner with some quick cash so he can cover the costs of vacating the property and finding a new place to live. It's also this

equity in the property that provides you with a profit potential after all of your costs of acquisition plus the required repairs and upgrades to maximize the resale value of the property.



Some real estate gurus recommend that you simply offer a nominal amount of cash to the owner facing a default and then begin making the payments on the existing loans or, in other words, purchase the property *subject to* the current loans. Be wary that the lender may not allow you to just step into the shoes of the original borrower and may still declare the loan to be in default. Have your legal advisor (see Chapter 6) look for an *assumption clause* in the loan documents that would allow you to properly assume the loan. Usually this process requires a loan application and a fee. You may also want to watch out for a *due on sale clause* that accelerates the entire loan and makes it due immediately upon the transfer of the property to a new owner. Foreclosure transactions aren't risk free; your legal advisor can tell you the potential downside of your proposed transaction with a defaulting buyer.



Many of the problems that occur in buying foreclosures can be avoided by structuring the purchase offer to require the owner to vacate the property immediately. It's difficult for an owner to lose her home, and it's often even more difficult for her to accept the fact that she's no longer the owner when she's still living in the property.

Foreclosure sale

Although the foreclosure process varies from state to state, the main difference is whether the loan is secured with a mortgage that requires a judicial foreclosure or by a deed of trust, in which case the nonjudicial process is used (for an introduction to these two types of states, see the beginning of this section).

✔ **Judicial foreclosure:** In a judicial foreclosure, the lender files a lawsuit against the borrower to get the property. Like any other lawsuit, it begins with the serving of a summons and complaint upon the borrower (along with any other parties with junior liens or encumbrances against the property). If the borrower responds, the court holds a hearing and rules that either the borrower has presented a legitimate issue (and alternate payment terms are arranged) or the lender is permitted to foreclose.

The most common scenario is that the borrower doesn't respond and the lender receives a judgment by default and can proceed to have a referee appointed by the court. The lender then advertises the sale for four to six weeks and then, if full payment hasn't been made, a public sale is held, typically on the courthouse or town/city hall steps. The time frame for this entire judicial foreclosure process is usually between 4 and 6 months, although the process can take as little as 3 months to as long as 12 months.

✔ **Nonjudicial foreclosure:** In a nonjudicial foreclosure state, lenders are allowed to foreclose without a lawsuit, using the power of sale provisions of the deed of trust. The deed of trust actually has three parties to the original loan agreement — the borrower (grantor), the lender (beneficiary), and the trustee who actually holds title during the term of the loan. In the event the borrower defaults, the trustee files a Notice of Default and a Notice of Sale in a legal newspaper.

As with the judicial foreclosure, if the loan in a nonjudicial foreclosure isn't fully reinstated prior to the date and time of the trustee's sale, the public auction or sheriff's sale occurs on the steps of a prominent public location in town such as a courthouse. If no one bids, the lender bids the amount of its loan plus accrued penalties and fees and takes title to the property. This is the most common scenario unless the property is desirable and has equity, in which case many interested bidders may compete in a free-for-all.



Bidding on and purchasing properties at the foreclosure sale can be exciting and even profitable if you do your homework and know everything about a property before you bid. But getting a little lazy or going with your gut feeling can lead to a disaster, and it often takes quite a few home runs to offset even one disaster. Something as simple as an unrecorded tax lien or latent physical problems like a cracked slab or expansive soil can turn your lemonade back into a lemon! Be sure to get a title report showing clear title and an owner's title insurance policy.

Redemption period

Some states allow the borrower the right to redeem her property after the sale during a *redemption period* in which she can pay the full amount owed, including the loan balance, late charges, legal fees incurred by the lender, and all of the costs of sale, and get title to the property back. The length of the redemption period varies from state to state. This period is also an opportunity to reach an agreement with the borrower for her deed. If successful, the purchaser then essentially obtains the borrower's redemption rights and has the right to redeem the property.



Even if you're the successful purchaser at the foreclosure sale, you still have to give the borrower the opportunity to redeem the property per the state-required redemption period. Don't make significant improvements only to have the borrower redeem the property and then thank you for renovating his distressed property from the worst on the block to the model home!

Because the majority of properties at a foreclosure sale end up with the lender (because most properties aren't desirable investment properties at this time due to foreclosure risks and limited due diligence, as we discuss in this section), you have a great opportunity to make a deal with the lender just after the foreclosure sale and before they've incurred the expense of hiring an agent to market and sell the property.

The ethics of foreclosures

One of the most difficult moral dilemmas facing real estate investors is the ethics of negotiating with an owner facing a foreclosure. Are you helping her or are you a vulture seeking to profit upon the misfortune of another? You must walk a fine line in many of these situations.

Although there's some value to a distressed seller in a quick transaction that provides needed cash, pushing too hard for a bargain can be unethical. Robert uses the "pillow test" to guide his conscience: Can you fall asleep at night and not feel guilty about your moral and ethical conduct?



You may also be able to make a better deal if the property has significant deferred maintenance or code violations, because the local building inspector or code enforcement departments know when a deep-pocketed lender has title to the property, and they expect all citations for substandard conditions or code violations to be corrected immediately. You may be able to relieve the lender of this liability while allowing yourself to negotiate a favorable transaction.

Lender REO (Real Estate Owned)

Because titles to the majority of foreclosed properties end up with the lender, you may find that your next opportunity to purchase the property is from the lender's real estate owned (REO) department that specializes in handling foreclosed properties. Some investors have found that this is one of the best times to buy a property because they're not dealing with an emotional or unreliable owner. Discovering the ins and outs of the lenders' policies and procedures of disposing of these foreclosed properties can be invaluable to your goal of buying real estate at below market prices.

The days of stealing prime REO properties from the Resolution Trust Corporation (RTC) are gone. The RTC was a quasi-federal government entity established by congress to dispose of the tremendous number of foreclosed assets of the major lenders during the real estate market downturn in the early '90s. Due to the numbers of properties and the relative inexperience of and limited due diligence by the RTC in some areas of the country, a once-in-a-lifetime real estate investment opportunity did fall into the lap of savvy real estate investors who had large amounts of cash, could act quickly, and then had the financial horsepower to ride out the market downturn.

Lender REOs remain one of the favorite strategies for the late-night infomercial gurus, but the reality is that the lenders are neither foolish nor benevolent. Although these nonperforming loans are a negative on their balance sheet, they're not going to sell a property below its market value just to get it off their books.

FHA/VA repos

Government agencies such as the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA) guarantee loans made by lenders to qualified individuals. When these home buyers fail to make their payments, the lender goes through the foreclosure process and ultimately repossesses the house. The government pays the lender the guaranteed loan amount and then takes possession of the property.

These FHA and VA repos are then listed for sale through real estate agents approved by the Department of Housing and Urban Development (HUD). Typically, real estate investors don't find these properties as attractive as some other real estate investment opportunities, because they're usually offered at or just a shade under market prices. Qualified first-time home buyers should look for these FHA/VA repos, because they're often available with favorable financing, including low, or no, down payments.

The disposition specialists in the REO department are professionals who understand the real estate markets well and are usually wired into the best real estate brokers in the market. These real estate brokers are often compensated as a percentage of the sales price and thus also motivated to achieve the highest value as is reasonably possible.

The only angle a real estate investor usually has with an REO is financing and the continued operating losses that often occur because the lender is merely holding the property and isn't willing to invest the time and money necessary to enhance the property physically and reposition it to perform better in the market.



Sales are as-is, and lenders are often exempt from the standard disclosure rules.

When lenders have an excessive number of REOs, they become more flexible, but they're often limited by the Office of Thrift Supervision (OTS), a government agency that oversees many savings banks and savings and loan associations and routinely audits their loan portfolio and their REOs.

Getting a Jump On Foreclosure and REO Competition with Short Sales

Savvy real estate investors know that the best properties are the ones that aren't exposed to the open market where the competition has a chance to drive up the price. They also know that the best deals can be made with motivated

sellers — and there's not much stronger motivation for a house seller than to know that they'll soon lose their property to foreclosure and find their credit ruined.

These homeowners don't have any equity, and the existing debt on the property exceeds the current loan balance. If the owners were to sell the property, they would owe the lender more money than they'd receive from the sale. In the late-2000s real estate market downturn, this was true for increasing numbers of properties. This is the concept and strategy behind short sales. A *short sale* occurs when you buy a property from the owner and have an agreement with the lender or lien holder that it will accept an amount that is less than its loan balance as payment in full.

Recognizing seller benefits

With the advent of subprime and zero-down-payment loans in the mid-2000s, combined with the decline in home values, many owners found that they had negative equity in their homes in the late-2000s; they literally couldn't afford to sell the properties because the sale proceeds wouldn't cover the loan balance (a situation known as being *upside down*).

Many of these owners had other financial challenges and little savings to fall back on, so they were unlikely to be able or willing to continue making their debt service payments on the upside down property. An owner in this situation is a prime candidate for a short sale.

The current owner or seller receives no proceeds from a short sale but will find it a quick exit strategy from a troubling situation, with the goal of minimizing damage to his credit (because he will likely want to be a homeowner again someday). Another benefit to the current owner is that the real estate investor is likely looking for a great tenant, and who would be a better tenant than the current occupant of the property? The current owner may no longer own the property, but he can at least continue to live there and not disrupt his life completely. Being able to remain in the property also avoids some of the stigma of losing the house. Plus, immediately having a tenant can help you get a loan for the property.

Comparing short sales to other properties

Many real estate investors find that buying foreclosures or REO properties can be challenging. With foreclosures, the public sale is published and readily known to all interested real estate investors, but there is limited information and rarely an adequate opportunity to conduct proper due diligence. Foreclosure properties can be full of surprises!

You often find that the best properties at the foreclosure auction attract the attention of other (often sophisticated) buyers who are prepared to pay more for the property than you are if they know they can make a good deal down the road. You also need to have 10 percent of the purchase price in cash and immediately have to find a loan for the balance within 30 days, whereas with the short sale you can usually negotiate for a sale closing date that gives you more time to find financing. A short sale also helps you avoid the complications of a borrower redemption possible with a judicial foreclosure.

Tracking down the property information for REO properties can be challenging, and the lenders or their agents may not be cooperative with requests for inspections or details about the condition of the property. Though the reputation for REOs is that lenders are anxious to sell these properties at any price, the reality is that they often go for pretty close to the full market value when discounted for the condition and quick sale terms that they require.



Find properties that are in preforeclosure — that is, properties where the owner is delinquent on her debt service payments — and make a deal to buy the property from the owner before she loses it anyway and ruins her credit. These situations became more common with the excessive use of highly leveraged financing where borrowers had loans that were equal to (or even greater than) the full value of the property when it was acquired. Some borrowers took out second loans, and the combined debt exceeded the value of the property.

Finding short-sale opportunities

The concept sounds much easier than it is to actually execute. The main problem is trying to identify the properties where the owner of the property is behind on payments but the lender hasn't filed a Notice of Default.

With foreclosures, you can generally find lists available from real estate agents and even the lenders themselves, or you can drive through the neighborhoods that appeal to you and find signs that say "bank owned". But with preforeclosure properties that are still owner-occupied and candidates for a short sale, there may not be an indication that anything is wrong. This is particularly true with many lenders now being asked to be extra patient with borrowers who are a little behind on their mortgage payments.

If you're looking for these opportunities, there are many ways to find them. Some companies specialize in assisting homeowners who know they'll have difficulty in making their mortgage payments; they work with the owners and the lenders to try and make loan modifications or alternative payment plans. These attempts may be successful, but many times they aren't, and they provide one source for identifying owners who are short-sale candidates.

Another way to identify potential short sale properties is when the mortgage holder sends a Notice of Default. But this document is public information, so many other real estate investors may be in contact with the owner seeking to arrange a short sale.

Just like in a regular foreclosure, you can find this information, and in the early days of the preforeclosure period many buyers may be willing to consider a short sale. Of course, you need to convince the lender and not just the current owner.



Note that lien holders may have purchased the underlying loan at a discount, and they may be more willing to negotiate with you to accept less money, which will enhance the prospects of a sale of the property. Your research will often reveal whether the loan that is in default has recently been sold; this is important information that can assist you with your negotiating strategy.



The concept of short sales often comes up if you have foreclosures in your area, but be careful: You need to check out the property just as thoroughly. You actually should have a better opportunity and better access to the property. It's not as bad as with foreclosure properties, but it has been our experience that short sale properties can also be properties that the owner is willing to walk away from for a reason. So be very careful because what may seem like the deal of the century may actually be a money pit.

Convincing a lender to agree to a short sale

In addition to the difficulty inherent in finding an opportunity for a short sale, you may also have a difficult time convincing the lender to agree to a short sale. The recent trend by the federal government has been to require lenders to work with borrowers at an unprecedented level of patience and cooperation. Some lenders become overwhelmed with the large numbers of negative equity loans and the thousands of requests they receive to restructure financing. On one hand, lenders are motivated to consider short sales, but they're also under pressure to formulate a workout strategy with the current borrower. This trend may actually reduce the motivation for lenders to cooperate with short sales.

The viability of short sales is really a function of the lenders and their business strategies to minimize their losses. The lenders know that the payments aren't being made and it's inevitable that they'll complete the foreclosure, have to hold the property for some period, and incur costs before they ultimately sell it.

Short sales in Hollywood

The short-sale concept has received a lot of notoriety, and late-night gurus promote seminars touting that they can teach you everything you need to know about short sales. Even Donald Trump has gotten into the game. Trump made the headlines when he proposed a short sale to help retired TV host Ed McMahon and his wife from losing their home in Beverly Hills. The McMahons were apparently \$643,597

behind in payments on their \$4.8 million loan. The Donald offered to buy the house, with Countrywide Home Loans taking a discounted payoff, and allow the McMahons to continue to live in the property as renters. Ultimately, the parties reached another solution, but this was a well-known example of how the short sale process works.

If they have a large number of nonperforming loans on their books, they may be motivated to quickly make a few short-sale deals. However, our experience has been that some lenders with few delinquent loans are actually more willing to agree to a buyer proposing a short sale because they want to cut their losses quickly and not risk government intervention or negative publicity. Lenders that participate in short sales are always secretive about it too.

One recent legislative change that has really helped owners of properties who want to work out a short sale is the Mortgage Forgiveness Act of 2007. Previously, mortgage debt that was forgiven or canceled by a lender had to be included on the borrower's tax return as taxable income. Under this new law, any loan that was used to buy, build, or substantially improve the borrower's principal residence (not second homes or investment properties) qualifies for the exemption from taxation as ordinary income. A refinance loan for the same purposes also qualifies. The lender is required to report the debt cancellation to the IRS on Form 1099-C, and the borrower must file Form 982. This law is scheduled to expire as of January 1, 2010, but may be extended. Be sure to seek the advice of your tax professional before agreeing to any short sale.

You need to send the lender a short sale package with the following information:

- ✔ A hardship letter or proof from the borrower that he is unable to continue to make mortgage payments.
- ✔ Copies of the borrower's income tax returns.
- ✔ Information on the current condition of the property with contractor estimates or proposals to make any needed repairs property.
- ✔ The estimated value of the property and your offer for the property.

The lender will want to verify current market conditions where the loan balance is greater than the current value of the property. They'll obtain a Broker's Price Opinion (BPO) or quick appraisal of the property. This figure acts as the basis for their negotiations with you, with the goal of achieving as close as possible to the BPO.

The one common denominator to short sales with all lenders is that short sales require a lot of phone calls and investigative legwork to even find out whether the lender is open to receiving an offer for less than the current loan balance. Each lender has a different organizational structure for various individuals or departments that handle non-performing loans. Some lenders have automated phone systems that can be helpful and allow you to get right through to people you need; others are best described as "voice mail jail." Live operators are probably already familiar with what you're looking for, and you just need to describe that the purpose of your call is to find someone in charge of loss mitigation or foreclosures. If all else fails, you should contact the customer service department and ask to speak to someone who is authorized to make sales on preforeclosure properties. Have the property address and the borrower name and loan number (if available).

These transactions aren't likely, and are a sure bet to take at least 30 to 90 days (or even more) because most lenders are now much more inclined to work with the current borrower if at all possible. Our advice is that short sales can be effective in limited circumstances and only if you have the ability to reach a decision-maker at a lender that is inclined to participate. The real estate investor looking for just one property may find that the effort exceeds the return and that there are better ways to locate and purchase rental properties.



Don't forget that with short sales, you need to have some cash as well as be preapproved for loans so that you can make deals quickly. Lenders that are willing to agree to short sales are going to require all cash and won't be willing to offer any sort of financing. Lenders that are likely to be sources of funds for your loan on a short sale are going to be selective about making loans on non-owner-occupied rental properties. Your credit worthiness and having an established banking relationship is helpful if you're going to be successful with buying short sales.

Looking Into Lease Options

A *lease option* is an excellent way to control and eventually purchase a property without the significant cash investment in a down payment. A lease option is essentially two different types of contracts combined into a single agreement. You have a lease (rental agreement), which has all of the usual terms, but the tenant also has the unilateral right to buy the property under certain terms and conditions in the future.

A lease option obligates the owner to sell the property but doesn't obligate the tenant to buy. This is a unilateral contract until the tenant exercises the option and a bilateral contract is created. One of the key issues with lease options is the *option price* (purchase price) that the buyer must pay. This figure can be a fixed price based on current market value, but often it's a future projected value based on anticipated appreciation with set time limits for exercising the option. For example, a home valued at \$200,000 today may be offered as a lease option with an option price of \$210,000 that can be exercised anytime in the next 12 months in a market where the seller expects appreciation of 5 percent per year. Of course, a savvy buyer doesn't exercise the option if the option price exceeds the market value of the property.

Lease options are much easier to find, and much more favorable deals can be made, when there are limited buyers, and sellers are anxious to sell. Lease options are most commonly used with single-family homes and condos, but the concept can be used with any type of property. Overall, in virtually all areas of the country, the demand for lease options is greater than the supply.

Remember that lease options aren't just a great way for real estate investors to buy property; they're also an opportunity for many first-time home buyers to ease into home owning. They're often in high demand relative to their supply, so lease options are rarely advertised; you may even need to run your own ad seeking lease options. Another way to track down a possible lease option is to respond to ads for "house for rent." When you own a property that you want to use a lease option to sell, a small ad often brings a large response. Check out Chapter 16 for more information on using a lease option as an exit strategy.

Probing Probate Sales and Auctions

A discussion of the more unusual real estate investments must include probate or sales of properties in estates. Also, auctions are becoming a more popular way to dispose of real estate, particularly because of the continued expansion of the Internet.

Probate sales

Even more reliable than taxes, death creates opportunities for the purchase of good real estate at attractive prices. Every day someone in your area dies and leaves behind real estate that his heirs may not have any desire to retain. These properties are sold in *probate sales* by executors of the estate with the assistance of probate attorneys (or by the public administrator if the owner dies without a trust or will).

Know the laws and rules regarding probate sales in your area, because waiting periods and even court confirmation may be required before the sale is finalized. Also, these sales are often subject to *overbids*. A potential buyer can use the overbid process to appeal directly to the court (before the court issues the order approving the probate sale) to outbid you and purchase the property for more than the current offer under consideration. Generally, the right to overbid requires an offer that exceeds the existing offer by at least 5 percent. Be aware that this possibility exists, and be prepared to raise your bid. Just be careful not to get caught up in a bidding war and overpay for a property. Set a maximum price for yourself before you begin bidding.

Robert has a friend who bought a one-of-a-kind beachfront property in San Diego at significantly below market value from the estate of an elderly gentleman who died and left the property to his son. Apparently, the son had no interest in living near the ocean because of the noise and traffic that accompanies beachfront properties. So, the son contacted a real estate broker. He was anxious to sell the property, including the house and two rental units, for not much more than the value of the land alone. The real estate broker and Robert's friend were surfing buddies and because the broker owed Robert's friend a favor, the broker was glad to give him the first shot at this once-in-a-lifetime opportunity!

Real estate auctions

Real estate auctions, in which companies claim to be selling prime real estate at below-market prices, have become one of the most popular ways for builders and investors to market their excessive inventory of properties in some areas. Don't confuse these auctions with the foreclosure sales that are referred to as auctions in some regions. We're talking about public auctions where antiques or collectibles may also be sold on the same afternoon. In strong real estate markets, even new home builders have turned to private auctions to sell their new homes in an attempt to generate interest and excitement in areas where demand is low.

Private individuals, government entities, and companies that specialize in auctions all use this method of selling real estate to the public. You can often find real estate auctioneers listed in your local yellow pages. Like any auction, the goal is to generate interest and competition among potential purchasers in order to drive up the sales price. Often a minimum or reserve price is set to protect the seller from giving the property away too cheaply.

These real estate auctions are promoted heavily in newspapers, on radio and television, and on the Internet with sample prices that sound enticing. They claim to have all types of properties and usually promote a few irresistible-sounding properties — like 10 acres of pristine land for only \$5,000. Of course, who knows how far out into the boonies the property is located?



Our experience is that auctions are rarely great opportunities for investors, because too many people compete for the unusual, quality property. Plus, the reserve or minimum prices are set so close to the actual market value of the property that the buyer essentially pays retail under the illusion that she's buying at wholesale. But some good opportunities do arise now and then, so check out these auctions to see if you can find anything worth pursuing.

If you do find a property of interest in an auction, follow the same thorough due diligence process that applies to foreclosures and REOs (see “Finding Foreclosures and REOs” earlier in this chapter).

Unfortunately, proper due diligence isn't always possible due to the short time frame available before the sale or because the auctioneer doesn't provide enough information. For example, the best way to minimize the possibility that the property contains some costly environmental hazards is to have a professional firm prepare a Phase I environmental report (see Chapter 12). But you're unlikely to be able to afford one for every property that interests you at an auction. This is just one example of the dangers in buying properties without a thorough and exhaustive due diligence investigation, so don't be rushed. Real estate is one investment that you can't easily get out of if you make a mistake. Remember — you don't want any surprises!

If you're the lucky buyer, you must immediately produce a certified funds check for at least 10 percent of the purchase price. Your final closing date usually falls within the next 30 days.



The Internet is the preferred method of promoting real estate auctions. As with many Internet opportunities, great care should be taken to ensure that you're dealing with a reputable firm. *Never* even consider buying *any* real estate sight unseen no matter how good the deal seems!

Chapter 4

Taking the Passive Approach

In This Chapter

- ▶ Researching real estate investment trusts (REITs)
 - ▶ Considering tenants in common realty investments
 - ▶ Exploring triple net properties
 - ▶ Understanding tax lien certificate sales
 - ▶ Looking at limited partnerships
-

Many investors want the diversification and solid returns offered by real estate but aren't qualified for or interested in actively managing their real estate holdings. These real estate investors often look for investment opportunities that require no management or even minimal interaction with a property manager. Real estate investment trusts (REITs) are probably the easiest to understand and access, but other avenues allow you to passively invest in real estate, including tenants in common, triple net properties, notes and trust deeds, tax lien certificate sales, and limited partnerships.

Current federal tax laws favor real estate investments in which the real estate investors qualify as active investors, and this book focuses on real estate investment strategies that qualify as active activities in order to garner the full tax benefits. If you're seeking a passive investment, though, this chapter is for you.

Using Real Estate Investment Trusts

Real estate investment trusts (REITs) are for-profit companies that own and generally operate different types of property, such as shopping centers, apartments, offices, warehouses, hotels, and other rental buildings (see Figure 4-1). These property-holding REITs are known as *equity REITs*. Some REITs, known as *mortgage REITs*, focus on the financing end of the business; they lend to real estate property owners and operators or provide credit indirectly through buying loans (mortgage backed securities).

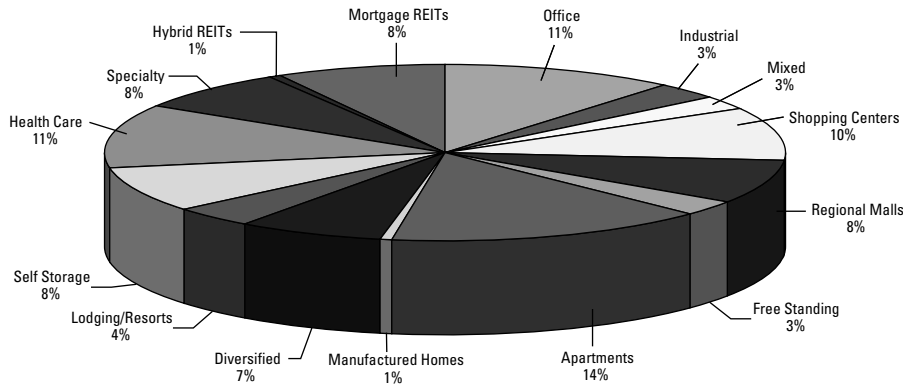


Figure 4-1:
Property
types
invested in
by REITs.

Source: National Association of Real Estate Investment Trusts.



Equity REIT managers typically identify and negotiate the purchase of properties that they believe are good investments and manage these properties directly or through an affiliated advisory and management company, including all tenant relations. Thus, REITs can be a good way to invest in real estate for people who don't want the hassles and headaches that come with directly owning and managing rental property.

Distinguishing between public and private REITs

We recommend that investors not be shy about asking for full disclosure of the relationship between the REIT, its advisors, and the management companies. REITs often involve conflicts of interest that aren't clearly disclosed or pay significant above-market fees that ultimately lower the cash flow and return on investment available for distribution.

Public REITs are traded on the major stock exchanges and thus must meet strict SEC reporting requirements:

- ✓ **Liquidity:** Public REITs trade every business day on a stock exchange and thus offer investors the ability to buy and sell as they please. Of course, as with other similarly liquid investments (like stock in companies in a variety of industries), liquidity can have its downside. More-liquid real estate investments like REITs may inspire frequent trades caused by making emotional decisions or trying to time market movements.
- ✓ **Independent board of directors:** A public company must have directors, the majority of whom are independent of its management. Shareholders vote upon and elect these directors.
- ✓ **Financial reporting:** Public REITs, like other public companies, must file comprehensive financial reports quarterly.



We recommend that you stay away from private REITs unless you're a sophisticated, experienced real estate investor willing to do plenty of extra research and digging. Because they're not publicly traded, private REITs don't have the same disclosure requirements as public REITs. This difference means an investor in a private REIT had better carefully scrutinize the prospectus and realize that the private REIT has the ability to make changes that may not be in the investor's best interests but that reward the private REIT sponsors or their affiliates.

Taking a look at performance

So what about performance? Over the long term, REITs have produced total returns comparable to stocks in general. In fact, over the past 35 years, REIT returns have actually been higher. In the context of an overall investment portfolio, REITs add diversification because their values don't always move in tandem with other investments.



For investments that move perfectly in lock step, their *beta* or *correlation* to the overall stock market is 1. For investments always moving in opposite directions, the correlation is 0. Over the long term, the correlation between stocks and REITs has been about 0.6 (which is about the level of correlation between foreign stocks and U.S. stocks).

One final attribute of REITs we want to highlight is the fairly substantial dividends that REITs usually pay. Because these dividends are generally fully taxable (and thus not subject to the lower stock dividend tax rate), you should generally avoid holding REITs outside of retirement accounts if you're in a high tax bracket (for instance, during your working years).



In case you care, and you may well not, the reason for the high dividends is the legal requirement in REIT charters that they have to distribute 95 percent of their income. In other words, REITs can legally only retain a maximum of 5 percent of their net income; they must distribute everything else to the shareholders.

Investing in REIT funds



You can research and purchase shares in individual REITs, which trade as securities on the major stock exchanges. An even better approach is to buy a mutual fund or exchange-traded fund that invests in a diversified mixture of REITs. Some of the best REIT mutual funds charge 1 percent per year or less in management fees. Vanguard's REIT index fund charges just 0.20 percent per

year in fees and has produced average annual returns of 12.3 percent since its inception in 1996. (An exchanged-traded version of this index fund offers an even lower-cost approach to investing with a wafer thin 0.1 percent annual operating fee.)

In addition to providing you with a diversified, low-hassle real estate investment, REITs offer an additional advantage that traditional rental real estate doesn't. You can easily invest in REITs through a retirement account such as an IRA or Keogh. As with traditional real estate investments, you can even buy REITs and mutual fund REITs with borrowed money (in nonretirement accounts). You can buy with 50 percent down, known as *buying on margin*, when you purchase such investments through a brokerage account.

Table 4-1 contains a short list of the best REIT mutual funds currently available.

<i>Fund</i>	<i>Toll-Free Number</i>	<i>Web Site</i>
American Century Real Estate Investments	800-345-3533	www.americancentury.com
CGM Realty	800-345-4048	www.cgmfunds.com
Cohen & Steers Realty Shares	800-437-9912	www.cohenandsteers.com
Fidelity Real Estate Investment	800-544-8888	www.fidelity.com
SSgA Tuckerman Active REIT	800-647-7327	www.ssga.com
Third Avenue Real Estate Fund	800-443-1021	www.thirdavenuefunds.com
TIAA-CREF Real Estate	800-223-1200	www.tiaa-cref.org
T. Rowe Price Real Estate	800-638-5660	www.troweprice.com
Vanguard REIT Index	800-662-7447	www.vanguard.com

If you really have your heart set on becoming the next Warren Buffett and you enjoy the challenge of selecting your own stocks, you can research and choose your own REITs to invest in. Both of the investment research publications *Morningstar* and *Value Line*, which can be found at many local libraries

as well as online (www.morningstar.com and www.valueline.com), produce individual stock page summaries on various REITs. *Forbes* magazine also writes articles about the better REITs (visit their Web site at www.forbes.com for more information).

In addition to having a professional manager deciding what REITs to buy and when, the mutual fund REITs listed in Table 4-1 also provide consolidated financial reporting. If you purchase individual REITs, you have to deal with tax statements for each and every REIT you're invested in.

Tenants in Common

Tenants in common (TIC) real estate investments have been heavily promoted as the common man's opportunity to own a piece of institutional-grade, (commonly known as *trophy*) properties that the average investor could never acquire on her own. Due to a March 2002 IRS real estate tax ruling, tenants in common real estate ownership has been gaining momentum.

Tenants in common ownership is arranged by sponsors that form a TIC investment group for each property; each individual investor actually receives a title deed for an undivided fractional share in a large institutional-grade property. The TIC sponsors either already have purchased or at least control these properties. TIC sponsored properties available for investment include regional shopping malls, large luxury apartment buildings, or even *class A* (with the best-quality locations, construction, and finishes) high-rise office buildings in major metropolitan areas.

These TIC investments do have some limitations: For instance, there are often limits on the number of investors (usually 35, and married couples count as a single investor) and their financial strength; each investor is proportionately responsible for the debt on the property, if any; and each owner must actually hold a specific fractional deeded interest in the property. All owners must share and pay all profits and losses proportionately, and the TIC sponsor can't advance funds to cover any expenses. The IRS also requires each owner to have a vote equal to his percentage of ownership.



Don't feel too confident about your voting rights, because you probably own only a small percentage (sometimes as little as 1 or 2 percent of the total property); you may find that the majority make decisions about management and leasing. Plus, the IRS requires unanimous approval of all co-owners to borrow against the property or sell — which may or may not coincide with your goals and needs.



Our advice is that although TICs provide some advantages for real estate investors seeking passive tax-sheltered income, new real estate investors and those with modest assets who may need to liquidate or sell their interest should avoid this investment for now because the current TIC offerings are typically overpriced retail investments with extremely high sales commissions and costs. We believe that this relatively new product will evolve and, with more offerings from additional market players, the properties will become more competitively priced and the commissions and costs will fall significantly.

Paying for 1031 availability and “hassle free” management

These investment vehicles can be right for certain investors with significant net worth and no desire to directly own real estate — as long as they fully understand the benefits and drawbacks. The minimum investment for most TICs is measured in the hundreds of thousands of dollars, although some TIC sponsors offer fractionalized ownership for as little as \$50,000.

Traditionally, owners with significant equity can use a *tax-deferred exchange* (also known as a *1031 exchange*) to either sell or exchange into a larger property, or simply continue to hold and refinance the highly appreciated property to generate cash for additional real estate investments, which also offer additional tax benefits. But TIC candidates are usually real estate owners currently in or contemplating a tax-deferred exchange that are facing the strict time limits and haven't been able to find a suitable property on their own. (See Chapter 18 for a discussion of the tax-deferred exchange.)



If you're considering a TIC as an alternative for your tax-deferred exchange, verify in advance with your tax advisor that your transaction qualifies. A tax-deferred exchange is limited to like-kind property with specific rules about how you hold title of both the relinquished and replacement properties. If the property being sold is directly owned, the transaction most likely meets the requirements and isn't taxable at the time of sale as long as the TIC property is a direct ownership of real estate and not a security. But many investors may find that the property they're selling is a partnership interest in real estate and doesn't qualify for the tax-deferred treatment because the two investments aren't like-kind. Obtaining competent legal and tax advice in advance is essential, or you may have a very unpleasant surprise when the IRS declares that your transaction is fully taxable.

However, the TIC sponsors have targeted these owners of highly appreciated properties who are considering a tax-deferred exchange but are at a stage in their lives in which they're not interested in expanding their real estate empire. Or they may have used all of the tax benefits of depreciation (see Chapter 18) and really should sell their property and simply pay the capital gains.

A downside of these TIC investments is that they're often extremely expensive. Because the majority of the potential purchasers for these real estate investments are coming out of a tax-deferred exchange, they're subject to tight time limits. The IRS requires 1031 exchanges to identify the replacement property within 45 days of the close of escrow of the property being sold. And the replacement property transaction must be completed within 180 days. Please see Chapter 18 for more details.

Thus, the syndicators of the tenants in common product are always standing by with a pending real estate acquisition for those buyers whose time limits are running short and who need to identify and close on a property within the time limits imposed by the IRS. If the owner is unable to meet the deadlines, they lose all of the tax deferral benefits, so they're often willing to overpay. The TIC sponsors know that many real estate investors panic and commit to real estate investments that aren't prudent or suited to them just to avoid paying the capital gains tax.

In exchange for this flexibility and readily available product, the syndicators have prepurchased these properties and roll them over to the tenants in common investors at a higher price. Further, the syndicators usually associate with financial advisors who receive hefty sales commissions of 3 to 5 percent and even as high as 10 percent of the investors' initial investment, plus a spread to the TIC sponsor to cover their internal marketing and administration costs. Then many TIC sponsors have separate "advisory firms" that are closely held by the principals of the sponsor, and they commonly charge upfront, plus ongoing, consulting fees. Thus, the purchaser of a tenants in common real estate investment is paying top dollar for the property and is only receiving the benefit of as little as 90 percent of her gross investment because of commissions and fees paid upfront.

The TIC sales pitch also places a heavy emphasis on the desirability of eliminating the trials and tribulations often associated with an owner trying to manage his own property. TIC sponsored properties are professionally managed by the sponsor or a property manager of their choice.

Asking the right questions: Are TICs for you?

Be aware that TIC sponsors often provide attractive teaser rates of return that are guaranteed only for the first couple of years. For example, a review of the private placement offering may indicate that investors will receive a 7 percent cash distribution per year for the first two years only. This rate may potentially entice investors who have built up significant equity in their real estate holdings but haven't seen their cash flow increase as fast.



Also, like many other financial products, a lot of effort goes into the promotion and sales of TICs, often through independent investment advisors, which translates to a lot of overhead to cover. You typically get slick marketing materials and are referred to fancy Web sites or supposedly free seminars reminiscent of the late-night infomercial gurus. These promotional efforts are high on fluff and scarce on details.

You need to determine whether TICs are right for you by asking your investment advisor and the TIC sponsor for written answers to some basic questions before sending them your money:

- ✔ **Who's receiving commissions and how much?** The TIC sponsor receives a commission or spread right off the top, plus the investment advisors (broker) who refer their clients get a piece of the action, too.
- ✔ **Was the offered property recently acquired and at what price?** Many TIC investors purchase the properties and then resell them within days or months at full retail or top of the market pricing, so it may be informative to know how much the TIC sponsor has made on the investment in addition to the commissions.
- ✔ **How much of my net investment is actually invested in the property?** At the end of the day, after everyone has been paid, how much of my investment actually is invested into the property?
- ✔ **What's the amount and timing of the cash distributions?** If based on a certain percentage rather than actual operating results, are the distributions guaranteed, and if so, for how long and by whom? Many TIC sponsors use an above-average cash distribution as a hook to entice new investors, but property performance may not generate enough cash to cover the distributions, and investors may actually be required to cover operating losses. Where's that fact in the fancy brochure?
- ✔ **What are the charges for property and asset management?** Most TIC sponsors have affiliated property management firms that handle the day-to-day management — but at fees toward the high end of reasonable. Also, there may be another layer for an asset manager or advisory firm that supervises the property management company, and they're also often controlled by or associated with the TIC sponsor. You have no guarantee that the asset or property management is qualified or competent, so be sure to ask questions about their experience and credentials; excellent management is extremely important. Remember that this is a passive investment, so you have little say in making any changes if they don't meet your expectations.
- ✔ **How liquid is my investment, and does the sponsor offer a buyback or loan program?** Currently, there's no viable secondary market for TIC investments, so you're at the mercy of the TIC sponsor or possibly another investor who'd be willing to buy you out. Anyone buying a fractional ownership is going to expect and receive a significant discount from the actual asset value. Have you ever tried to sell a timeshare interest at the price you paid originally from the developer?

Of course, many investors are attracted to the fact that someone else (all TIC sponsors claim to be experts) is tracking down the properties and doing all of the due diligence, and you definitely pay a price for these benefits. So follow the money and make sure you're comfortable with this investment, because it isn't easy to sell should your needs change.

The evolving TIC industry is in its infancy and is trying to set standards that should address some of the concerns about these investments and raise the level of the sponsors. You can find more information on TICs at the Tenant-In-Common Association Web site at www.ticassoc.org.

Triple Net Properties

Triple net property is a common term for a type of net lease where the tenant pays some or all of the property operating and repair and maintenance expenses in addition to the rent. Many investors are attracted to the minimal property management and maintenance requirements of triple net properties because the tenant is responsible for the majority of all operating costs and maintenance.

Triple net properties are often promoted as another real estate option for investors looking to avoid the headaches of day-to-day management. These investments may seem like real estate investments, but they're primarily an investment in the net cash flow (after debt service) from a lease to a credit tenant, and they're promoted based on the cash-on-cash rate of return or cap rate (see Chapter 12 for information on these measures of investment return).

For years, these properties have been the favorites of real estate investors who like the steady income stream and safety usually associated with bonds. But net leases come in all varieties, and though all net leases are often referred to generically as triple net leases, the reality is that there is no standardization of terms or definitions. So the challenge is always to determine exactly which responsibilities belong to the landlord and which are the tenant's, and it's those vagaries that often make it difficult to precisely evaluate these investments.

Thinking ahead about landlord/tenant division of duties

There are several different types of triple net properties. All net leases have some aspect of the tenant paying for operating expenses, taxes, insurance, maintenance, repairs, and even capital improvements. These investments (sometimes referred to as *bond leases*) include net leases where the total

responsibility rests with the tenant. In a bond lease, the tenant is fully responsible for the repairs, maintenance, and operating expenses (including taxes and insurance) of the entire property without any limitations.

The *net net net leases* (or *NNN leases*) are similar to the bond lease, with the tenant being responsible for all operating and fixed costs of the property, but often come with limitations on capital improvements or upgrades that the landlord can pass on to the tenant.

Another type of net lease is the *net net lease* (or *NN lease*), which is an investment where the tenant pays most operating expenses but the landlord retains responsibility for the structural components such as the foundation, bearing walls, and roof. Sometimes a net net lease also includes a property where the owner is also responsible for major building systems such as HVAC equipment, electrical, plumbing, and driveways and parking areas.



If you're considering an investment in any type of net lease, you must carefully review the lease to determine exactly who is responsible for all components of the building. You should also be very specific on your requirements or expectations about the quality of the maintenance of the property as well as the details of the insurance coverage, including making sure you're named on all policies as an additional insured. If you're a novice, be sure to use the services of a real estate attorney or lease expert to prepare a *lease abstract*, which is a summary of the pertinent information from the lease.

A triple net lease typically involves a fast-food franchise, restaurant chain, local chain drugstore, or similar retail outlet. The owner buys the building, which is built precisely to the tenant's specifications, and the tenant then enters a long-term fixed-rent lease in which she pays for almost everything, including the property taxes, insurance, utilities, and most of the maintenance. Many companies rely heavily on the sale/leaseback of their newly built locations. The advantage to the tenant is that they free up capital to expand and grow their primary business, which isn't actually real estate.

Originally, these investments were offered by developers who worked exclusively with such companies, but now many brokers specialize in the marketing and sale of triple net properties.



The owner should regularly inspect the property under any type of net lease that isn't a bond lease because she retains ultimate control — and thus the liability — if the tenant fails to properly maintain the building. Robert has seen a litany of litigation between the owner and tenant over issues of exactly what type of net lease exists, with the key dispute being an interpretation of who is responsible for the repair and maintenance of building components. These lawsuits often result from third-party injuries, with the landlord and the tenant each accusing the other of failing to properly inspect, maintain, and/or repair the property.

Minimizing the risks of triple net investments

Lately, the returns available on these triple net properties have been low due to the perception that they're essentially a risk-free investment. However, should the tenant find that the location isn't profitable, you may find yourself owning a customized taco stand that requires a lot of modifications to be a viable location for another business.



Triple net real estate investments are suitable for some, but stay away from them unless you're really comfortable with the tenant and the location and are willing to accept relatively low rates of return. Also, look closely at the rent structure because most leases have many years of flat, fixed rental income with an occasional upward adjustment that's likely to be lower than the future market rent. Triple nets may make some sense if you can consistently earn a return that's higher than a comparable bond investment. But you always run a risk with any single-tenant investment property, and fast-food and drugstore chains can (and do) go out of business. We advise investors interested in this type of investment to consider the diversification and lower risk associated with purchasing REITs (discussed earlier in this chapter) that hold triple net properties (among others) rather than a direct purchase of a triple net property.



Robert is aware of many triple net properties that probably seemed like great deals at the time buyers purchased them with a *national credit tenant* (an expanding company that has a very solid financial balance sheet) on a long-term lease. What could go wrong? A lot. With leases as long as 50 years and set rents that are modestly adjusted over time, you run a serious inflation risk unless the rents can adjust to fair market rent at least every 5 to 10 years. The more specialized the use of the building by the tenant, the more challenging your life can be if the tenant vacates, so consider whether the tenant improvements are suitable or can be modified at a reasonable cost to suit the needs of a replacement tenant.

Notes and Trust Deeds

Although the vast majority of real estate loans for purchasing or renovating properties comes from conventional lenders, some private sources of money make loans backed by notes or trust deeds. Real estate investors have found that they can benefit from the strong demand for real estate in their area by acting as a lender. They purchase notes and trust deeds that are backed by pledged real estate. *Pledged real estate* is the collateral or security interest provided to the investors to protect them from nonpayment by giving them the ability to foreclose on the real estate. Besides the interest earned on the investment, the note or trust deed holder has the collateral of the underlying real property if the borrower defaults on the loan.

Real estate investors who buy and sell trust deeds are also often interested in making private *hard money loans* (loans on top of the first mortgage made by a traditional lender) to property owners or other real estate investors. These hard money loans are secured by the owner's equity in the property and offer potentially favorable returns for the lender willing to make loans to borrowers that often have poor credit. Although your risk increases when the borrower has credit issues, the terms can be quite attractive — typically above-market interest rates ranging from 10 to 15 percent, plus loan fees of 3 to 5 points (a *point* is 1 percent of the loan amount and is essentially prepaid interest), plus prepayment penalties that lock in the high interest rates or require a hefty payment for the privilege of refinancing.

Your loan is secured by a mortgage or deed of trust against the property, so it's extremely important to be conservative with the loan-to-value ratio or the amount of money you actually lend the borrower versus the fair market value of the property. At times, borrowers damage or neglect the property if they fall behind on the payments, so we advise real estate investors to limit their exposure to no more than 50 to 60 percent of the value of the property.



Although making and purchasing real estate notes and trust deeds can be a lucrative investment vehicle, acting as a real estate lender can be risky for the novice. Properties with latent problems or unrecorded tax liens are just some of the potential pitfalls. Should you decide that lending money on real estate offers you the high returns you're looking for without the headaches of ownership, proceed with caution. Also be sure that you have an experienced real estate advisor and/or your real estate attorney review the documents before making an agreement or advancing any funds (see Chapter 6).

The safest approach to making secured loans on property is to thoroughly evaluate the pledged collateral to protect your investment and determine the fair market value if you had to foreclose. Never make a loan on a property that you wouldn't be willing to own if that becomes your best way to protect your investment. Some lenders actually hope that the borrower does default so they can obtain the property for a fraction of its market value.

However, don't forget that you're responsible for legal fees and foreclosure costs in addition to the unpaid balance of your loan and accrued interest in the event that the borrower defaults.

Tax Lien Certificate Sales

Real estate owners who fail to pay their property taxes in a timely manner find that the local county files a lien on their property. A *lien* is any legal claim or charge against real or personal property for the satisfaction of a debt or duty that includes the right to take the property if the obligation isn't

discharged. The county ultimately sells the property in a tax lien certificate sale auction to generate the funds necessary to satisfy the unpaid real estate property taxes, along with the accrued penalties and fees.

But local municipalities don't want to foreclose or wait for payment because they need the funds today to pay the costs of government, so they auction off these tax lien certificates to investors.

Tax lien certificates can be a good investment regardless of the economic cycle, because some property owners will always be unable to pay their property taxes. When you buy a real estate tax lien, you're simply providing the government entity with the funds for the delinquent taxes and buying the rights to collect those taxes from the property owner (plus penalties and a fixed rate of interest that can range from 12 to 24 percent per year).



The property owner can't sell or pledge her real estate without paying the outstanding tax liens, so over 90 percent of the tax lien certificates are redeemed within 24 months (or the maximum allowable redemption period set by each state or county). Look for tax lien certificates in certain types of real estate, such as owner-occupied properties, because these tend to have nearly a 100 percent redemption rate. You may ultimately have to give the required legal notices and foreclose on the underlying real estate to achieve your return of capital and realize your return on investment, so always limit your purchase of tax lien certificates to properties that you're willing to own.

Tax lien certificates aren't available in every state, and you don't have any way to control the timing of the redemption. Savvy real estate investors that have done quite well with tax lien certificate sales generally buy multiple liens to spread out their anticipated payoffs. Also, they read the fine print of the government rules and regulations concerning these sales, because the rules vary greatly from state to state — and each county within a state may have different rules. Contact your county tax collector to see whether real estate tax lien certificates are a viable investment alternative in your area.



You have to devote the time necessary to really find out about the underlying properties even though finding information is difficult. The conventional sources of local real estate knowledge — brokers and agents — don't work in this market because they offer no opportunities for them to earn commissions.

Limited Partnerships

Unlike a *general partnership*, in which every partner has full management authority and accountability, a real estate *limited partnership* is an investment program in which general partners manage property and accept unlimited liability, and the limited partners don't participate in management decisions

and their liability for losses is limited to their investment. A limited partnership offers advantages to real estate investors who want to participate in the market while limiting their day-to-day involvement and liability.

The disadvantage of limited partnerships is that limited partners don't have any authority, so limited partnerships are passive investments.

In a limited partnership, the general partner makes all the decisions of management and even decides when to sell the property. Upon disposition, many limited partnerships provide for the general partner to receive a portion of the appreciation (usually from 10 to 25 percent) right off the top — prior to distributions to the limited partners who get a share of the remaining realized appreciation based on their ownership percentage. This equity kicker for the general partner is typically in addition to brokerage fees upon acquisition and disposition, plus market rate or higher fees for property management and asset management.



Although some limited partnerships are formed by general partners who treat each partner as an equal, the majority is structured by general partners with the perspective of “Heads: I win! Tails: You lose!” Some limited partnerships are nothing more than a pure profit play for the general partner in which they get their money upfront — often while the limited partners are held captive and can only hope to see the return of their capital and some appreciation in the distant future.

Limiting the scope of limited partnerships

Limited partnerships have been available for many years. Prior to the extensive overhaul of the federal taxation of real estate investments in the 1980s, they were a common method of real estate investing. Up until that time, all losses from real estate were fully deductible, and these loopholes created opportunities for aggressive tax management to avoid legal tax liabilities.

In 1986, Congress passed new tax regulations that eliminated the favorable tax treatment of most losses unless the real estate investor was an active participant. To qualify as an active participant, an individual must be involved in direct management decisions of the property, although the day-to-day rental activities of collecting rent, overseeing repairs, and paying bills can be delegated to a property manager.

Further, the federal tax code limits the deductibility of your passive losses against your earned income (salary, dividends, and interest) to a maximum of \$25,000, as long as your adjusted gross income doesn't exceed \$100,000. The maximum \$25,000 passive loss deduction phases out at a ratio of \$1 for every \$2 in adjusted gross income between \$100,000 and \$150,000. For real estate owners with adjusted gross income exceeding \$150,000, any passive losses are carried forward to future years or until the property is sold.

However, we discuss an extremely valuable exception for real estate investors who qualify as real estate professionals in Chapter 18.

Chapter 5

Fast Money: Small Down Payments and Property Flips

In This Chapter

- ▶ Debunking no-money-down strategies
 - ▶ Choosing the best fast-money strategy
 - ▶ Uncovering those buy-and-flip properties
-

The only thing better for a small-time investor than getting rich is getting rich quickly. Entire books have been written about hitting the real estate big time with little money to invest through buying and flipping properties to turn quick profits.

Does this scenario sound too good to be true? Of course it does! In some cases, these strategies have proven profitable — but those success stories are few and far between. That’s why we warn you about the realities and truths of the get-rich-quick-and-with-little-money sales pitches in this chapter, and we offer our best advice to guide you in case you choose to walk these dangerous paths despite our persistent warnings!

Purchasing with No Money Down

If you’ve ever had insomnia and turned on the television in the middle of the night, you’ve likely seen the late-night infomercial real estate gurus who claim to possess the true secrets of buying real estate significantly below market value — and they don’t even use their own money! They tell viewers that anyone can buy real estate tomorrow using their no-money-down strategies. And it gets even better — they tell you that you can actually receive money from the seller to buy her property.

The birth of the no-money-down movement

The popularity of no-money-down investing peaked in the early-1980s when most real estate loans were *assumable* — the buyer of the property essentially took over or assumed the payments on the current loan from the seller. Properties weren't appreciating that quickly in that time frame, so many owners didn't have

significant equity in their homes and were willing to take small down payments or carry seller financing as part of the transaction. The advent of the due on sale clause in many mortgages virtually eliminated the ability of buyers to assume the sellers current loan.



Although we do believe it's possible to find a buyer who is so motivated that she'll actually pay you to take a property off her hands, the reality is that the vast majority of such properties don't prove to be profitable for you in the long run. Ask yourself — why would anyone give away a property unless it had some really serious problems?

Understanding why we recommend skipping these investments



The concept of buying real estate without using any of your own money is clearly dependent on finding an extremely motivated seller. A *motivated seller* is one who faces circumstances that don't allow him the flexibility to achieve full market value for his property. For sure, a certain number of motivated sellers exist in any market.

The late 2000s downturn in the real estate market may seem a perfect opportunity to explore the benefits of putting less money down to purchase a property. The reality is that most lenders are no longer in the creative financing business after being burned by the stated income or “no doc” and similar subprime loans in which the buyers have no vested interest and were counting on unsustainable appreciation to create equity.

There are also fewer sellers with significant equity in their properties so the margin for seller financing is diminished. Low money down and/or installment sales are much more likely and feasible when you have a seller with plenty of equity. However, many of the most motivated current sellers are owners of properties in which they owe as much or more than the property's current market value.

The stock market is a relatively liquid market where buyers and sellers can enter or leave the market quickly with broad knowledge of current pricing. In contrast, real estate assets are *illiquid* — it can take a relatively long time

to enter or leave the real estate market. Real estate is also unique: A share of your favorite stock always represents the same investment; not so with real estate. This creates the opportunity to profit from pricing inefficiencies between one property and another. Also, the ability to complete a real estate transaction quickly provides an additional factor that can affect the price.

The following are examples of motivated sellers who may be willing to accept a no-money-down offer:



- ✓ **A seller who's relocating and needs to sell in a hurry:** An owner who's leaving the area may need to quickly sell his home so he can buy a replacement home in his new location. In order to complete the sale in a timely manner, he may be willing to lower the price to somewhat below the *full market value* (the price he could have received if he were not in such a hurry).

Finding a seller in a hurry is one of the most reliable ways to buy real estate with little or no money down.

- ✓ **A seller who's desperate to sell and exasperated by the effort:** The owner of a property that has been vacant for an extended time period or that requires extensive renovation may be desperate to sell. The property may have a deadbeat tenant, or maybe it's vacant after being destroyed by the last tenant and the owner lacks the cash to make the significant investment in repairs. This type of seller may be willing to offer generous seller financing terms or even pay you to remove him from his liability.

But even when sellers find themselves in such positions, who will stamp "Desperate to Sell" on their forehead? Trying to determine a seller's motivation always takes work. Check out Chapter 13 for more on the subject.



Although, clearly, such real estate owners exist, they're not as common as some of the real estate investment gurus would have you believe. There are always anecdotal stories about an amazing success story, but there are many more untold stories of cocky novice real estate investors who found out the hard way that you get what you pay for.

Finding no-money-down opportunities (if you insist)



No-money-down sellers are in greater abundance in a weak real estate market (or *buyer's market*) because sellers have fewer options. The target market for no-money-down deals is a real estate market environment with highly motivated sellers facing dire consequences (including foreclosure, which we discuss in Chapter 3) unless they dispose of their property. Usually, sellers that need to sell quickly are in one of the following situations:

- ✓ **A seller who has had some unfortunate circumstances** such as an illness, a death in the family, a divorce, a job loss, or a significant loss of income such that she can no longer afford to make the payments and handle the ongoing expenses of the property — this situation is often the one that leads to a no-money-down offer. Because of her compromised situation, such a property seller may not readily qualify for new or additional loans that would allow her to handle the cash flow dilemma she faces. Although home equity loans may be available in these circumstances, the owner may be so financially overwhelmed that she prefers to sell her property and downsize her financial obligations to a more manageable level.
- ✓ **A seller with significant equity but limited options to tap that equity** is likely to have cash flow problems, but the overall equity in the property can allow her to act as a lender to you (see Chapter 8 for seller-financing strategies).



The two most common *good candidates* (as opposed to the classic definition of folks who would be flexible out of desperation) for no-money-down scenarios are

- Folks at or approaching retirement age who would prefer a steady income stream to a lump sum.
- Individuals who inherited the property and are looking for monthly income without the hassles of being a landlord.

In order to know whether the candidates you're considering fall into one of the preceding scenarios, you need to assess their motives. Chapter 13 helps you do that.

Buying, Fixing, and Flipping or Refinancing



In a solid real estate market, you often find properties appreciating at an annual rate of 3 to 5 percent — a solid and sustainable rate of appreciation that rewards investors with long-term investment horizons who take the buy-and-hold approach with their real estate assets. This buy-and-hold strategy works and should always be the foundation of your wealth-building.

But in some areas, the demand for housing has been so great that the limited supply of new and existing properties available in the market is insufficient to meet the demand. It's in these markets of high demand and rapidly escalating prices that real estate speculators with a buy-and-flip strategy appear.



There's nothing wrong with the buy-and-flip strategy, but we prefer the more conventional and lower-risk strategy of buy, fix, and hold.

The buy-and-flip strategy

The buy-and-flip strategy can also work with existing homes that the investor can purchase from a motivated seller at a wholesale price that is below the market value. The investor may not even have to close escrow before finding a buyer willing to pay a retail price. There may be some minor cosmetic work or simple improvements needed before reselling, but typically, buy-and-flip investors really make their money when they buy at a discount and then locate a buyer at full market value. This approach is risky, but it can also be rewarding.



This high-risk strategy requires a rapidly rising real estate market with higher than normal appreciation rates to allow for profits on short term investments. Not only do you have to have excessive demand driving up the prices of real estate, but you also have to cover all of the costs of real estate. With online stock trading firms, you can buy shares of your favorite company in minutes with relatively low transaction costs. But with real estate, the costs of buying, holding, and selling a property are much higher and unknown, and generally include

- ✓ **Acquisition costs:** Due diligence and inspection fees plus loan fees/costs and points
- ✓ **Transaction costs:** Closing and escrow fees
- ✓ **Repair or upgrade costs:** Costs to renovate or fix property to make it more desirable and generate the highest resale price (unless the property is brand-new)
- ✓ **Holding costs:** Property taxes, insurance, and any negative cash flow while the property sits vacant or if the rental income doesn't cover the carrying costs
- ✓ **Sales costs:** Commissions and title insurance from the sale of the property

Even during the weak real estate market in the late-2000s, you see late-night infomercials promoting the flipping strategy, but they often cite examples with just limited information. These ads feature an average Joe who invests his excess income in a fixer-upper down the street — he pays \$150,000 for it and then sells it for \$200,000 after replumbing the property and installing all new flooring, window coverings, and appliances. The infomercials imply that he just made a quick and effortless \$50,000.

But what they don't say is that he has \$3,000 in acquisition costs, \$2,000 more in transaction costs, \$15,000 in repairs and upgrades, and \$10,000 in sales costs for a total of \$30,000. That brings the theoretical profit down to \$20,000 before factoring in holding costs. Even if everything works out well for Joe, his property likely sits empty for at least six months while he renovates it, puts it on the market, and shows it to prospective buyers. So by the time Joe has completed this investment cycle, he's quite possibly spent another \$6,000 in mortgage interest payments, plus \$2,000 in property taxes and insurance. His pre-tax profit is now \$12,000 if everything goes well. But wait — there's more. Because he only held this investment for less than one year, he pays income tax at his nominal ordinary earned income tax rate of, say, 30 percent, which brings his amazing \$50,000 profit down to a measly \$8,400.

But what if there are some additional problems with the property when Joe opens up the walls to replumb his new investment gem? Maybe there are termites or roof leaks or problems with the foundation. What if the demand for this property diminishes and he has to hold the property for 12 months? (Some folks got burned in the late-2000s when the demand for housing suddenly evaporated.) Even in the best scenario, where Joe has accurately estimated the repair and upgrade costs and there are no surprises, he finds that just owning the property for six months longer than he expected doubles the holding costs from \$8,000 to \$16,000, reducing the pre-tax profit to \$4,000. By the time he is done paying 30 percent of that in taxes, Joe has just \$2,800 to show for his efforts.

You may be located in a market that has experienced rapid housing price increases, but be careful. If there is too much excess demand for new housing in the area, real estate speculators — not long-term investors or homeowners — can make up the majority of the purchasers. This tendency can be dangerous when the majority of buyers in the market are looking for the quick profit rather than a long-term, stable real estate investment. When enough of these speculators head for the exits (as happened in some areas in the late-2000s real estate market decline) and don't return, prices can quickly turn tail. The speculators are then forced to mitigate their losses by renting out their properties (sometimes for years) until the real estate market rebounds and they're able to sell the property to break even.

But we're pragmatists — we know that lightning may strike and you may run into a property that turns out to be a buy-and-flip candidate. So in Chapter 13, we detail how to keep this possibility open by using an assignment clause when completing a purchase agreement. And we also cover possible tax drawbacks of losing the advantages of lower capital gains taxes in Chapter 18.

The buy, fix, and refinance strategy

With the *buy, fix, and refinance strategy*, you invest in properties where value can be added to the property through repairs, upgrades, and improvements that take a distressed property and turn it into a solid and well-maintained property. Over the years, with increased equity in the property and as long as interest rates are attractive, you could refinance the property if you so choose and use some of your equity towards other real estate investments.

We strongly prefer this method because it has proven throughout the years to be the lowest risk, highest probability way to make money in real estate. You can think of it as the tortoise in the old tortoise-and-the-hare story, where the hare is the fast-money, high-risk, high-return strategy. The tortoise may be slow and steady, but he ends up winning in the long run. As an example, Robert is a conservative person by nature, yet he has acquired a significant real estate portfolio by simply purchasing well-located-but-distressed properties and renovating, filling them up, and then refinancing.

Chapter 6

Building Your Team

In This Chapter

- ▶ Assembling your team first
 - ▶ Hiring tax and financial advisors
 - ▶ Seeking lending professionals
 - ▶ Finding top real estate agents and brokers
 - ▶ Adding appraisers and attorneys
-

There are some investments — called *passive investments* — where you can simply turn your money over to professional money managers or financial advisors who then act on your behalf and make the day-to-day investment decisions, buying and selling investment assets within the portfolio. Mutual funds are an example of this type of passive investment. You send your money to your favorite mutual fund firm and periodically evaluate how your fund's managers are doing.

Investments in real estate that you're directly involved in managing are the norm, because passive investments in real estate aren't readily available (except for REITs and TICs, which we discuss in Chapter 4). And for most real estate investors, real estate investing is hands-on and complicated enough to require the services and knowledge of a team of professionals. Although you may be skilled in your chosen field, it's unlikely that you possess all of the varied and detailed skills and knowledge necessary to initiate and close a good real estate transaction.

Evaluate proposed real estate investments carefully and methodically before you make the ultimate purchase decision. The uniqueness of each potential real estate opportunity requires the investor to patiently critique the pending investment. You should understand the economic climate and potential for growth, the current physical condition of the property, the tenants, and the value of the property in the marketplace. Then you should ensure that you've got a solid negotiating strategy to orchestrate a deal, that the financing comes through, and that the transfer of real estate is handled properly. This requires a team approach.

In this chapter, we discuss the different real estate professionals and service providers that you should consider teaming up with as you search for real estate investment opportunities and proceed with the purchase of property.

Knowing When to Establish Your Team



Some real estate investors make the mistake of looking for a property to buy without spending enough time upfront thinking about and identifying the pros whose help should be hired. We recommend that you have your team in place before you begin your serious property searching, for two reasons:

- ✔ **You can move quickly.** The speed at which you can close a transaction is an advantage in any type of market. In a soft or buyer's market, some sellers are desperate for cash and need to close quickly. In a rising or seller's market, sellers typically don't tolerate having their property tied up in a long escrow with a buyer who doesn't understand the current market conditions or how to properly evaluate the property. Sellers may be missing out on a better deal with a more qualified buyer. In a buyer's market, although less property may be selling overall, there is always demand for the most appealing properties that are priced right and well located. These properties often attract multiple offers, so being organized and efficient can make the difference between securing and losing a desirable property.
- ✔ **You can effectively research the property before making an offer.** Prudent investors conduct research and gather information before they buy, so they know which property or properties are worthy of an offer. Typically, the real estate industry describes *due diligence* as the period of time after you place a property under contract (see Chapter 14). But you really need to perform due diligence even before making an offer. You don't want to waste time or money on a property that can't meet your goals.

Some real estate investors like to make an offer and get a property under contract before they begin due diligence. We believe that this is a mistake and can lead to a reputation with sellers (and agents) that you're not a serious buyer (see the "Working with Real Estate Brokers and Agents" section later in the chapter). We recommend only making offers when you have done enough due diligence to feel comfortable that your further, thorough review of the property interiors and books probably won't reveal any surprises that will lead to canceling the purchase.

The most effective research is done with the assistance of real estate professionals to give you the advice and information you need to make an intelligent decision. This pre-offer period is critical; it's the one real opportunity for a prospective buyer to investigate a property while retaining the ability to terminate the transaction without a significant monetary loss. You may invest time and several hundred to several thousand dollars to perform the necessary due diligence, but this is a small amount compared to the potential losses from the purchase of a bad property. (We cover this prepurchase research in Chapters 10 through 12.)

Adding a Tax Advisor

A tax advisor may not be the first person that you think to consult before making a real estate transaction. However, our experience is that a good tax advisor can highlight potential benefits and pitfalls of different real estate investment strategies. Of course, make sure that your tax person has experience with real estate investing and understands your needs and specific goals in regard to your property investments. (We cover the ins and outs of real estate accounting and taxation in Chapters 17 and 18.)



Although you may pick up a lot of information about real estate and discover some of the advantages of property investing speaking with some tax people, don't rely on generic information ("investing in real estate offers a terrific tax shelter," for example). You need specific feedback and ideas from a tax expert regarding your unique financial situation and which types of real estate investments work best for you.

Based on your age, income, and other important factors, the benefits you seek from real estate may be entirely different from other investors. Many real estate investors are looking for immediate cash flow from their properties. But others have sufficient income currently from other sources and prefer to look at real estate as a wealth builder for their retirement years. And almost all real estate investors are looking for tax benefits.

The role of your accountant is to evaluate and recommend investments and tax strategies that maximize your financial position. Remember the old adage that says, "It's not what you make that matters but what you keep."

A good tax advisor with property investment experience can tell you whether your best real estate investment is the direct ownership of properties or perhaps owning triple net leased properties with lower returns but fewer management headaches. An accountant can inform his clients as to whether they can still meet the active participation required for certain tax benefits while hiring a property management company to handle the bulk of the day-to-day tenant/landlord issues.

You may also want to find out whether you qualify for the added tax benefits that are available for some investors who qualify as real estate professionals. Achieving such qualification isn't easy, and the IRS may someday audit you. Meet with your tax advisor and get to know the benefits and pitfalls of your proposed real estate investments before you start making offers.

Finding a Financial Advisor

Over the years, Eric has written extensively about the financial planning profession and how individuals can best navigate important personal financial

decisions with and without the help of such planners. In theory, everyone entering into major investments like real estate should seek holistic financial advice from a financial advisor who charges an hourly fee.

Avoiding financial conflicts of interest

Here are a couple of stories that highlight the conflicts of interest you may be subjected to when working with a financial advisor.

✔ While serving as an expert real estate witness, Robert had a case where a retired couple was given some self-serving advice by their financial planner. This couple owned their principal residence plus three other rental homes valued at \$1 million. All of their real estate was owned free and clear, and the rentals were in great condition with good long-term tenants. The properties provided a nice monthly income stream that was mostly tax-free due to their depreciation deduction (see Chapter 18). Although the real estate was clearly their largest asset and completely debt-free, they also had nearly \$500,000 in liquid assets such as stocks, bonds, and IRAs and seemed to be fairly set. That was, until their new financial advisor told them that their retirement was at risk because they had too much invested in real estate. The planner's recommendation was to keep their own home as their real estate investment, but sell the three highly appreciated rental properties and invest the proceeds in mutual funds and other financial products from companies affiliated with the planner.

The planner failed to disclose his relationship with the sponsors of the new investments and also failed to warn them about the significant capital gains taxes that would be due upon sale. By the time they met with their accountant, it was too late — two of the three rental properties had been sold and over \$200,000 in taxes was due. The accountant advised the couple to contact an attorney and file a lawsuit against the financial advisor. Although

the couple prevailed, they recovered only a small portion of what they paid in taxes. Even worse — they lost the benefits of cash flow and appreciation on their real estate while now owning fully taxable investments.

✔ In Eric's previous work as an hourly-based financial advisor, he often had clients come to him who were disappointed with the biased and confusing advice they got from various so-called financial planners. In one typical case, a widow had been told by an advisor to sell her two investment properties because he believed that the stock market would produce better returns. She set the wheels in motion to unload the properties but put the brakes on at the last minute after deciding she needed a second opinion. She met with Eric. The first thing that she noticed working with him was that he was far more thorough in examining her overall financial situation, including *all* of her investments, insurance, and resources for retirement. She also realized that she was happy with her real estate holdings and really didn't have any motivation to sell them. Furthermore, she found out from Eric that over the long-term, the returns from stocks and real estate were quite comparable. She thus decided to keep her life simple and stable and hold onto her nicely performing rental properties.

Don't get us wrong, selling real estate can make sense at times. However, you must ask a lot of questions and run any proposed investment strategies by good independent advisors before you make the decision to liquidate your real estate and shift your investments to other opportunities.



In reality, many financial consultants sell investment and insurance products that provide them with commissions or manage money for an ongoing percentage in stocks, bonds, mutual funds, and the like. Such salespeople and money managers can't provide objective, holistic advice, especially on real estate transactions. When you buy property, you spend money these people want to manage. Check out the "Avoiding financial conflicts of interest" sidebar in this chapter for more information.



If you've worked with or can locate a financial advisor who sells her time and nothing else, just as a good tax advisor does, consider hiring her. A true financial advisor can help you understand how real estate investment property purchases fit with your overall financial situation and goals. (Chapter 1 discusses all the variables that affect the way your investments mesh with your situation and goals.)

Lining Up a Lender or Mortgage Broker



Before looking at specific real estate opportunities, you need a budget. And because your budget for real estate purchases is largely a function of how much you can borrow (in addition to your cash available for a down payment), you need to determine the limits on your borrowing power. If you can't afford a property, it doesn't matter what a great deal it is.

Postpone making an appointment to look at investment properties until after you examine the loans available. You have two resources to consult:

- ✓ **Lender** is a generic term for any firm, public or private, that directly loan you the cash you need to purchase your property. This type of lender is often referred to as a *direct lender*. Most often, your list of possible lenders includes banks, credit unions, and private lenders (including property sellers). Lenders tend to specialize in certain types of loans.
- ✓ A **mortgage broker** is a service provider that presents your request for a loan to a variety of different lenders in order to find the best financing for your particular needs. Just like real estate or insurance brokers, a good mortgage broker can be a real asset to your team (we cover mortgages in detail in Chapter 8, along with the advantages and disadvantages to working with mortgage brokers versus direct lenders in Chapter 9).

Protecting yourself by understanding lending nuances

Lenders and mortgage brokers are in the business of making loans. That's how they make money. Their product is cash, and they make money by renting it to people and businesses that pay them the money back plus

interest, which is the cost of renting the money. Money is a commodity just like anything else and its availability and pricing are subject to an assortment of variables.



Lenders and mortgage brokers want to find you money for your next real estate purchase, but they're not objective advisors to provide counsel for how much you should borrow. They're trained to calculate the maximum that you *may borrow*. Don't confuse this figure with the amount that you *can truly afford* or that fits best with your overall financial and personal situation. Because they only are paid when they make loans, many borrowers have learned the hard lesson that some lenders and mortgage brokers are willing to make any loan.



So why is getting a loan so difficult at times? Because lenders want to make loans to those investors who are a good credit risk and who they think have a high probability of repaying the loan in full plus the interest. This concern became more pronounced in the late-2000s as real estate prices fell and defaults and foreclosures escalated. The lender has costs of doing business and needs to make a profit. Because the money they lend often belongs to their depositors, lenders need to be careful and selective about the loans they make. (See Chapter 9 for more information on the necessity of a good credit rating when investing in real estate.)

On the upside, we've found that lenders can also serve a valuable role by preventing you from making serious mistakes. Particularly in overheated seller's markets where prices are irrationally climbing with little fundamental economic support, your lender and the required appraisal from a competent professional appraiser can keep you from getting caught up in a buy-at-any-price frenzy. (Of course, this isn't always the case; look no further than the subprime loan debacle that came to light in the late-2000s.) In these markets, lenders tend to be a little more conservative, limiting loan amounts and requiring larger down payments. These factors provide the lender with additional protection should market prices fall, but they're also a signal that the lender feels the loan exceeds the intrinsic value of the property that they'll be stuck with if you default. Smaller loan offers with higher down payments are a clue that you may be paying more than a property is worth or buying at the market's peak.

The lender requires collateral to protect them if the borrower doesn't make the debt service payments as required. *Collateral* is the real or personal property that's pledged to secure a loan or mortgage. If the debt isn't paid as agreed, the lender has the right to force the sale of the collateral to recover the outstanding principal and interest on the loan. Typically, the property being purchased is the pledged collateral for real estate loans or mortgages.

Building relationships with lenders



Relationships with lenders can take time to build, so begin looking for lenders that specialize in the types of properties within the geographic area that you have targeted. They can help you understand your financial qualifications or how much you can borrow before you begin your search for an investment property. Although lenders only make money by making loans and some lenders seem to be willing to lend money on any property at any price, the type of lender you should associate with is one who understands real estate cycles and your local real estate market. Not all lenders and mortgage brokers were hit by the subprime lending mess, and it does matter that you develop a relationship with a lender that's likely to be there when you want to acquire additional properties.

When you get together with your lender or mortgage broker, provide them with your latest personal financial statement, which includes your income and expenses as well as your assets and liabilities and net worth. The days of "no documentation" or "stated income" loans are hopefully over.



Always be truthful with your lender. One way to sabotage a relationship with a lender is to exaggerate or stretch the truth about your current financial situation or about the potential for your proposed property acquisition. Most lenders require supporting documents for your income and assets and will obtain a current credit report. When you don't oversell yourself or your proposed property, lenders are often more willing to work with you and even offer better terms.

Working with Real Estate Brokers and Agents

Your investment team should include a sharp and energetic real estate broker or agent. All real estate brokers and agents are licensed by the state in which they perform their services. A real estate *broker* is the highest level of licensed real estate professional, and a licensed real estate sales *agent* is qualified to handle real estate listings and transactions under the supervision of a broker. The vast majority of real estate licensees are sales agents. Throughout this chapter, we refer to both real estate brokers and agents simply as agents.

A real estate agent must have his license placed under a supervising broker who's ultimately responsible for the actions of the sales agent. Real estate brokers often begin their careers as real estate agents, but it's possible to

meet the more stringent qualifications and immediately qualify as a broker. Brokers and agents can perform the same functions; many real estate agents actually have more practical experience and hands-on market knowledge than the brokers they work for. Brokers that have many agents reporting to them often spend most of their time educating, supervising, and reviewing the transactions presented by their agents. So, if you have a problem with an agent, contact the broker — the buck stops with her!



Generally, you deal with real estate agents, but the added experience and dedication of a broker can be beneficial to you if you're involved in larger and/or more complicated transactions. Real estate agents are fine to handle the majority of real estate transactions, including the typical purchase or sale of an owner-occupied single-family home or condo. However, many owners of investment real estate don't want the disruption that can occur with openly listing the property. The management company and employees begin to worry about their jobs, and tenants become concerned that rents will be raised. These problems can be avoided by quietly talking to one or two top brokers in an area with the understanding that the potential transaction is to be kept confidential. This leads to some great opportunities for the top brokers and their clients.

Whether you use a broker or an agent, make sure that this person has a solid track record with investment property transactions in your area. And although having a real estate agent on your team is an excellent strategy that gives you a competitive edge, don't completely ignore the Multiple Listing Service or in-house listings of brokers. Such sources often include properties that other investors overlooked because they didn't have the vision or the right team members to see a potential opportunity.

Seeing the value of working with an agent

In many metropolitan areas, looking at the properties on a Multiple Listing Service (MLS) or in the newspaper or online listings isn't enough. The best deals are often the ones that don't make it into these sources. This is where the insider information from real estate sales agents can make you the bride and not the bridesmaid. (Of course, many brokers are themselves interested in investing in income producing properties, and they have the first chance at the best deals.)

You want to be the first one contacted about the best properties coming on the market rather than one of many when everyone knows about the property from the MLS. The *MLS* is a service created and maintained by real estate professionals per guidelines established by the National Association of Realtors (NAR). This service gathers all of the local property listings into a single place so that purchasers may review all available properties from one source. The MLS also deals with commission splitting and other relations between agents.

For many years the MLS dominated the markets, but the Department of Justice filed an antitrust lawsuit that was settled with NAR in 2008, agreeing that other listing services would be given access to the same listings. Now there are several investment real estate listing services that are gaining market share and offering instant access to an incredible database of information on all types of properties from single-family homes and condos to large commercial, industrial, and retail properties. Two of the most popular listing services for investment properties are Loopnet (www.loopnet.com) and CoStar (www.costar.com).

Understanding the implications of agency: Who the agent is working for

When you deal with a real estate agent, you need to know who she represents. Real estate investors need to understand the concepts of dual agency and single agency and the implications of each:

- ✔ **Single agency:** This is when an agent only represents the buyer or the seller. The other party either represents herself or is represented by an agent who doesn't work for the same broker as the other agent. For example, a buyer's agent only has a fiduciary relationship with the buyer. The buyer's agent has a duty to promote the interests of the buyer and keep all information confidential unless legally required to disclose. The buyer's interest should be first and foremost, and no information is passed to the seller without your knowledge other than that information that directly affects your ability to perform on the contract as written.

We strongly recommend that you work with an agent who operates as a single agency representative. A lot of money is involved in income property transactions, and you want to have someone looking out for your interests whether you're buying or selling an investment property.

- ✔ **Dual agency:** A situation in which the same individual agent represents both the seller and the buyer *or* when two different agents representing the seller and buyer are from the same firm (with the same broker). With any transaction, each agent involved owes a fiduciary duty of loyalty to each client he represents, but this is nearly impossible for one agent who is representing both the buyer and seller in the same transaction (and difficult as well if two agents work for the same broker).

Avoid the inherent conflict of interest found with dual agency and establish a relationship with a single agency agent who represents only *your* interests. Dual agency makes it extremely challenging for one agent, or two agents working for the same broker, to be loyal to clients with opposing interests. For example, an agent may hear confidential information from sellers about what their minimum acceptable price is, and the same agent or another agent from the same firm hears from buyers that they're willing to pay more than what they first offered.



Agents, and especially their brokers, prefer dual agency — they generate more commissions by representing both sides of the transaction. That’s why many agents start out showing their clients only properties that are listed by their firms. However, this desire to capture a bigger share of the real estate commission has led to some serious conflicts of interest. Now most states either prohibit dual agency or at least require the agent to disclose the exact nature of the agency relationship prior to commencing the representation of a client by taking a listing, showing a property, or making an offer.

Getting a feel for compensation

Real estate agents are generally motivated to see the transaction go through because they’re compensated when a sale is made. Compensation for agents is typically calculated as a percentage of the sales price paid for a property. So the agents actually have an interest in the property going for a higher price. Commissions vary based on the property and the size of the transaction:

- ✔ Individual residential properties, such as single-family homes and condos, have commissions of 5 to 6 percent of the sales price.
- ✔ Small multifamily and commercial properties are often in the 3 to 5 percent range.
- ✔ Larger investment properties have commissions of 1 to 3 percent.
- ✔ Raw land (in its natural state with no grading, construction, or improvements) is usually at 10 percent, unless the acreage is large. Subdivided or finished developable lots in suburban areas typically draw a lower commission.

These commissions are typically split between the firm listing the property for sale and working with the seller and the agent representing the buyer. The actual proportion of the split varies, with the listing agent sometimes taking a smaller percentage than the buyer’s agent if the commissions aren’t evenly split. The commission actually is paid to the broker, and the agent receives his share based on his employment or commission agreement, which also often calls for the agent to cover some of his own expenses and overhead.

Real estate commissions can be a significant cost factor for real estate investors. Most listing agreements acknowledge that commissions aren’t fixed by law and are negotiable. Traditionally, the seller “pays” the commission to the real estate agents involved in the transaction, although because the buyer is the one paying for the property, we say that both the buyer and seller ultimately pay for the agent’s commissions.

Real estate agents do add to the cost of purchasing property, but a good agent, like a good property manager, can justify the cost of her services by introducing you to properties that you would not otherwise have an opportunity to purchase. A good agent earns her commissions other ways as well — as a good negotiator and through her other marketplace knowledge.

Some real estate investors get a real estate license so that they can eliminate paying at least one-half of the real estate commission to agents. And there are times when you'll be able to use your sale's or broker's license to effectively reduce your transaction expenses and investment requirement by representing yourself in a transaction. This is particularly helpful when you're looking to sell a property in a strong seller's market.

But as a licensee you need to be very careful to follow all real estate disclosure laws about your licensing status to all parties in the transaction. Generally, a real estate agent is expected to have more knowledge in a real estate transaction than others without such credentials. Thus, you must be very careful when you act as an agent and a principal in a purchase or sale transaction.

Although you may often have superior knowledge of market values and opportunities in the marketplace, you need to make sure that you're not self-dealing or taking advantage of insider information that would have a material impact on the value of the property. A real estate agent who buys properties for the long-term for his own account is not likely to be challenged, but such an individual that uses his knowledge to flip properties for a quick profit may be subject to claims by the seller that he withheld information. For example, you may find yourself named in a lawsuit if you bought a property at a low price when you knew that a new road was going to be built that would greatly enhance the property value in the next year or so.

Robert has seen many allegations against licensed real estate professionals who have been accused of self-dealing or failing to act properly in real estate transactions when they buy the property for an entity that they have a financial interest in or have a straw man or secret partner. This situation can happen even if you disclose your real estate license status and your financial interest in the buyer entity, but it is illegal and likely to be considered more egregious if you conceal this information from the seller. Agents have also been accused of illegal activity when they sell their own property (for example, as a tenants in common or triple net investment opportunity) at a much higher than market value.

One recent example from Robert's litigation consulting practice involved a real estate agent who advised an elderly owner to sell a residential rental fourplex where the apartments were contiguous but each rental unit was on a separate lot. The agent advised this unsophisticated owner to sell all four units as a single property to a business associate of the agent. Then the new

owner turned around and within less than 12 months had sold each of the four individual properties separately at a gross profit of over \$1 million. The agent clearly knew that real estate sold in smaller increments generates a higher overall value. The aggrieved elderly owner filed suit against the agent.

Finding a good broker or agent



The key to finding a good broker or agent to assist you in the purchase of investment real estate is to narrow the field down to those individuals who are the best. Look for folks with the following qualifications:

- ✓ **Full-time professional:** Because the commissions earned on the sale of a large income property can be so great, you'll find that almost every broker or agent will claim that she can represent you. But you want to eliminate those brokers or agents who are greedy, incompetent, or simply mediocre. Although many part-time real estate professionals sell single-family homes and condos, you'll quickly find that the most qualified real estate investment property agents are full-time.
- ✓ **Expert in the geographic market and specific property type:** Find someone who knows your market and the specific property type you're seeking. This knowledge is especially important if you don't live nearby. Avoid brokers who aren't experts in your specific property type. For example, don't use a broker who specializes in single-family homes and condominiums unless that's your target market. Likewise, a commercial property broker is unlikely to have the best investment opportunities for your consideration with single-family investment property.



Some real estate investment books advise you to contact every broker or real estate agent who targets your preferred geographic area. Although casting a bigger net has some inherent attraction, our experience is that you should only work with one broker or agent at a time in a given market area.

Real estate agents can be a key source for new investment opportunities and general market information. This is where our advice about finding an experienced agent who specializes in the types of properties you're looking for and knows the local market pays off. These agents know buyers and sellers and also possess contacts for other services and products that you need as your real estate investment portfolio expands.

After narrowing down the candidates, many standard screening techniques can then be applied to pinpoint the top three that you should interview:

- ✓ **Verify the professional's license status:** Most states have an online broker and agent database, so this step is simple. Confirm that their real estate license is current with no citations or disciplinary action for past or pending violations. If you're using a real estate agent, check both the license status of the agent and her supervising broker. If the broker or

agent has been disciplined by the state, inquire further to understand the relevance to your transaction. A suspension or temporary revocation of a license can be a serious issue — even if it was reinstated. The facts of the case may be material to your choice of a real estate professional.

- ✔ **Check references:** Get the names and numbers for at least three clients (in the geographical area where you're seeking property) that the broker or agent has worked with in the past year. Investment real estate transactions tend to be fewer than owner-occupied property transactions, so speaking with three or more clients from the last year maximizes your chances of speaking with clients other than the agent's all-time favorites.

Don't just ask for the references; call them. And don't just ask generic questions about whether the client was happy with the broker or agent. Dig deeper — find an agent who you can work with on investments that are critical to your long-term wealth-building goals. Ask questions about the types of properties and the geographic locations involved. Ask questions like, "Did the broker or agent assertively represent you and take charge of the transaction or did you have to initiate conversations?"

Consider these traits when investigating potential brokers and agents as well:



- ✔ **Willingness to communicate with you:** The number one complaint about real estate professionals is that they don't keep their clients informed during transactions. You're looking for someone with experience who isn't necessarily the top producer, because you want someone who can take the time to communicate regularly with you.
- ✔ **Interpersonal skills:** A broker or agent needs to get along with you and with a whole host of others involved in a typical real estate deal: other agents, property sellers, inspectors, lenders, and so on. An agent needs to know how to put your interests first without upsetting others.
- ✔ **Negotiation skills:** Putting a real estate deal together involves negotiation, so you want a broker or agent with negotiating skills and lots of experience in larger transactions. Is your agent going to exhaust all avenues to get you the best deal possible? Most people don't like the sometimes-aggravating process of negotiation, so they hire someone else to do it for them. Be sure to ask the agent's former clients how the agent negotiated for them.
- ✔ **Reputation for honesty, integrity, and patience:** When it comes to the brokering of investment properties, the reputation of your representative can be critical. Brokers or agents with a track record of dealing fairly with their clients and their peers can greatly assist in gaining the cooperation of an adversarial seller. And gaining such cooperation is often needed to close a complicated transaction. Some strife is almost guaranteed when buying investment real estate — there are several opportunities where the transaction can unravel and only the trustworthiness, perseverance, and patience of the real estate professionals involved can keep the transaction on course.

Making the most of your agent

To get the best deals, timing is critical. You want your broker or agent to think of you first. To do this, you need to build a solid rapport with your agent, which you can do by building a track record of not wasting the time of your professional team. Because agents only get paid for deals they close, they're not interested in investing time and energy with numerous potential buyers. They want serious buyers who will close the deal. Plus, if you garner a reputation of tying up properties and then renegotiating the deal or canceling the escrow, you'll find that your offers won't be accepted in the future. Sellers and their brokers don't want to waste time with phantom buyers.



If you're not interested in or not able to purchase a property at the time, explain your situation and thank them for thinking of you. A handwritten thank you note or simple gift also lets them know you appreciate their efforts — and keeps you at the top of their lists for the next opportunity.

Considering an Appraiser

Many real estate investors know appraisers solely in the role of providing the property valuation report required by lenders. And it's generally in this role that investors can find appraisers to be a source of aggravation rather than a potential resource. However, an appraiser can be an effective team member if your real estate investment strategy involves buying and selling properties with somewhat-hidden opportunities to add value. Appraisers sometimes possess insight into real estate opportunities that others miss.



Appraisers can help you by telling you the current value of a property, but they bring real value as part of your real estate investment team by

- ✓ Providing insight into the factors that can lead to an increase in the market value of a property.
- ✓ Assisting you in maximizing the return on your investment in upgrades to distressed or fixer-upper properties.
- ✓ Giving you useful information on the demographics of the area and helping to identify those properties that are distressed but have plenty of upside potential (properties requiring work in good neighborhoods).

One of Robert's partners, a highly successful real estate investor in foreclosure properties, has even hired an appraiser as an in-house member of his real estate investment team. Virtually every property that appears on the weekly Notice of Default list from the title company is reviewed first by the appraiser, who looks for properties that are located in the path of progress

and with some real upside potential if brought to marketable condition physically and aesthetically. (For more on Notice of Default, see Chapter 3; for information on getting in front of the path of progress, see Chapter 10.)

The appraiser is also able to assist in determining the as-is value and the cost of making the necessary repairs and upgrades to the property. This information helps the investor establish the maximum price she should pay for the property, based on comparable sales in the market.

As many have learned from the debacles of the real estate collapse in the early-1990s and the late-2000s subprime disaster, appraisals are often an art and can be very subjective. You need to make sure you find an appraiser that has a comprehensive education and training in proper appraisal techniques and complies with USPAP (Uniform Standards of Professional Appraisal Practice) set out by the Appraisal Foundation. The appraiser you use should have extensive product knowledge of your target property type (residential, commercial, and so on.) along with significant experience and market knowledge in your area. Contact the local American Society of Appraisers and the Appraisal Institute for referrals. Like many of the top professionals you seek for your team, you should not simply look for the lowest price, because you may end up with inferior value.

Finding an Attorney

You may think that adding an attorney to your real estate investment team seems like an expensive luxury that you can't afford. Indeed, you may be able to purchase properties when you're just starting out as a real estate investor without consulting an attorney, because buying a small rental property is often not much different from purchasing your own home. The process is relatively simple with preprinted forms that seem so easy to complete. And you usually have an experienced real estate agent to guide you through the process. (See Chapter 13 for information on locating forms.)

For simple transactions, the retention of an attorney is strictly a function of whether attorneys are traditionally involved as the intermediary or closing agent. If you live in an area where attorneys aren't usually involved in real estate transactions, an attorney may not be necessary. In some states, it's essential to have an attorney actually handle the transaction and closing.



But we strongly suggest that you consult with an experienced real estate attorney as your investments increase in size and complexity. With more complicated transactions, have the attorney review the documents — even in states where the title or escrow company handles the paperwork and serves as the independent intermediary or closing agent. A good real estate attorney can

help you structure proposed transactions. Particularly if you're looking into a large transaction where you assume loans or you're attempting to secure special financing, a competent real estate attorney can be invaluable.

Robert's late father, a real estate attorney, taught him early in his real estate investment career that the best time to consult with an attorney is before you finalize the proposed transaction. There is nothing your attorney can do to avoid legal snafus and expensive litigation if he isn't hired to draft, review, and negotiate the terms of your proposed transaction in advance. Although such a review may cost you some money up front, it's definitely much more economical than having to hire an attorney to get you out of a bind.



Seek an attorney who specializes in real estate purchasing and lease transactions. Ideally, you'll find one attorney or law firm that can assist you not only with your transactions but also with the drafting and review of other documents as you operate the property. In particular, look for attorneys who have specialized knowledge of tenant-landlord laws and the complicated issues surrounding commercial leases.

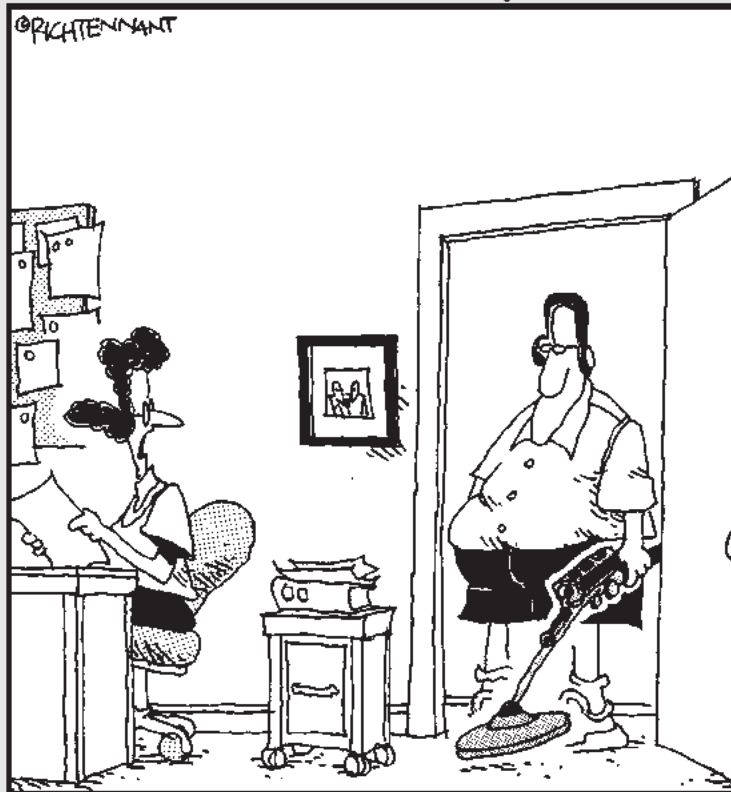
Check references and find an attorney who has excellent communication skills and can explain complicated legal terms and documents in terms you understand. As with any professional, the old adage that "You get what you pay for" holds true more often than not. So remember that the lower hourly rate attorneys aren't necessarily your better option, because more expensive, yet more experienced, attorneys are your best bet when you're investing in large real estate transactions.

Part II

How to Get the Money: Raising Capital and Financing

The 5th Wave

By Rich Tennant



"So...how did our first stage financing go today?"

In this part . . .

In this important part, we detail the amount of money you need to have in hand for various real estate investments, as well as where you can go to borrow the rest (because few real estate investors buy property with 100 percent cash). In addition to discussing traditional lending sources, we also cover seller financing of properties. Last but not least, we explain how to save money and get the best loan for your situation.

Chapter 7

Sources of Capital

In This Chapter

- ▶ Moving beyond the no-money-down myth
 - ▶ Knowing what you need to get going in real estate
 - ▶ Locating cash
-

For many people, the trouble with real estate investing is that they lack the access to cash for the down payment. The old adage that “it takes money to make money” is generally true in our experience. Most real estate investing books make one of two assumptions. Some assume that you have plenty of money and just need to figure out how to buy, add value to a property, and then sell. Of course, it would be great if that were true, but not everyone is flush with cash. The other common assumption is that you have no money and must resort to scouring the real estate market in search of sellers so desperate to sell that they or their lenders don’t require any down payment. We assume neither.

So how do you get started in real estate if you don’t want to own distressed properties in the worst neighborhoods, and you don’t have a six-figure balance in your checking account to pay top dollar in the best neighborhoods? You muster all the patience you can and embrace a long-term vision. You don’t have to be wealthy or have great savings to begin making attractive real estate investments. In this book, we present a wide range of investment options, so there’s something for virtually everyone’s budget and personal situation. Our method of building real estate wealth over time is to create investment returns that are sustainable and provide generous returns on your investments.

Calculating the Costs of Admission



At some point in your life, you’ve surely had the experience of wanting to do something and then realizing that you don’t have sufficient money to accomplish your goal. Perhaps it was as simple as lacking the pocket change to buy a chocolate bar as a child. Or maybe it happened on a vacation when you ran low on funds and tried to do business with a merchant who only took Visa when you only carried American Express. No matter — the world of real estate investing is no different. You can’t play if you can’t pay.

Forgetting the myth of no money down

The title of this chapter says it all: To invest in real estate, you need capital, and likewise you need a source from which to gather said capital. On late-night infomercials, at seminars, on audiotapes, and in books, you may hear many self-appointed real estate experts tell you that you can invest in real estate with literally no money. And if that's not enticing enough, you may hear that you can buy properties where the seller will put cash in your hands.



Have such no-money-down situations ever existed among the billions of completed real estate transactions in the history of the modern world? Why, yes they have. Realistically, can you find such opportunities among the best real estate investing options available to you? Why, no you can't.

Think of the people you know who still haven't found the perfect mate after decades of searching. Mr. and Ms. Perfect don't exist. Ditto the ideal real estate investment. If you use our sensible criteria when seeking out properties that'll be good real estate investments and then add the requirement that you can only make such investments with no money down, you'll probably waste years searching to no avail. We've never made a no-money-down real estate investment because the best properties simply aren't available on that basis.



Our experience is that the no-money-down properties we have seen aren't properties we want to own. And if you receive cash out of escrow upon closing on a property, you're either buying a severely distressed property that will soon require major cash infusions or you've overleveraged the property. If it sounds too good to be true, it *is* too good to be true! For a more complete discussion of no money down, please see Chapter 5.

Getting in the door with good credit

Don't underestimate the importance of establishing good credit, because the best returns on real estate rely upon the use of credit to obtain the leverage of using OPM (other people's money). Lenders, property sellers, potential partners, and so on all prefer to deal with you if you've established a reputation for paying your bills. Good to great credit is essential. Why pay more for money when you can show the ability to handle it properly and be rewarded with a lower price?

Both of us began building our credit through the responsible use of credit cards in our 20s (paying monthly bills in full), and to this day, our high FICO scores have allowed us to borrow at favorable rates and terms and save tens of thousands of dollars per year in financing costs. And that difference will sometimes enable you to make a deal work that otherwise won't. We cover the importance of good credit and ways to remove unsightly blemishes on your credit history that may keep you from getting solid interest rates in Chapter 9.

Determining what you need to get started



Most of the time, real estate investors make a down payment and borrow the majority of the money needed to complete a purchase. That is the conventional way to purchase real estate investment properties and will be the most successful method for you in the long run (as it has been for us).

In order to qualify for the most attractive financing, lenders typically require that your down payment be at least 20 percent of the property's purchase price. The best investment property loans sometimes require 25 to 30 percent down for the most favorable terms. Lenders tend to be more conservative and require larger down payments during periods of falling real estate prices such as most areas experienced in the late-2000s.

For most residential investment properties, such as single-family homes, attached housing such as condos and townhomes, and small apartment buildings of up to four units, you can get access to the best financing terms by making at least a 20 to 25 percent down payment. (Mortgages on non-owner-occupied property tend to be $\frac{1}{4}$ to $\frac{1}{2}$ percent higher). You may be able to make smaller down payments (as low as 10 percent or less), but you'll pay much higher interest rates and loan fees, including private mortgage insurance. (We cover the topic of financing in Chapter 8.)

You won't find such wonderful financing options for larger apartment buildings (five or more units), commercial real estate, and raw land. Compared with residential properties of up to four units, such investment property generally requires more money down and/or higher interest rates and loan fees. Please see Chapter 8 for more details.

Determining how much cash you need to close on a purchase is largely a function of the estimated purchase price. Suppose you're looking to buy some modest residential housing for \$100,000. For a 25 percent down payment you need \$25,000, and adding in another 5 percent for closing costs brings you to \$30,000. If you have your heart set on buying a property that costs three times as much (\$300,000 sticker price), you need to triple these amounts to a total of about \$90,000 for the best financing options.

Rounding Up the Required Cash by Saving

Most successful real estate investors that we know, including us, got started building their real estate investment portfolio the old-fashioned way — through saving money and then gradually buying properties over the years.

Many people have difficulty saving money because they don't know how to or are simply unwilling to limit their spending. Easy access to consumer debt (through credit cards and auto loans) creates huge obstacles to saving more and spending less.

Investing in real estate requires self-control, sacrifice, and discipline. Like most good things in life, you must be patient and plan ahead to be able to invest in real estate.

As young adults, some (but not most) people are good savers out of the gate. Those who save regularly are often folks who acquired sound financial habits from their parents. Other good savers have a high level of motivation to accomplish goals such as retiring young, starting a business, buying a home, having the flexibility to spend time with their kids, and so on. Achieving such goals is much harder (if not impossible) when you're living paycheck to paycheck and worried about next month's pile of bills.



If you're not satisfied with how much of your monthly earnings you're able to save, you have two options (and you can take advantage of both):

- ✔ **Boost your income:** To increase your take-home pay, working more may be a possibility, or you may be able to take a more lucrative career path. Our main advice on this topic is to keep your priorities in order. You shouldn't put your personal health and relationships on the back burner for a workaholic schedule. We also believe in investing in your education. A solid education is the path to greater financial rewards and leads to all of the great goals we discuss here. Education is key not only for your chosen profession but also for real estate investing. Consider getting a real estate license or learn to be an appraiser or property manager — skills that not only help you with your property investing but that also may allow you to take on part-time work to supplement your income.
- ✔ **Reduce your spending:** For most people, this is the path to increased savings. We have both routinely generated cash flow for investments by living well beneath our means. Start by analyzing how much you expend on different areas (for instance, food, clothing, insurance) each month. After you've got the data, decide where and how you want to cut back. Would you rather eat out less or have a maid come less often? How about driving a less expensive (but not less safe) car versus taking lower cost vacations? Although the possibilities to reduce your spending are many, you and only you can decide which options you're willing and able to implement. If you need more help with this vital financial topic, consult the latest edition of Eric's bestseller *Personal Finance For Dummies* (Wiley).

Overcoming Down Payment Limitations

Most people, especially when they make their first real estate purchase, are strapped for cash. If you don't have 20-plus percent of the purchase price, don't panic and don't get depressed — you can still own real estate. We've got some solutions — you can either change your approach, allowing you more time to save or lowering your entry fees, or you can seek other sources of funding. In the following section, we lay out your options.

Changing your approach

Some ways you can alter your approach without having to find money elsewhere are as follows:

- ✔ **Seek low money down loans with private mortgage insurance:** Some lenders may offer you a mortgage even though you may be able to put down only 10 percent of the purchase price. These lenders will likely require you to purchase *private mortgage insurance* (PMI) for your loan. This insurance generally costs several hundred dollars per year and protects the lender if you default on your loan. (When you do have at least 20 percent or higher equity in the property, you can generally eliminate the PMI.)
- ✔ **Delay your gratification:** If you don't want the cost and strain of extra fees and bad mortgage terms, postpone your purchase. Boost your savings rate. Examine your current spending habits and plan to build up a nest egg to use to invest in your first rental. Often real estate investors get started by actually buying a new home and simply keeping their old home as a rental. For more information, see the section “Make saving a habit” later in the chapter.
- ✔ **Think smaller:** Consider lower-priced properties. Smaller properties and ones that need some work can help keep down the purchase price and the required down payment. For example, a duplex where you live in one unit and rent out the other is also a cost-effective way to get started.
- ✔ **Turn to low entry cost options:** For the ultimate in low entry costs, *real estate investment trusts* (REITs) are best. These stock exchange traded securities (which can also be bought through REIT-focused mutual funds) can be bought into for several thousand dollars or less. REIT mutual funds can often be purchased for \$1000 or less inside retirement accounts. (See Chapter 4 for more on investing in REITs.)

Lease options represent another low cost (although more complicated) opportunity. With these, you begin by renting a property you may be interested in purchasing down the road. In the interim, a portion of your monthly rental payment goes toward the future purchase price. If you can find a seller willing to provide financing, you can keep your down payment to a minimum. Turn to Chapter 3 for more on lease options.

Tapping into other common cash sources

Saving money from your monthly earnings will probably be the foundation for your real estate investing program. However, you may have access to other financial resources for down payments. Before we jump into these, we offer a friendly little reminder: Monitor how much of your overall investment portfolio you place into real estate and how diversified and appropriate your holdings are given your overall goals. (Please see Chapter 1).

Dipping into your retirement savings

Some employers allow you to borrow against your retirement account balance, under the condition that you repay the loan within a set number of years. Subject to eligibility requirements, first-time homebuyers can make penalty-free withdrawals of up to \$10,000 from IRA accounts. (**Note:** You still must pay regular income tax on the withdrawal, which can significantly reduce the cash available.)

Borrowing against home equity

Most real estate investors that we know began building their real estate portfolio after they bought their own home. Conservatively tapping into your home's equity may be a good down payment source for your property investments.



You can generally obtain mortgage money at a lower interest rate on your home than you can on investment property. The smaller the risk to the lender, the lower its required return — and thus, the better rates for you as the borrower. Lenders view rental property as a higher risk proposition and for good reason: They know that when finances go downhill and the going gets really tough, people pay their home mortgage to avoid losing the roof over their heads before they pay debts on a rental property.



Unless your current mortgage was locked in at lower rates than are available today, we generally recommend refinancing the first loan and freeing up equity that way versus taking out a home equity loan or line of credit.

A variation on the borrowing-against-home-equity idea uses the keep-your-original-home-as-a-rental strategy. You build up significant equity in your owner-occupied home and then need or want a new home. Refinance the existing home (while you still live there, for the best owner-occupied rates) and then convert it into a rental. Take the tax-free proceeds from the refinance and use that as the down payment on your new owner-occupied home.



Before you go running out to borrow to the maximum against your home, be sure that you

- ✔ **Can handle the larger payments:** In the previous edition of this book, we said,

“We don’t recommend borrowing more than the value of your home, as you may be enticed to do with some of the loan programs that pitch borrowing upwards of 125 percent of the value of your home. We hear these programs being routinely touted as not only a way to free up equity and pay down consumer debt, but also encouraging people to borrow in excess of the current value of their home so they can invest in more real estate. This excessive leveraging is dangerous and could come back to haunt you!”

We’re proud to have provided this sage advice before the real estate crisis hit home in the late-2000s. Please see Chapter 1 for the big picture on personal financial considerations.

- ✔ **Understand the tax ramifications of all your alternatives:** Borrowing more against your home at what appears to be a slightly lower rate may end up costing you more after taxes if some of the borrowing isn’t tax deductible. Under current tax laws, interest paid on home mortgages (first and second homes) of up to \$1 million is tax deductible. You may also deduct the interest on home equity loans of up to \$100,000.

Be careful to understand the tax-deductibility issue when you refinance a home mortgage and borrow more than you originally had outstanding on the prior loan. If any of the extra amount borrowed isn’t used to buy, build, or improve your primary or secondary residence, the deductibility of the interest on the excess amount borrowed is limited. Specifically, you may not deduct the interest on the extra amount borrowed that exceeds the \$100,000 home equity limit.

- ✔ **Fully comprehend the risks of losing your home to foreclosure:** The more you borrow against your home, the greater the risk that you may lose the roof over your head to foreclosure should you not be able to make your mortgage payments. That’s exactly what happened to too many folks during the late-2000s real estate market decline.

Moving financial investments into property investments

As you gain more comfort and confidence as a real estate investor, you may want to redirect some of your dollars from other investments like stocks, bonds, and mutual funds into property. If you do, be mindful of the following:

- ✔ **Diversification:** Real estate is one of the prime investments (the others being stocks and small business) for long-term appreciation potential. Be sure that you understand your portfolio’s overall asset allocation and risk when making changes. Please see Chapter 1 for more details.

✔ **Tax issues:** If you've held other investments for more than one year, you can take advantage of the low long-term capital gains tax rates if you now want to sell. The maximum federal tax rate for so-called long-term capital gains (investments sold for more than they were purchased for after more than 12 months) is now just 15 percent. Investors in the two lowest federal income tax brackets of 10 and 15 percent enjoy a 0 percent long-term capital gains tax rate. Try to avoid selling appreciated investments within the first year of ownership. Be sure to check on the latest tax laws because there's no guarantee these rates will continue in the future.

Separating investments from cash value life insurance

You may own a *cash value* life insurance policy — one that combines a life insurance death benefit with a savings type account in which some money accumulates and on which interest is paid. In addition to being a costly cash drain with its relatively high premiums, cash value life insurance investment returns tend to be mediocre to dismal.



You're best off separating your life insurance purchases from your investing. If you need life insurance (because others are dependent on your income), buy a *term life* policy, which is pure, unadulterated life insurance. But don't cancel your current cash value policies before replacing them with term if you do indeed need life insurance protection.

Robert had a \$500,000 whole life policy that he was sold when he was much younger and more naive — and before he knew of Eric and his financial advice! He ultimately decided to cash out the policy, the proceeds from which he used to invest in an apartment deal. So rather than earning a meager few percent per year in a cash value life policy, Robert has since enjoyed double-digit annualized returns in a good real estate investment.

Capitalizing on advanced funding strategies

Sophisticated investors who develop an extensive real estate investment portfolio can employ more complicated strategies. In this section, we outline those along with our advice for how to make them work.

Leveraging existing real estate investments

Over time, if the initial properties you buy do what they're supposed to do, they'll appreciate in value. Thus, you may be able to take extra tax-free cash from your successful investments to make more purchases. This tactic is

called *hypothecating* your real estate. As we discuss in the section “Borrowing against home equity” earlier in this chapter, many investors begin by employing this strategy with their owner-occupied home. They buy a home, it appreciates over the years, and then they tap that equity to fund other real estate purchases. By the same token, as you acquire more properties and they then appreciate, you can tap their equity for other purchases.



As you build a real estate empire, you must exercise care not to overextend yourself. The downside to continually pulling equity out of appreciated properties is that your fortunes may change. If the local real estate market or economy hit difficult times as happened in some areas in the late-2000s, you may find yourself with vacancies and falling rents. In the worst cases, excessively leveraged real estate investors have ended up losing some properties or even bankrupt.

Bringing in partners or other investors

If smaller, lower-priced properties don't satisfy your desires, you may be able to find a partner. For example, find a duplex and get a partner where you both initially occupy the property and make the payments, because duplexes are typically more cost-effective per unit than unattached properties.

Especially to accomplish larger deals, you may need or want to invest with a partner or other investors for the sake of diversification and risk reduction. Bringing in a partner can also provide additional financial resources for down payments and capital improvements as well as greater borrowing capability.



Partners can be either the best thing or the worst thing that ever happened to you. Although the additional financial resources are essential when you're starting out in real estate, attempt to find partners with complementary skills to really take advantage of the potential of real estate investment partnerships.

For example, Robert has focused on establishing partnerships where each partner brings a needed skill to the table. One partnership consisted of a top local real estate broker who identified properties along with a partner who was a real estate lender and knew the ins and outs of lending. Robert's company provided the property and asset management to reposition the property and create value. This team used their complementary skills to successfully purchase, renovate, and later resell a 48-unit apartment building while providing cash distributions to the partners during the holding period.



With the assistance of a good attorney, prepare a legal contract to specify (among other issues) what happens if a partner wants out. A *buy/sell agreement* makes a lot of sense because it outlines the terms and conditions in advance for how partnership assets can be redistributed. With life events (death, divorces, new marriages) constantly changing partnerships, having a

buy/sell agreement in place at the time the partnership is initially established prevents bickering down the road. Partnership disputes often enrich attorneys and accountants, rather than the partners or their intended beneficiaries.

Family members sometimes make good partners. Parents, grandparents, and perhaps even siblings may have some extra cash they want to loan or invest. But some families aren't suited for partnering to buy and operate real estate. Disputes over management style, cash distributions versus reinvesting in the property, and how and when to sell are difficult in any partnership but particularly in families where there may be different goals based on the age or personal desires of the family members. If you already don't get along well at family gatherings, throw in a real estate partnership to really get the fireworks going! To minimize the potential problems, we strongly suggest documenting any real estate investment or lending relationship in writing just as diligently as you would with a non-family member. When working with family, you may be better off borrowing money with a promissory note, a repayment plan, and interest payments. Check out Chapter 14 for more on partnerships.

Seeking seller financing

You may be able to find some properties that your research suggests offer potentially attractive investment returns and for which the seller may be willing to extend financing. Some property owners or developers may finance your purchase with as little as 10 percent or even less down. This method can be an extremely beneficial way to buy real estate when your cash position is limited. You can often set up the transaction as an installment sale so that the seller has the added benefit of stretching the reporting of income over a period of time and thus reducing her tax liability. You conserve your cash; the seller reduces her taxable income.

The drawback with seller-financed properties is that you can't be as picky about what you get; a limited supply is available, and many properties offered with seller financing need work or haven't yet sold for other reasons. Often these are reasons that only become apparent after you're the owner!



Avoid properties that are *distressed* (have major problems and flaws). Don't get sucked in by great financing alone; only consider purchasing a property with seller financing that you would be willing to buy conventionally. The seller financing should just be an extra benefit, not the only benefit! Please see Chapter 8 for details.

Taking on margin debt

In the section "Stocks, bonds, mutual funds, and other investments" earlier in this chapter, we cover selling some of your non-real estate investments in order to raise capital for property purchases. If you own stocks and other

securities in a brokerage account, you can actually borrow funds against those investments. For example, if you're the proud owner of \$100,000 worth of so-called marginable securities in a brokerage account, you may be able to borrow up to \$50,000 at attractive interest rates, typically a little lower than on fixed rate mortgages for a home.

In addition to providing you with a relatively low-cost source of funds, utilizing margin debt for real estate purchases also enables you to hold onto more securities, which can better diversify your real estate holdings.



Be careful when using margin debt. Stocks, bonds, and other investments can drop in value, sometimes sharply. When that happens as it did in 2008, you may face what is known as a *margin call*, where you have to increase the equity in your brokerage account, either by adding cash to it directly or by selling some of your securities. Having to sell during tough times can force you to liquidate shares at low prices. To add insult to injury, a significant stock market decline like the ones that occurred in 2008 or in the early-1990s, can coincide with a slumping real estate market.

Chapter 8

Financing Your Property Purchases

In This Chapter

- ▶ Understanding lender financing options
 - ▶ Selecting the best mortgage for your situation
 - ▶ Looking at home equity loans
 - ▶ Seeking seller financing
 - ▶ Knowing which mortgages to avoid
-

We know property investors who spent dozens to hundreds of hours finding the best locations and properties only to have their deals unravel when they were unable to gain approval for needed financing. You can't play if you can't pay.

This chapter covers the financing options you should consider (and highlights those that you should avoid). We explain how to select the mortgage that is most appropriate for the property you're buying and your overall personal and financial situation. In Chapter 9, we cover the actual process of applying for and locking up the specific loan you want.

Taking a Look at Mortgage Options

Although you can find thousands of different types of mortgages (thanks to all the various bells and whistles available), only two major categories of mortgages exist: fixed interest rate and adjustable rate. Technically speaking, some mortgages combine elements of both — they may remain fixed for a number of years and then have a variable interest rate after that. This section discusses these major loan types, what features they typically have, and how you can intelligently compare them with each other and select the one that best fits with your investment property purchases.

Fixed-rate mortgages

Fixed-rate mortgages, which are typically for a 15- or 30-year term for single-family properties, condos, and one- to four-unit apartments, have interest rates that remain constant over the life of the loan. Because the interest rate stays the same, your monthly mortgage payment stays the same.

Examining the pros and cons

For purposes of making future estimates of your property's cash flow, fixed-rate mortgages offer you certainty and some peace of mind because you know precisely the size of your mortgage payment next month, next year, and ten years from now. (Of course, the other costs of owning investment property — such as property taxes, insurance, maintenance, and so on — still escalate over the years.) But this piece of mind comes at a price:

- ✔ You generally pay a premium, in the form of a higher interest rate, compared with loans that have an adjustable interest rate over time. If you're buying a property and planning to improve it and sell it within five to ten years, you may be throwing money away by taking out a fixed-rate loan to lock in an interest rate for decades.
- ✔ If, like most investment property buyers, you're facing a tough time generating a healthy positive cash flow in the early years of owning a particular investment property, a fixed-rate mortgage is going to make it even more financially challenging. An adjustable-rate mortgage, by contrast, can lower your property's carrying costs in those early years. (We discuss adjustable-rate mortgages in the next section.)
- ✔ Fixed-rate loans carry the risk that if interest rates fall significantly after you obtain your mortgage and you're unable to refinance, you're stuck with a relatively higher-cost mortgage. For example, you may be unable to refinance if you lose your job, your employment income declines, the value of your property decreases, or the property's rental income slides. Also remember that even if you're able to refinance, you'll probably have to spend significant time and money to get it done.

Making a point of comparing fixed rates

In addition to the ongoing, constant interest rate charged on a fixed-rate mortgage, lenders also typically levy an upfront fee, called points, which can be considered prepaid interest. *Points* are generally a percentage of the amount borrowed. To illustrate, 1.5 points are equal to 1.5 percent of the loan amount. So, for example, on a \$200,000 mortgage, 1.5 points translate into a \$3,000 upfront (also known as prepaid) interest. Points can add significantly to the cost of borrowing money, particularly if you don't plan to keep the loan for long.



Generally speaking, the more points you pay on a given loan, the lower the ongoing interest rate the lender charges on that loan. That's why you can't compare various lenders' fixed-rate loans to one another unless you know the exact points on each specific mortgage, in addition to that loan's ongoing interest rate.

The following are two approaches to dealing with points, given your financial situation and investment goals:

- ✓ **Minimize the points:** When you're running low on cash to close on a mortgage, or if you don't plan to hold the loan or property for long, you probably want to keep your points (and other loan fees discussed in the next section) to a minimum. You may want to take a higher interest rate on your mortgage.
- ✓ **Pay more points:** If you're more concerned with keeping your ongoing costs low, plan to hold the property for many years, and aren't cash constrained to close on the loan now, consider paying more points to lower your interest rate. This is known as *buying down the loan rate* and can be an excellent strategy to lower your overall costs of borrowing and increase the property's cash flow and equity buildup.



To make an easier apples-to-apples comparison of mortgages from different lenders, get interest rate quotes at the same point level. For example, ask each lender for the interest rate on a particular fixed-rate mortgage for which you pay one point or two points, for example. You may also compare the *annual percentage rate* (APR), which is a summary loan cost measure that includes all of a loan's fees and costs. However, please remember that the APR assumes that you hold the mortgage for its entire term — such as 15 or 30 years. If you end up keeping the loan for a shorter time period, either because you refinance or pay off the mortgage early, the APR isn't valid and accurate (unless you recalculate based on the changed term and payoff).

Adjustable-rate mortgages (ARMs)

Adjustable-rate mortgages (ARMs) carry an interest rate that varies over time. An ARM starts with a particular interest rate, usually a good deal lower than the going rate on comparable length (15- or 30-year) fixed-rate mortgages, and then you pay different rates for every year, possibly even every month, during a 30-year mortgage. Because the interest rate on an ARM changes over time, so too does the size of the loan's monthly payment. ARMs are often attractive for a number of reasons:

- ✔ You can start paying your mortgage with a relatively low initial interest rate compared with fixed-rate loans. Given the economics of a typical investment property purchase, ARMs better enable an investor to achieve a positive cash flow in the early years of property ownership.
- ✔ Should interest rates decline, you can realize most, if not all, of the benefits of lower rates without the cost and hassle of refinancing. With a fixed-rate mortgage, the only way to benefit from an overall decline in the market level of interest rates is to refinance.

ARMs come with many more features and options than do fixed-rate mortgages, including caps, indexes, margins, and adjustment periods. The following sections help you to understand these important ARM features.

Start rate

The *start rate* on an ARM is the interest rate the mortgage begins with. Don't be fooled though: You don't pay this tantalizingly low rate for too long. That is why it's often called a *teaser rate*. The start rate on most ARMs is set artificially low to entice you. In other words, even if the market level of interest rates doesn't change, your ARM is destined to increase as soon as the terms of the loan allow (more on this topic in a minute). An increase of one or two percentage points is common. The formula for determining the future interest rates on an ARM and rate caps is far more important in determining what a mortgage is going to cost you in the long run.

Future interest rate

The first important thing to ask a mortgage lender or broker about an ARM you're contemplating is the formula for determining the future interest rate on your loan. ARMs are based on the following formula:

$$\text{Future Interest Rate} = \text{Index} + \text{Margin}$$

The *index* is a designated measure of the market interest rate that the lender chooses to calculate the specific interest rate for your loan. Indexes are generally (but not always) widely quoted in the financial press. The *margin* is the amount added to the index to determine the interest rate that you pay on your mortgage.

For example, suppose that the loan you're considering uses a one-year treasury bill index, which is currently 4 percent, and the loan you're considering has a margin of 2.75 percent (also often referred to as 275 *basis points*; 100 basis points equals 1 percent). Thus, the following formula would drive the rate of this mortgage:

$$\text{One-Year Treasury Bill Rate (4 percent)} + \text{Margin (2.75 percent)}$$

Do the math and you get 6.75 percent. This figure is known as the *fully indexed rate* (the rate the loan has after the initial rate expires and if the index stays constant). If this loan starts out at just 4 percent, you know that if the one-year Treasury bill index remains at the same level, your loan can increase to 6.75 percent. If this index rises one percent to 5 percent during the period that you're covered by the ARM's start rate, that means the loan's fully indexed rate goes to 7.75 percent ($5.00 + 2.75$), which is three percent higher than the loan's start rate.



Compare the fully indexed rate on an ARM you're considering to the current rate for a comparable term fixed-rate loan. You may see that the fixed-rate loan is at about the same interest rate, which may lead you to reconsider your choice of an ARM that carries the risk of rising to a higher future level.

Understanding ARM indexes

The different indexes used on ARMs vary mainly in how rapidly they respond to changes in interest rates. If you select an adjustable-rate mortgage tied to one of the faster-moving indexes, you take on more of a risk that the next adjustment may reflect interest rate increases. When you take on more of the risk that rates may increase, lenders cut you breaks in other ways, such as through lower *caps* (the maximum rate increase possible over a given time period; see "Future interest rate adjustments" later in the chapter), lower margins or lower points.

Should you want the security of an ARM tied to a slower-moving index, you pay for that security in one form or another, such as a higher start rate, caps, margin, or points. You may also pay in other, less-obvious ways. A slower-moving index, such as the 11th District Cost of Funds Index (COFI, discussed later), lags behind general changes in market interest rates, so it continues to rise after interest rates peak and goes down slower after rates have turned down. The following list covers some of these indexes.

- ✓ **Treasury bills (T-bills)** are IOUs that the U.S. government issues. Most ARMs are tied to the interest rate on 6-month or 12-month T-bills (also referred to as the one-year constant maturity Treasury index). This is a relatively rapidly moving index. Some investment property mortgages are tied to the rate on ten-year Treasury Notes. Being a somewhat longer-term bond, a ten-year index doesn't generally move as rapidly as the shorter-term indexes.
- ✓ **Certificates of deposit (CDs)** are interest-bearing bank deposits that lock the depositor in at a set interest rate for a specific period of time. ARMs are usually tied to the average interest rate that banks are paying on six-month CDs. Like T-bills, CDs tend to respond quickly to changes in the market's level of interest rates.

- ✓ **London Interbank Offered Rate Index (LIBOR)** is an average of the rate of interest that major international banks charge each other to borrow large sums of U.S. dollars, which is commonly referred to by real estate lenders as an index for their adjustable loans. LIBOR tends to move and adjust quite rapidly to changes in interest rates and is at times even more volatile than the U.S. Treasury or CD index rates.
- ✓ **Eleventh District Cost of Funds Index (COFI)** is a relatively slow-moving index. Adjustable-rate mortgages tied to the 11th District Cost of Funds Index tend to start out at a higher interest rate. A slower-moving index has the advantage of moving up less quickly when rates are on the rise. On the other hand, you have to be patient to benefit from falling interest rates.



In a relatively low-interest rate environment, such as in the early-2000s, few lenders offer COFI loans. This illustrates the point that lenders don't always offer the same choice of indexes. Rather, each lender offers one or typically no more than two indexes, and borrowers should specifically look at the index as part of their overall decision on choosing a lender.

Future interest rate adjustments

After the initial interest rate ends, the interest rate on an ARM fluctuates based on the loan formula. Typically, ARM interest rates change every 6 or 12 months, but some adjust every month. In advance of each adjustment, the lender sends you a notice telling you your new rate. Be sure to check these notices because on rare occasions, lenders make mistakes.

Almost all ARMs come with a rate cap, which limits the maximum rate change (up or down) allowed at each adjustment. This limit is usually referred to as the *adjustment cap*. On most loans that adjust every six months, the adjustment cap is 1 percent; the interest rate charged on the mortgage can move up or down no more than one percentage point in an adjustment period.

Loans that adjust more than once per year usually limit the maximum rate change that's allowed over the entire year as well — known as the *annual rate cap*. On the vast majority of such loans, 2 percent is the annual rate cap. Likewise, almost all ARMs come with *lifetime caps*, which represent the highest rate allowed over the entire life of the loan. Lifetime caps of 5 to 6 percent higher than the initial start rate are common for adjustables.



Taking an ARM without rate caps is like heading out for a weeklong outdoor trek without appropriate rain gear. When you consider an adjustable-rate mortgage, you must identify the maximum payment that you can handle. If you can't handle the payment that comes with a 10 or 11 percent interest rate, for example, don't look at ARMs that may go that high. As you crunch the numbers to see what your property's cash flow looks like under different circumstances (see Chapter 12), consider calculating how your mortgage payment changes based on various higher interest rates.

Avoiding negative amortization ARMs

As you make mortgage payments over time, the loan balance you still owe is gradually reduced or *amortized*. *Negative amortization* (when your loan balance increases) is the reverse of this process. Some ARMs allow negative amortization. How can your outstanding loan balance grow when you continue to make mortgage payments? This phenomenon occurs when your mortgage payment is less than it really should be.



Some loans cap the increase of your monthly payment amount but don't cap the interest rate. Thus, the size of your mortgage payment may not reflect all the interest that you currently owe on your loan. So, rather than paying the interest that you owe and paying off some of your loan balance (or *principal*) every month, you end up paying off some, but not all, of the interest that you owe. Thus, lenders add the extra, unpaid interest that you still owe to your outstanding debt.

Negative amortization is similar to paying only the minimum payment that your credit card bill requires. You continue to rack up finance charges (in this case, greater interest) on the balance as long as you only make the artificially low payment. Taking a loan with negative amortization defeats the whole purpose of borrowing an amount that fits your overall financial goals.



Avoid ARMs with negative amortization. The only way to know whether a loan includes negative amortization is to explicitly ask. Some lenders and mortgage brokers aren't forthcoming about telling you. If you have trouble finding lenders that will deal with your financial situation, make sure that you're especially careful — you find negative amortization more frequently on loans that lenders consider risky.

Reviewing Other Common Fees

Whether the loan is fixed or adjustable, mortgage lenders typically assess other upfront fees and charges. These ancillary fees can really amount to quite a bundle with some lenders. Here's our take on the typical extra charges you're likely to encounter and what's reasonable and what's not:

- ✔ **Application fee:** Most lenders charge several hundred dollars to work with you to complete your paperwork and see it through their loan evaluation process. Should your loan be rejected, or if it's approved and you decide not to take it, the lender needs to cover its costs. Most lenders credit or return this fee to you upon closing with their loan.
- ✔ **Credit report charge:** Most lenders charge you for the cost of obtaining your credit report, which tells the lender whether you've repaid other loans, including *consumer debt* (such as credit cards, auto loans, and so on), on time. Your credit report should cost about \$50 for each individual or entity that will be a borrower.

- ✔ **Appraisal fee:** The property for which you borrow money needs to be valued. If you default on your mortgage, a lender doesn't want to get stuck with a property that's worth less than you owe. The cost for appraisal typically ranges from several hundred dollars for most residential properties to as much as \$1,000 or more for larger investment properties. (On particularly large properties, this fee can be more significant — on a 30,000-square-foot office building, an appraisal may run around \$5,000; on a 300-plus-unit apartment building, it is more in the \$10,000 range.)
- ✔ **Environmental assessment or phase I:** Virtually all lenders making loans on residential properties with five or more units or, especially, commercial property, require a qualified engineering company to perform a site assessment and overview of the entire area in which the property is located to identify possible environmental issues. This type of report is commonly referred to as a *phase I environmental report*, and the cost directly correlates to the location, type of property, size, and even the prior use of the property and the surrounding area. Phase I reports can run from \$300 to as much as tens of thousands of dollars. (We include more details in Chapter 14.)
- ✔ **Third-party physical inspection:** Depending on the property being financed, lenders often require third-party inspections by competent professionals. For example, an inspection report from a licensed pest control firm documenting the property condition and specifically the presence of termites and/or wood-destroying organisms is required in virtually all transactions, including single-family homes and commercial properties. Again, the cost of these reports varies depending on the property. (More details to come in Chapter 14.)



No-point mortgages aren't no-brainers

Some property buyers are attracted to *no-point* or *zero-cost mortgages* (which also sometimes have no other loan fees or costs either). Remember that if a loan has no points, it's sure to have a higher interest rate. That's not to say that no-point loans are better or worse than comparable loans from other lenders, but don't get duped into a loan because of a no-points sales pitch. The lenders who heavily promote

these types of loans rarely have the best mortgage terms.

Consider a no-point/no-fee mortgage if you can't afford more out-of-pocket expenditures now or if you think that you'll only keep the loan a few years. But if you're that cash constrained, you may want to consider whether you can truly afford to buy investment property (see Chapter 1).

Request a detailing of other fees and charges in writing from all lenders that you're seriously considering. You need to know the total of all lender fees so that you can accurately compare different lenders' loans and determine how much closing on your loan will cost you. For residential and commercial income properties, the lender usually asks for a deposit that the lender uses to cover the types of fees and charges outlined here.



To reduce the possibility of wasting your time and money applying for a mortgage that you may not qualify for, ask the lender for any reasons it may not approve you. Disclose any problems on your credit report or with the property. Don't expect the lender to provide you with a list of credit or property problems that may conceivably put the kibosh on a mortgage.

Making Some Mortgage Decisions

You can't (or at least shouldn't) spend months deciding which mortgage may be right for your situation. So, in this section, we help you zero in on which type is best for you.

Choosing between fixed and adjustable

Choosing between a fixed-rate or adjustable-rate loan is an important decision in the real estate investment process. Consider the advantages and disadvantages of each mortgage type and decide what's best for your situation prior to going out to refinance or purchase real estate. This section covers the key factors to consider.

Your ability and desire to accept financial risk

How much risk can you handle in regard to the size of your property's monthly mortgage payment? If you can take the financial risks that come with an ARM, you have a better chance of saving money and maximizing your property's cash flow with an adjustable-rate rather than a fixed-rate loan. Your interest rate starts lower and stays lower with an ARM, if the overall level of interest rates stays unchanged. Even if rates go up, they'll likely come back down over the life of your loan. If you can stick with your ARM for better and for worse, you should come out ahead in the long run.

ARMs make more sense if you borrow less than you're qualified for. If your income (and applicable investment property cash flow) significantly exceeds your spending, you may feel less anxiety about the fluctuating interest rate on an ARM. If you do choose an adjustable loan, you may feel more financially

secure if you have a hefty financial cushion (at least six months' to as much as a year's worth of expenses reserved) that you can access if rates go up.

Some people take ARMs when they can't really afford them. When rates rise, property owners who can't afford higher payments face a financial crisis. If you don't have emergency savings that you can tap into to make the higher payments, how can you afford the monthly payments and the other expenses of your property?



If you can't afford the highest-allowed payment on an ARM, don't take one. You shouldn't take the chance that the rate may not rise that high — it can, and you can lose the property.

Ask your lender to calculate the highest possible monthly payment that your loan allows. The number the lender comes up with is the payment that you face if the interest rate on your loan goes to the highest level allowed, or the *lifetime cap*. (For more on caps, see the “Future interest rate adjustments” section earlier in the chapter.)



Don't take an adjustable mortgage because the lower initial interest rate allows you to afford the property that you want to buy (unless you're absolutely certain that your income and property cash flow will enable you to meet future payment increases). Try setting your sights on a property that you can afford to buy with a fixed-rate mortgage.

Length of time you expect to keep the mortgage

Saving interest on most ARMs is usually a certainty in the first two or three years. An adjustable-rate mortgage starts at a lower interest rate than a fixed one. But, if rates rise, you can end up repaying the savings that you achieve in the early years of the mortgage.

If you aren't going to keep your mortgage for more than five to seven years, you pay more interest to carry a fixed-rate mortgage. A mortgage lender takes extra risk in committing to a fixed-interest rate for 15 to 30 years. Lenders don't know what may happen in the intervening years, so they charge you a premium in case interest rates move significantly higher in future years.



You may also consider a hybrid loan, which combines features of fixed- and adjustable-rate mortgages. For example, the initial rate may hold constant for three, five, seven, or ten years and then adjust once a year or every six months thereafter. Such loans may make sense for you if you foresee a high probability of keeping your loan seven to ten years or less but want some stability in your future monthly payments. The longer the initial rate stays locked in, the higher the interest rate. Don't confuse these loans with the often-unadvisable balloon mortgage (which we discuss in the “Mortgages That Should Make You Think Twice” section later in the chapter).

Selecting short-term or long-term

Most mortgage lenders offer you the option of 15-year or 30-year mortgages. You can also find 20-year and 40-year options, but these are unusual. So how do you decide whether a shorter- or longer-term mortgage is best for your investment property purchase?

To afford the monthly payments and have a positive cash flow, many investment property buyers need to spread their mortgage loan payments over a longer period of time, and a 30-year mortgage is the way to do it. A 15-year mortgage has higher monthly payments because you pay it off quicker. At a fixed-rate mortgage interest rate of 7 percent, for example, a 15-year mortgage comes with payments that are about 35 percent higher than those for a 30-year mortgage.



Locking yourself into higher monthly payments with a 15-year mortgage may actually put you at greater financial risk. If your finances worsen or your property declines in value, odds are you'll have trouble qualifying for a refinance. You *may* be able to refinance your way out of the predicament, but you can't count on it.

Don't consider a 15-year mortgage unless you're sure that you can afford the higher payments that come with it. Even if you can afford these higher payments, taking the 15-year option isn't necessarily better. You may be able to find better uses for the money. If you can earn a higher rate of return investing your extra cash versus paying the interest on your mortgage, for instance, you may come out ahead investing your money rather than paying down your mortgage faster. Some real estate investors, including Robert, are attracted to 15-year mortgages to get their loans paid off by retirement age.



If you decide on a 30-year mortgage, you still maintain the flexibility to pay the mortgage off faster if you choose to. You can choose to make larger-than-necessary payments and create your own 15-year mortgage. However, you can fall back to making only the payments required on your 30-year schedule when the need arises. The only situation in which you can't pay off your 30-year mortgage faster is if the loan has a *prepayment penalty* (a penalty for paying off your loan before you're supposed to), which we dislike. Normally, prepayment penalties don't apply if you pay off a loan because you sell the property, but when you refinance a loan with prepayment penalties, you have to pay the penalty.

Borrowing Against Home Equity

Home equity loans (or a derivative called a *HELOC* — home equity line of credit) enable you to borrow against the equity in your home. Because such loans are in addition to the mortgage that you already have (known as the *first mortgage*), home equity loans are also known as *second mortgages*.

A home equity loan may provide a relatively low-cost source of funds for an investment property purchase, especially if you're seeking money for just a few years. You can refinance your first mortgage and pull cash out for an investment property purchase, but we don't advise doing that if your first mortgage is at a lower interest rate than you can obtain on a refinance.

Home equity loans generally have higher interest rates than comparable first mortgages because they're riskier to a lender. The reason: In the event that you default on the first mortgage or file for bankruptcy protection, the first mortgage lender gets first claim on your home.

Interest paid of up to \$1 million on home mortgages for primary or secondary residences is tax deductible (on loans taken out after October 13, 1987). The tax deduction for home equity loans is limited to the interest paid on up to \$100,000 of home equity debt. See Chapter 7 for a discussion of borrowing against home equity in the context of finding down payment money.

Getting a Seller-Financed Loan

Not every seller needs or even wants to receive all cash as payment for his property, so you may be able to finance part or even all of an investment property purchase thanks to the property seller's financing. The use of seller financing is the cornerstone of most no-money-down strategies.

Seller financing is a transaction in which the seller accepts anything less than all cash at closing. One form of an all-cash transaction to the seller is the buyer literally paying all cash, but typically it's a transaction in which the buyer uses a *conventional loan* (money to purchase the property from a lender other than the seller) so that the seller effectively receives all cash at closing.

Some sellers are financially well off enough that they don't need all of the sales proceeds immediately for their next purchase or are buying a property for less money — or maybe not buying a replacement property at all — and prefer to receive payments over time. They may be looking for the payments to replace their income in retirement or they may prefer to receive the funds over time so they can reduce their taxable income.



Any seller with equity can offer seller financing, but usually private individuals are the best sources. The best candidates for seller financing are sellers with significant equity or, best of all, folks who own their property free-and-clear (without any debt on the property at all). Many seniors have owned their properties for years and may be more willing to extend a loan.

Sometimes sellers offer this option, but in other cases, you need to pop the question. We can think of two good reasons to ask for the seller to help finance an investment property purchase:

- ✔ **Better terms:** Mortgage lenders, which are typically banks or large monolithic financial institutions, aren't the most flexible businesses in the world. You may well be able to obtain a lower interest rate, lower or waived fees, and more flexible repayment conditions from a property seller. There are also many expenses with conventional loans that a property seller may not require: loan points, origination fees, and an appraisal. Some sellers may not even require a loan application or credit report, but they'd be wise to go through due diligence (including a personal financial statement) on the buyer.
- ✔ **Loan approval:** Perhaps you've had prior financial problems that have caused mortgage lenders to routinely deny your mortgage application. Some property sellers may be more flexible, especially in a slow real estate market or with a property that's challenging to sell. A seller can also make a decision in a few days, whereas a conventional lender often takes weeks.

Be careful when considering a property where a seller is offering financing as part of the deal; this act may be a sign of a hard-to-sell property. Investigate how long the property has been on the market and what specific flaws and problems it may have.



Some of the reasons why sellers may offer their own financing are listed below:

- ✔ **They're attracted to the potential returns of being a mortgage lender.** This reason shouldn't concern the buyer as long as the terms of the seller financing are reasonable and avoid the issues raised earlier in the chapter about balloon payment or interest-only loans.
- ✔ **The seller has significant equity.** This situation creates another win-win opportunity for both the buyer and seller to use seller financing.
- ✔ **The current financing has prepayment issues.** This road can be a problem for the buyer; if the underlying financing has a due-on-sale clause and the lender becomes aware of the sale, it can demand the full payment of the outstanding loan balance on short notice.
- ✔ **They're seeking a price that exceeds the normal conventional loan parameters, or the property doesn't qualify for a conventional loan for some reason.** Examples of qualification issues include a cracked slab, environmental issues, improvements done without permits, and so on. This scenario is risky for the buyer and may be an indication that they're over-reaching or pursuing a property that's not a good investment.



Be sure that your seller financing agreement is nonrecourse (as discussed later in the chapter) and doesn't contain a *due-on-sale clause* prohibiting you from selling the property without paying off the loan in full. If the seller requires a due-on-sale clause, you have to pay off the full balance owed to the seller when you sell the property. Most sellers wisely ask for the due-on-sale clause so that the property can't be sold to another owner.

Mortgages That Should Make You Think Twice

You may come across other loans such as balloon loans and interest-only mortgages. We also want you to know the potential risks associated with recourse loans. The following section presents our thoughts on these options.

Balloon loans

One type of loan that is sometimes confused with a hybrid loan is a balloon loan. *Balloon loans* start off just like traditional fixed-rate mortgages. You make level payments based on a long-term payment schedule, over 15 or 30 years, for example. But at a predetermined time, usually three to ten years after the loan's inception, the remaining loan balance becomes fully due.

Balloon loans may save you money because they have a lower interest rate than a longer-term fixed-rate mortgage. Sometimes, balloon loans may be the only option for the buyer (or so the buyer thinks). Buyers are more commonly backed into these loans during periods of high interest rates. When a buyer can't afford the payments on a conventional mortgage and really wants a particular property, a seller may offer a balloon loan.



Balloon loans are dangerous for the simple reason that your financial situation can change, and you may not be able to refinance when your balloon loan is due. What if you lose your job or your income drops? What if the value of your property drops and the appraisal comes in too low to qualify you for a new loan? What if interest rates rise and you can't qualify at the higher rate on a new loan? We recommend balloon loans only when the following conditions apply:

- ✓ Such a loan is your sole financing option.
- ✓ You've really done your homework to exhaust other financing options.
- ✓ You're certain that you can refinance when the balloon comes due.

If you take a balloon loan, get one with as much time as possible, preferably seven to ten years, before it becomes due.

Interest-only loans

In the early years of such mortgages, your monthly mortgage payment is used only to pay interest that is owed. Although this helps to keep your payments relatively low (because no money is going toward repaying principal), the downside is that you're not making any headway to pay down your loan balance.

Usually, after a preset time period, such as five or seven years, your mortgage payment jumps substantially so that you can begin to pay down or amortize your loan balance. Our experience and observation has been that many people don't really understand or investigate how this increased payment affects them, which is why we've long advised against taking these types of loans.

The main attraction that we see for interest-only mortgages for investment property purchases is that the low initial payments help you achieve more positive cash flow early on. Our concern, however, is seeing some property buyers attracted to interest-only loans to afford purchasing high-cost property that is difficult to realize positive cash flow from.



If the only way for you to invest in an income property is to use an interest-only loan, perhaps you shouldn't invest. Investing in rental real estate is risky, and you can lose your entire investment if the market turns and you don't have the staying power to ride through the real estate cycles.

If you consider an interest-only mortgage, be sure that you understand upfront exactly how high your payment will be after the loan moves out of the interest-only payment phase. And be sure that you've surveyed the mortgage marketplace and understand how the terms and conditions of interest-only loans stack up versus other types of mortgages.

Recourse financing

The goal of most real estate investors is to accumulate wealth over time while not taking any unreasonable risks. That's why we discourage using interest-only loans or loans with balloon payments. But there is another factor to explore before agreeing to any loan: Is the loan nonrecourse or recourse?

- ✓ **Nonrecourse financing:** In the event you fail to fulfill the terms of your loan, this type of loan limits the lender to only foreclosing on the underlying property. *Foreclosure* is the full and complete satisfaction of the loan, and the lender can't seek a deficiency judgment or go after your other assets.

✔ **Recourse loans:** These loans lower the lender's risk because they offer additional protection. The lender has the legal right to seek a deficiency judgment against you personally or pursue other assets to cover any shortfall should the property value not fully cover the lender's outstanding debt balance. Remember that after a loan is in default, the interest penalties and legal fees can add up quickly. If you're already in default on the loan for your rental property, the last challenge you need is to have a lender looking to take your home or other viable rental properties to satisfy their deficiency judgment.

As long as you're not too aggressive and don't overleverage your rental properties, real estate investing can be relatively safe, and the chances are you won't be faced with losing your property by defaulting on your loan. But there are limits to your ability to control all of the diverse factors that can affect your property. For example, your cash flow will definitely suffer if the major employer in your area suddenly leaves.

Nonrecourse financing has more stringent qualification standards, such as higher debt coverage ratios (see Chapter 6), and generally results in a lower loan amount. But just as with borrowers who utilize interest-only loans so that they can borrow as much money as possible, the closer you live to the edge, the more likely you'll regret it.

Many of the loans you consider will be nonrecourse, but if you're seeking financing for an *unstabilized property* (a property whose cash flow is uncertain due to vacancy or unusually high expenses) or a property requiring major renovation, you may find that lenders are willing to provide the funds you need only with a full recourse loan.



Typically you're evaluating different loan proposals with either full recourse or full nonrecourse financing. But lenders can also offer a partial recourse loan. A *partial recourse loan* allows the lender to seek a deficiency judgment up to a certain limit if you default. Again, there may be great real estate investment options where such a loan makes sense, but be very careful before agreeing to such terms, and include the consequences to your overall financial status in a worst-case scenario in your overall analysis.



No matter what type of loan you use, we strongly recommend that you only use nonrecourse financing. You'll sleep better at night!

Chapter 9

Securing the Best Mortgage Terms

In This Chapter

- ▶ Understanding the best ways to shop for mortgages
 - ▶ Solving common loan problems
-

In Chapter 8, we discuss how to choose among the many loan options available to select the one that best suits your personal and financial situation. In the process of delving into the different types of real estate investment financing, you may have already begun the process of speaking with different lenders and surfing Web sites.

In this chapter, we provide our top tips and advice for shopping for and ultimately securing the best financing that you can for your real estate investment purchases and refinances. We also cover common loan problems that may derail your plans.

Shopping for Mortgages

Financing costs of your real estate investment purchases are generally the single biggest expense by far, so it pays to shop around and know how to unearth the best deals. You may find that many, many lenders would love to have your business, especially if you have a strong credit rating. Although having numerous lenders competing for your business can save you money, it can also make mortgage shopping and selection difficult. This section should help you simplify matters.

Relying on referrals

Many sources of real estate advice simply tell you to get referrals in your quest to find the best mortgage lenders. Sounds simple and straightforward — but it's not. For instance, loans for commercial investment properties and residential rental properties with five or more units have different lender underwriting requirements and terms compared with residential one- to four-unit loans (see Chapter 2 for explanations of these types of investments).



Good referrals can be a useful tool for locating the best lenders. Here are a few sources we recommend:

- ✔ Start with a bank or credit union that you have a relationship with currently and then seek referrals from it if it's not interested in making the specific loan you have in mind.
- ✔ Collect referrals from people who you know and trust and who have demonstrated some ability to select good service providers. Start with the best professional service providers (tax advisors, lawyers, financial planners, real estate agents, and so on) you know and respect, and ask them for their recommendations.
- ✔ Contact associations of real estate investors, especially those in your state. (You can find a comprehensive list organized by state at the Web site www.realestateassociations.com.) Networking with local investors is a great way to learn about the local real estate market and to benefit from other people's experiences.



Don't take anyone's referrals as gospel. Always be wary of business people who refer you to folks who have referred business to them over the years. Whenever you get a recommendation, ask the person doing the referring why they're making the referral and what they like and don't like about the service provider.

Mulling over mortgage brokers



You don't need to use a mortgage broker unless you're trying to get a loan for a property that has some challenges or you as the buyer have less than stellar credit or want to put the minimum down. Thus, we recommend going directly to lenders for simple deals (a relatively small price tag, a property that's in good condition and enjoys a good location, and so on) and using mortgage brokers for bigger, more complicated, or more difficult deals.

But many property buyers get a headache trying to shop among the enormous universe of mortgages and lenders. Check out the following sections when deciding on whether you want to use a broker.

Counting a broker's contributions

A good mortgage broker can make the following contributions to your real estate investing team:

- ✓ **Advice:** If you're like most people, you may have a difficult time deciding which type of mortgage is best for your situation. A good mortgage broker can take the time to listen to your financial and personal situation and goals and offer suggestions for specific loans that match your situation. Brokers do work on commission, which unfortunately can temper the objectivity of their advice, so tread carefully. Don't blindly accept a mortgage broker's advice, which may be nothing more than a commission-driven sales pitch masquerading as counsel.
- ✓ **Shopping:** Even after you figure out the specific type of mortgage that you want, dozens (if not hundreds) of lenders may offer that type of loan. (You'll find fewer lender options for five-plus-unit residential properties and commercial properties.)

Thoroughly shopping among the options to find the best mortgage takes time and knowledge you may well lack. A good mortgage broker can probably save you time and money by shopping for your best deal. Brokers can be especially helpful if you have a less than pristine credit report or you want to buy property with a low down payment — like 10 percent of the value of a property. Purchasing a multifamily residential property with five or more units or a commercial, industrial, or retail property is difficult with less than a 20- to 30-percent down payment.)

Be careful, when selecting a broker, because the worst among them get in the habit of repeatedly using the same lenders — perhaps because of the lofty commissions those lenders pay out. (More on understanding mortgage broker's commissions in the “Keeping up with commissions and other contingencies” section.)

- ✓ **Paperwork and presentation:** An organized and detail-oriented mortgage broker can assist you with completing the morass of forms most lenders demand. Mortgage brokers can assist you with preparing your loan package so that you put your best foot forward with lenders.

Have your personal financial statement prepared in advance so that it can be easily updated. Each time you seek a loan for an investment property, you have to provide a current financial statement to the broker (and, actually, all potential loan sources).

- ✓ **Closing the deal:** After you sign a purchase agreement to buy a real estate investment property, you still have a lot to do before you're the proud new property owner (see Chapter 14 for all the details). A competent mortgage broker makes sure that you meet the important deadlines for closing the deal.



Keeping up with commissions and other contingencies

A mortgage broker typically gets paid a percentage, usually between 0.5 to 1 percent, of the loan amount. This commission is completely negotiable, especially on larger loans that are more lucrative. (In case you're interested, the commission on larger deals — say, on a loan of \$25 million or more — is 0.25 to 0.5 percent.)



Be sure to ask what the commission is on every alternative loan that a broker pitches. Some brokers may be indignant that you ask — that's their problem. You have every right to ask; after all, it's your money.

Even if you plan to shop on your own, talking to a mortgage broker may be worthwhile. At the very least, you can compare what you find with what brokers say they can get for you. Again, be careful. Some brokers tell you what you want to hear — that is, that they can beat your best find — and then aren't able to deliver when the time comes. Some mortgage brokers promise fantastic terms to get you in the door; then, when you're just about ready to close on your loan, they come up with a last minute problem with your credit report, appraisal or some other issue that prevents them from delivering on the loan as quoted. This bait-and-switch tactic often works because most borrowers have some blemish or negative on their loan application or credit report. So make sure you find a mortgage broker who doesn't overpromise and underdeliver.

If your loan broker quotes you a really good deal, make sure you ask who the lender is. Most brokers refuse to reveal this information until you pay the necessary fee to cover the appraisal, credit report, and required environmental reports. But after taking care of those fees, you can check with the lender to verify the interest rate, the points, the amortization term, and the prepayment penalties (if any) that the broker quotes you, and make sure that you're eligible for the loan.

Web surfing for mortgages

You can shop for just about anything and everything online, so why should mortgages be any different? Mortgage Web sites often claim that they save you lots of time and money.



In our experience, the Internet is better used for mortgage research than for securing a specific mortgage. That's not to say that some sites can't provide competitive loans in a timely fashion. However, we've seen some property purchases fall apart because the buyers relied upon a Web site that failed to deliver a loan in time.

Here's a short list of some of our favorite mortgage related Web sites that you may find helpful:

- ✔ **HSH Associates:** The folks at HSH Associates (www.hsh.com) publish mortgage information for most metropolitan areas. For \$20, you can receive a list of dozens of lenders' rate quotes, but you need to be a real data junkie to wade through all the numbers on the multipage report that features lots of abbreviations in small print.
- ✔ **Government-related sites:** The Web sites of the U.S. Department of Housing and Urban Development (www.hud.gov) and the Veterans Administration (www.va.gov) provide information on government loan programs and feature foreclosed homes for sale.

Fannie Mae, which stands for the Federal National Mortgage Association (www.fanniemae.com), and Freddie Mac, which is the Federal Home Loan Mortgage Corporation (www.freddiemac.com), have worked over the years with the federal government to support the mortgage marketplace.

- ✔ **Mortgage Bankers Association:** The trade association for mortgage lenders, the Mortgage Bankers Association (www.mbaa.org), has articles and data on the mortgage marketplace. Its Web resources page also includes links to state and local mortgage banker associations.

This group is an excellent source of information on loans for residential properties with five or more units and commercial, industrial, and retail properties.

- ✔ **E-LOAN:** One of the first major online lenders, E-LOAN has stood the test of time and continues to offer competitive loans (www.eloan.com). This well-organized site can give you a quick overview of competitive mortgage pricing. Of course, you're under no obligation to use one of its mortgages just because you survey the options available.
- ✔ **Journalistic sites:** Numerous Web sites feature news and information about the real estate markets around the country. Several journalistic sites worth perusing include www.realtytimes.com, www.deadline.com, www.inman.com, and www.erictyson.com.
- ✔ **Legal research sites:** Legal issues certainly raise their ugly heads on many a real estate deal. The Web site of self-help legal publisher Nolo Press (www.nolo.com) offers some free resources as well as details on all of the company's legal books.

Cornell Law School's Legal Information Institute (www.law.cornell.edu/topics/mortgages.html) includes legal information on mortgages, including hard-to-find links to federal- and state-specific statutes.



Solving Potential Loan Predicaments

In Chapter 8, we discuss the different types of mortgages and how to select the one that best fits your situation. But remember that just because you want a particular mortgage doesn't mean that you're going to get approved for it.



The best defense against loan rejection is avoiding it in the first place. To head off potential rejection, disclose anything that may cause a problem *before* you apply for the loan. For example, if you already know that your credit report indicates some late payments from when you were out of the country for an extended period or your family was in turmoil over a medical problem, write a letter to your lender that explains this situation. Or perhaps you're self-employed and your income from two years ago on your tax return was artificially much lower due to a special tax write-off. If that's the case, explain that in writing to the lender.

Lenders who understand investment property

Al, an investor Robert knows, had an interesting experience when a lender initially indicated that he had insufficient income to support the purchase of four brand-new rental condos he was buying. (This situation is also a real-world example of a potential quick buy-and-flip scenario — the properties in question appreciated about 12 percent from a purchase agreement in six months.)

The lender had trouble understanding a basic concept of real estate ownership — it offers the benefits of depreciation to shelter other income for real estate professionals. So much of Al's income was sheltered through real estate holdings that his tax returns showed only about 20 percent of his actual income, which wasn't sufficient to qualify for the loan. Al had to actually educate the loan underwriters by showing them the various real-estate limited-liability

corporation tax returns with the significant amounts of depreciation and how they flowed through to his personal tax return.

Real estate investors need to be aware that when they're looking to purchase additional real estate, they need to work with a lender that understands that depreciation is a noncash item that allows real estate investors to actually keep more of their income. Al asked the mortgage broker who was a better risk — someone who makes \$100,000 and has no tax benefits from depreciation and thus pays 40 percent in taxes with a net income of \$60,000, or someone who makes several hundred thousand dollars but only reports \$50,000 and thus pays taxes at a lower rate. Remember the old adage, "It's not what you make but what you keep that really counts."

Even if you're the ideal mortgage borrower in the eyes of every lender, you may encounter financing problems with some properties. And of course, not all real estate buyers have a perfect credit history, lots of spare cash, and no debt. If you're one of those borrowers who must jump through more hoops than others to get a loan, don't give up hope. Few borrowers are perfect from a lender's perspective, and many problems aren't that difficult to fix.

Polishing your credit report

Late payments, missed payments, or debts that you never bothered to pay can tarnish your credit report and squelch a lender's desire to offer you a mortgage loan. If you've been turned down for a loan because of your less-than-stellar credit history, request a free copy of your credit report from the lender that turned you down.



Getting a report before you even apply for a loan is advisable and no longer costs you any money. Once a year, you're entitled to obtain a free copy of your credit report from each of the three credit bureaus. The contact information for the credit bureaus is

- ✓ **Equifax:** 800-685-1111; www.equifax.com
- ✓ **Experian:** 888-397-3742; www.experian.com
- ✓ **Transunion:** 800-916-8800; www.transunion.com

If problems are accurately documented on your credit report, try to explain them to your lender. Getting the bum's rush? Call other lenders and tell them your credit problems up front and see whether you can find one willing to offer you a loan. Mortgage brokers may also be able to help you shop for lenders in these cases.



Sometimes you may feel that you're not in control when you apply for a loan. In reality, you can fix a number of credit problems yourself. And you can often explain those that you can't fix. Some lenders are more lenient and flexible than others. Just because one mortgage lender rejects your loan application doesn't mean that all the others will.

As for erroneous information listed on your credit report, get on the phone to the credit bureaus. If specific creditors are the culprits, call them too. They're required to submit any new information or correct any errors at once. Keep notes from your conversations and make sure that you put your case in writing and add your comments to your credit report. If the customer service representatives you talk with are no help, send a letter to the president of each company. Getting mistakes cleaned up on your credit report can take the tenacity of a bulldog — be persistent.

Another common credit problem is having too much *consumer debt* at the time you apply for a mortgage. The more credit card, auto loan, and other consumer debt you rack up, the less mortgage you qualify for. If you're turned down for the mortgage, consider it a wake-up call to get rid of this high-cost debt. Hang on to the dream of buying real estate and plug away at paying off your debts before you make another foray into real estate. (See Chapter 8 for more information.)

Conquering insufficient income

If you're self-employed or have changed jobs, your income may not resemble your past income, or more importantly, your income may not be what a mortgage lender likes to see in respect to the amount that you want to borrow. A simple (although not always feasible) way around this problem is to make a larger down payment.

If you can't make a large down payment, another option is to get a cosigner for the loan — your relatives may be willing. As long as they aren't overextended themselves, they may be able to help you qualify for a larger loan than you can get on your own. As with partnerships, make sure that you put your agreement in writing so that no misunderstandings occur.

Dealing with low property appraisals

Even if you have sufficient income, a clean credit report, and an adequate down payment, the lender may turn down your loan if the appraisal of the property that you want to buy comes in too low. This is a relatively rare situation that happens more in rapidly appreciating markets; it's unusual for a property not to appraise for what a buyer agrees to pay.



With the decline in real estate values in the late-2000s, many sellers are still unrealistic about the value of their property and need a reality check. Assuming that you still like the property, use the low appraisal to renegotiate a lower price from the seller.



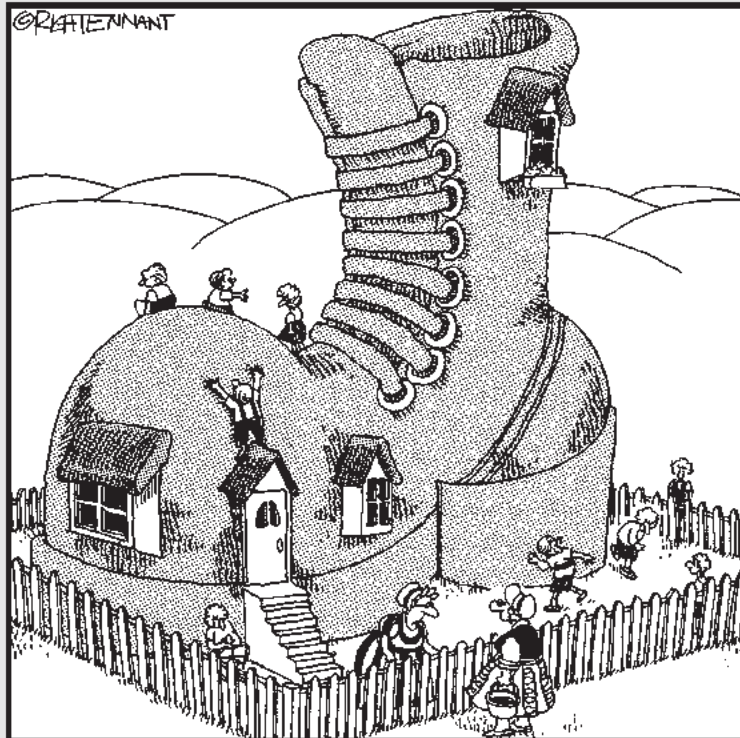
You may be the owner of a property in need of refinancing because the loan is coming due or the terms are unfavorable and the appraisal is too low. In this case you obviously need to follow a different path. If you have the cash available, you can simply put more money down to get the loan balance to a level for which you qualify. If you don't have the cash, you may need to forgo the refinance until you save more money or until the property value rises.

Part III

Finding and Evaluating Properties

The 5th Wave

By Rich Tennant



"Of course I could never afford a shoe this size if I weren't collecting rents from a tennis shoe across town and two espadrilles in Florida."

In this part . . .

Here's where the rubber hits the road. In this part, we discuss what, where, and how to buy a rental property. We cover the vital topic of how to value and evaluate real estate investment properties using a variety of financial tools and techniques. And, if you want the low-down and advice for negotiating contracts, performing inspections, and closing of your purchase, this is the part for you.

Chapter 10

Location, Location, Value

In This Chapter

- ▶ Choosing your investment area
 - ▶ Looking at what makes a good investment location
 - ▶ Discovering what's in your own backyard
 - ▶ Contrasting neighborhoods
 - ▶ Getting to know seller's markets and buyer's markets
-

As the most well-known saying in real estate goes, “The three most important factors to success in real estate are location, location, and location!” There *is* a strong correlation between the location of your real estate investments and your financial success. And we firmly agree that the location of your real estate investment is critical in determining your success as a real estate investor. But we prefer the phrase coined by Eric: “Location, location, value.” This revised adage clearly emphasizes location but also stresses the importance of finding good value for your investment dollar.

Merely owning real estate isn't the key to success in real estate investing; acquiring and owning the right real estate at the right price is how to build wealth! As you gain experience in real estate, you'll develop your own strategy, but to make any strategy succeed, you need to do your homework and diligently and fairly evaluate both the positive and negative aspects of your proposed real estate investment. That's where we come in.

In this chapter, we cover important aspects of regional and local demographics, how to analyze the economy, and which factors are most important to real estate investing. We also discuss barriers to entry and the supply/demand equation. Then we show you where to find this information and how to interpret the numbers to determine your local areas with the most potential. Finally, we discuss real estate cycles and timing.

Deciding Where to Invest

If you're going to invest in real estate, you need to decide on a location. Most real estate investors initially — and wisely — look in their local communities.



We give you the tools to evaluate properties anywhere, but you have an inherent advantage if you begin your search close to home. Unless you really know another real estate market and regularly find yourself there for other reasons anyway, we recommend that you stay close to home with your real estate investments — no more than one to two hours by your favorite mode of transportation.



Robert has had success with a real estate investment strategy that limits his potential markets to cities where he had personal management experience when he worked for a large national real estate firm. He also limits himself to areas that are no farther than a one-hour, nonstop flight on Southwest Airlines.

Although we strongly advise that you cut your teeth on an income property or two in your local market, establish parameters that meet your specific needs. For example, maybe you have family responsibilities that limit the amount of time you can devote to overseeing and managing your real estate investments. The one-hour-flight rule that Robert uses would likely be too taxing in that situation, and could be replaced by something like a 30-minute-drive rule.

Although virtually everyone lives in an area with opportunities for real estate investing, not everyone lives in an area where the prospects are good for real estate in general. That's why it's important to broaden your geographic investment horizon as long as you don't compromise your ability to effectively manage and control your property.

Even if you decide to invest in real estate in your own locale, you still need to do tons of research to decide where and what to buy — extremely important decisions with long-term consequences. In the pages that follow, we explain what to look for in a region, a community, and even a neighborhood before you make that investment decision. Keep in mind, though, that you can spend the rest of your life looking for the *perfect* real estate investment, never find it, never invest, and miss out on lots of opportunities, profit, and even fun.



The dangers of investing out of your area

In many regions of the country, real estate prices escalated in the early- to mid-2000s to the point that it was difficult for entry-level real estate investors to buy. If you lived in such an area, it was tempting to go far afield in search of reasonably priced property. Recently, the decline in prices in some areas is equally enticing, but you need to exercise caution.

Regardless of whether prices are up or down, there always seem to be a proliferation of seminars that promise real estate investment opportunities in other areas of the country. In California and other areas (where even with the recent price adjustments many properties are still relatively high-priced), seminar sponsors target owners and wannabe real estate investors, touting the great investments that can be found in other, often unnamed, parts of the country. They claim that you can buy rental real estate for a fraction of your local prices and achieve high returns on your investment. They even provide pictures of these properties — but there are always tiny little disclaimers somewhere on the page!

We strongly advise against investing blindly in areas that you don't know personally. And never consider these investments unless you have the proper local contacts such as a great property manager, contractors and suppliers, and competent legal and accounting advice. In the greater Las Vegas area alone, an estimated 40,000 non-owner occupied rental homes are primarily owned by out-of-state real estate speculators that bought new homes as investments to flip but got stuck with them when the market turned.

Robert routinely serves as an expert witness and recently had a case where an out-of-state

owner saw a great investment opportunity for an upscale four-bedroom executive home. Even though he worked over 3,000 miles away, what could go wrong with such a beautiful rental in a dynamic and prosperous suburb of San Diego? It looked like a good investment in a great neighborhood, and the property manager found a respectable renter in just a few days.

Unfortunately, what seemed so good suddenly turned south when the initial check for the security deposit and first month's rent was returned, marked "account closed." Later that week, the owner got a long-distance call from a disgruntled neighbor complaining about the barking dog and that many more people were occupying the home than just one family. Six months later, after paying hefty legal bills for the eviction plus making several cross-country airline flights, the owner finally regained possession of his now-trashed executive home. Aside from the lost rent for six months, the damage to the home was in excess of \$50,000. In the subsequent lawsuit against the broker, it came out that the broker had recommended an unlicensed property manager who never did any screening of the tenant.

One experience like this, and you may stick to money market accounts. So when you read about great real estate opportunities in faraway places, remember that it's better to be safe than sorry. Our experience indicates that if it sounds too good to be true, it *is* too good to be true! Risk and return are truly related. It's better to have a more solid and easy-to-manage property in your own community than to try and hit a home run in a different time zone.

Understanding the Goal: Finding Properties Where You Can Add Value

So you're looking for properties that allow you to lower the cap rate, which is essentially lowering the required rate of return. You want to buy when you determine that the property has a strong likelihood of producing future increases in NOI and cash flow. So you should look for properties where your analysis shows that the income for the property can be increased or the expenses reduced.

However, certain clues indicate whether a property really has rents that are below market. Properties with no vacancies and a waiting list are prime candidates. Other telltale signs are properties that have low turnover and then have multiple applicants for those rare vacancies. Economics 101 says that if demand exceeds supply, the price is too low.

Some owners actually market their real estate investment properties at a below-market price. These are motivated sellers, probably with a variety of personal reasons for their need to sell more quickly and cheaply than they would if they had more time and patience. Health reasons, family dissolutions, financial issues, and so on are all likely reasons that a seller will agree to a quick sale at a below-market price.

However, some sellers don't achieve the top value in the market for other reasons. For example, some owners despise the whole process of selling their rental properties so much that they knowingly underprice the property to ensure a quick and clean transaction and retain the ability to reject any and all contingencies that a buyer would typically require in a *market deal*. The elimination of hassling and haggling is paramount to these sellers; they just want to get the sale done, so they're willing to give the buyer such a good deal that the buyer takes the property essentially as is.

Some sellers are truly ignorant of the actual market value of the property they're selling. There really is no excuse (save laziness) for a seller in a major metropolitan area to not know the true value of the property he owns, because there are many real estate professionals who can inexpensively assist sellers in determining the estimated value of their property. Simply ask a real estate broker for a comparative market analysis (CMA) or hire an appraiser, and you'll get a detailed report determining the current as-is value of the investment property.



The most common question Robert hears from real estate investors is “How do I find these underpriced properties?” Our experience indicates that underpriced investment properties typically have older owners with no mortgage who have exhausted the possibility of taking depreciation deductions on their tax returns.

Look for properties where you can increase value. These *value-added properties* are properties that allow you to either increase the NOI or decrease the rate and thus create value. As we point out in the “Income capitalization approach” section earlier in this chapter the value of a property is increased with an increase in NOI or a decrease in the capitalization rate. The capitalization rate is directly correlated to the anticipated risk of the investment, so stabilizing properties through long-term leases and more financially viable tenants can reduce risk and lead to a lower cap rate.

A simple example of how to increase the value of a building is to find a residential rental property in a high demand area where all rental rates are the same for similar floor plans. In reality, the rents should reflect the fact that, say, not all two-bedroom units have the same location benefits. For example, a unit overlooking the pool is often more desirable than a unit on the main street, so raising the rents for the more desirable units increases rental income.

Evaluating a Region: The Big Picture



Though we advise you to think local, any decision about where to invest should start with an evaluation of the overall economic viability and trends of the surrounding region. If the region isn’t economically sound, the likelihood for successful real estate investments within that area is diminished. Understand how to evaluate important economic data so that you can invest in the areas that are poised for growth.

We define a *region* as a concentrated population base (rather than an entire state or section of the country). Data for any larger geographic area would be difficult to use for the types of real estate investments you’ll be making. For example, data for the state of Texas isn’t as important as vital economic trends for your proposed investment in the Houston area.

Gathering and analyzing the relevant economic data has never been easier, thanks to the Internet. The most important data for population growth, job growth, and economic trends is available online, and there are numerous entities tracking this information. From the federal government, to state and local governments, to universities and business groups, information on regional economic trends is readily available.



In addition to the academic and governmental agencies that provide broader economic indicators, several private firms specialize in providing specific data on occupancy, availability, and rental rates for different types of real estate for many of the major cities throughout the country. These services offer limited information to non-subscribers. For example, two of our favorites with a national perspective are the CoStar Group (www.costar.com) and Real Estate Research Corporation (www.rerc.com). There are many smaller firms that specialize in specific geographic areas, like MarketPointe Realty Advisors,

which focuses on Southern California (www.marketpointe.com). Check with real estate investment professionals that hold the Certified Commercial Investment Member (CCIM) designation in your area, because they have access to the excellent CCIM Institute's Site to Do Business (STDB).



You can find the vital economic data you need for your evaluation through your local economic development department, chamber of commerce, or public library. Real estate lenders often have in-house economists that collect information concerning areas where they lend money, and these folks are often the first to detect weaknesses in the market. So if your lender isn't particularly enamored about the location for your proposed real estate investment, it probably knows something that you should heed. Also, contact a professional appraiser in your area, because they routinely collect this information for their appraisals.

These sources collect, record, analyze, and report information according to specific geographic boundaries as established by the federal government. The U.S. government divides urbanized areas of the country into *Standardized Metropolitan Statistical Areas* (SMSA). SMSA's are large areas that consist of one or more major cities. For example, the entire San Francisco Bay Area, the combined areas of Dallas and Fort Worth, Greater Los Angeles, and Greater New York City are each a single SMSA.

If your proposed investment isn't in an area tracked as part of an SMSA, much of the same information is available, but you have to do a little more digging.



You're looking for more than just numbers. Attitude and leadership are important as well. Many neighboring cities are working together with regional planning boards and economic development agencies. Their goal is job creation, and they possess great powers to make important economic decisions regarding regional airports, mass transportation, and the reuse of surplus military installations. Clearly, such regional governance can have a major impact for better or worse on your real estate investments.

You're looking for a region or area that is growing and has a diverse economic base with strong employment prospects. In the following sections, we cover some of the more significant factors that can impact real estate demand and values.

Population growth



Population growth is one of the cornerstones upon which demand for real estate is based. An area with a steady growth in population soon needs more residential and commercial rental properties. More people mean more demand for housing, retail shopping, and offices and service providers. In other words, people use real estate, so the demand for real estate is enhanced as the population increases.

Increases or decreases in population are the result of three activities: births, mortality, and people moving into or out of the area. In most areas, births exceed deaths, and thus most areas experience moderate growth. So the real impact comes from a dynamic and mobile society. We've seen tremendous shifts in population from northern states to the more temperate climates of the Sunbelt. Immigration has also been a major factor in many parts of the country.



How does population growth affect your real estate decisions? Simply put, economists find that a new household is needed for every increase in population of three persons. Of course, these numbers can vary based on average household size. So if you're considering investments in rental homes or small apartment buildings in a certain area, the overall net population growth can be a factor in determining current and future demand for rental housing.

But knowing the increase in population for the entire SMSA or region isn't enough because population growth isn't evenly spread and can vary. As you get down to the next level in your research (see the "Investigating Your Local Real Estate Market" section later in the chapter), you need to determine the communities and even neighborhoods where the increased population will want to live, work, and shop. Real estate developers, and their lenders, look closely at net population growth in specific submarkets to forecast the demand for their proposed developments.

Job growth and income levels

Job growth is another fundamental element in determining demand for real estate. Economists generally predict that a new household is needed for every 1.5 jobs created. So if a new employer moves into the area and brings 150 new jobs, the local real estate housing market will need approximately 100 new dwelling units. Of course, these new jobs also positively impact the demand for commercial, industrial, and retail properties.



The U.S. Bureau of Labor Statistics compiles job growth and other economic data by SMSA as well as by county. This info is available at the Bureau's Web site (www.bls.gov). Other great sources for economic data are local colleges and universities and good local libraries.

But you need more information about the types of jobs before you can estimate their effect on the demand for each type of real estate. Although job growth is critical, so are the following factors:

- ✓ **Income levels:** Without stable, *well-paying* jobs, an area can stagnate. Even with positive growth in population and jobs, a lack of income can stifle the demand for additional residential and commercial properties.



- ✔ **Level of employment diversification:** If the local economy is heavily reliant on jobs in a small number of industries, that dependence increases the risk of your real estate investments. Some areas of the country have plenty of jobs, but they're lower- rather than higher-paying jobs. Ideally, look to invest in real estate in communities that maintain diverse job bases.
- ✔ **Industries represented:** Consider which industries are more heavily represented in the local economy. If most of the jobs come from slow-growing or shrinking employment sectors, such as farming, small retail, shoe and apparel manufacturing, and government, real estate prices are unlikely to rise quickly in the years ahead. On the other hand, areas with a greater preponderance of high-growth industries, such as technology, generally stand a greater chance of faster price appreciation.
- ✔ **Types of jobs:** The specific types of jobs available can be important depending on the target market for your income property. If you're buying a class A office building in an urban area, look for statistics on current and future employment levels for professional employment. For example, owning an office building across the street from the new regional courthouse gives you a real advantage in attracting law firms and legal support firms. Of course, you also want to make sure that the area boasts a good mix of nearby retail and food services to complement and support the tenants in your building.



In addition to job growth, other good signs to look for include the following:

- ✔ **Stable-to-increasing wages:** The demand for real estate clearly correlates to income levels, so local jobs with strong underlying demand are key. With many jobs being outsourced to other parts of the country and world, it's important that the local jobs aren't only secure but also unlikely to see an erosion in purchasing power.
- ✔ **A recession-resistant employment base:** Traditionally, jobs that enjoy stability are in the fields of education, government, and health care. Even areas renowned for strong demand and limited supply of real estate can slow down if the economy is hit hard, as shown by the collapse of some technology firms in the early-2000s.
- ✔ **Employment that's highly unlikely to be outsourced:** Jobs can flow to another area of the country or overseas to the latest low-cost manufacturing base.
- ✔ **Declining unemployment:** Examine how the jobless rate has changed in recent years. You wouldn't want to invest your entire savings into a rental property located adjacent to the large typewriter factory!

The problem with forecasting the future

No one can precisely predict the future. And with due respect to our friendly economists, forecasts of population and job growth can go awry. For example, the impact of 9/11 was widely predicted to present a crushing blow to local economies that relied heavily on tourism. A significant decrease in tourism would then ripple through the economy and result in heavy job losses and lead to lower real estate demand.

There was a short-term impact, and some people were adversely affected. However,

Robert figured that everyone needs a vacation, and if folks can't feel safe traveling abroad, then they're going to travel domestically. So he invested in Las Vegas apartments in 2002 at a time when the major hotels were still limiting their employees to part-time work in an effort to stem losses. Within three years, most tourism-dependent cities saw a record number of visitors — Americans fundamentally shifted their travel patterns and habits to travel domestically, where they felt safe.

Investigating Your Local Real Estate Market

Although everything starts at the regional level, you need to fine-tune your perspective and look at your local real estate market, too. All of the same types of economic data that you collect on a regional basis are important in evaluating your local real estate market.



With real estate investing, deciding where to invest is frequently more important than choosing the specific rental property. You can have a rental property that meets the needs of the market, but if it's located in a declining area where the demand is weak or an area with overbuilding and an excess of available properties, your investment won't perform financially. (These are the properties that perform the worst over time but are typically the types of properties highly touted by the infomercial gurus who love to brag about how much real estate they control but rarely tell you about their long-term investment returns.)

Likewise, you need to determine the areas that may be too richly priced, because your cash flow and future appreciation will be hurt if you overpay for a property. Often properties in the best neighborhoods in town are so overpriced that there is little appreciation potential and thus we advise you to seek other properties unless you're content with low returns similar to investing in safe and low yielding bonds.

In many local real estate markets, the demand for real estate is impacted more by the regional economy than by the local economy. For example, bedroom communities have high demand for rental homes and apartments even though they may only have service sector jobs in the immediate area, because the higher income professional and manufacturing jobs are concentrated in other areas of the region.



In the sections that follow, we help you research quantitative issues to consider when deciding where to invest in real estate. But you also must consider other factors, for instance, the weather or recreation and entertainment options — all key factors in the livability or quality of life for citizens. All of these criteria contribute to the overall desirability of a local market area and should be important considerations for the real estate investor. And don't underestimate the image or reputation of an area.

Supply and demand

The supply and demand for real estate in a given market has a direct impact on the financial performance of your income property. And although we firmly believe that the overall economic prospects for a region or community are vital, you must also find supply and demand information about the specific type of real estate that you plan to purchase.

Obviously, the best environment for investing in real estate is one with strong demand and limited supply. When the demand exceeds supply, shortages of available real estate push up prices.

Both sides of the equation — supply and demand — have indicators that you should evaluate in forming your consensus about the strength of the local real estate market. In the sections that follow, we take a close look at each indicator in detail. Supply-side indicators include building permits, the rate at which new properties have been rented or absorbed into the market, and the availability of alternatives for similar real estate. Demand indicators include occupancy and rent levels.

The overall relationship between supply and demand determines the market conditions for real estate. For example, a large number of pending or recently issued building permits, weak absorption or rental of new properties, and an excess of income property listings that have been on the market for an extended time are all indicators that the supply of a specific product type is greater than the demand. Such market conditions soon result in lower occupancy, lower rents, and often rental concessions like free rent or lower rental rates early in the lease, which mean lower cash flow and smaller appreciation potential. These aren't the markets you should be seeking.

When the demand for real estate is high, there are few vacancies and, property owners raise rents and eliminate or minimize any concessions. In commercial properties, landlords cut back on the tenant improvement (TI) allowance and require the tenants to take the space as-is and make any upgrades or changes to the space at their own expense.

Building permits and absorption

Building permits are often the first tangible step outlining the intent of a developer to build new real estate projects. Therefore, knowing about the issuance of building permits is an essential leading indicator to future supply of real estate.



The trend in the number of building permits tells you how the supply of real estate properties may soon change. A long and sustained rise in permits over several years can indicate that the supply of new property may dampen future price appreciation. Many areas experienced enormous increases in new building during the late-1980s, right before prices peaked due to excess inventory. Conversely, new building dried up in many areas in the late-1970s and early-1980s as onerous interest rates strangled builders and developers. In the early-2000s, despite the record low-interest-rate environment, most parts of the country weren't overbuilding, but by the late-2000s, there was nevertheless an excess of supply. Though building levels were in equilibrium with demand, the problem was that the demand was artificially inflated. This inflation was the result of governmental pressure to increase home ownership by offering creative financing to individuals who were unqualified to borrow such large amounts, as well as speculation by some real estate investors. The crazy and irresponsible speculation was particularly pronounced in certain Sunbelt areas like Las Vegas, Phoenix, and many parts of Florida.

Absorption, the rate at which new buildings are rented and occupied, can be useful to determine the potential for the market to become *saturated*, or over-supplied with certain types of real estate. A healthy real estate market is one in which the available new properties have rented in a relatively short period of time — typically measured in months. Absorption is measured in housing units for residential properties and in square footage for all commercial types of properties.

Absorption can be either a positive or negative number and is usually tracked on a quarterly and annual basis:

- ✓ **Positive absorption:** More space is rented or occupied by owners/users during the measured time period than was built or taken out of the rental housing supply by demolition or even conversion to owner-occupied condominiums.
- ✓ **Negative absorption:** The new supply of a given type of real estate is being built faster than users can or want to use it.



You can obtain information on building permits from your local planning or building department. Absorption statistics aren't as easy to find, but absorption is tracked by local real estate appraisers and real estate brokers. For example, professional real estate brokers holding the CCIM (Certified Commercial Investment Member) designation specialize in the sale of income properties and often have that information. See Chapter 6 for many other reasons to have an appraiser on your real estate team.



Building permits and absorption are property-type specific, and an oversupply in industrial properties generally has no bearing on other types of commercial income properties such as retail or office. The only exception is when the use of a property can be changed. For example, many industrial properties have been upgraded to add office space for manufacturing firms so they can have their administrative functions and operations in the same facility. This type of hybrid usage is more difficult to track — but extremely important to note if it's occurring in your proposed investment market.

Another noteworthy trend for residential real estate investors is that new construction favors single-family homes rather than multifamily apartments. This discrepancy can have a significant impact on your decision whether to invest in single-family rental properties or multifamily properties, because multifamily properties benefit from the reduced competition. There are several reasons for this phenomenon, and we discuss some of them in the section “Considering barriers to entry” later in this chapter.

Availability of alternatives — renting versus buying



When the cost of buying is relatively low compared with the cost of renting, more renters can afford to purchase, thus increasing the number of home sales and lowering demand for rentals. A key indicator you can use to gauge the market is the number of property listings:

- ✔ **Increase in property listings:** Increasing numbers of property listings or a significant increase in the time the average property is unsold is an indication of future trouble for real estate price appreciation. However, as property prices reach high levels, some investors decide that they can make more money cashing in and investing elsewhere. When the market is flooded with listings, prospective buyers can be choosier, exerting downward pressure on prices.
- ✔ **Decrease in property listings:** A sign of a healthy real estate market is a decreasing and low level of property listings, which indicates that the demand from buyers meets or exceeds the supply of property for sale from sellers. At high prices (relative to the cost of renting), more prospective buyers elect to rent, and the number of sales relative to listings drops.



Occupancy levels

Before you invest your hard earned money, determine the current occupancy levels for your proposed type of income property.

The market occupancy rate is another way to gauge the supply and demand for a given property type in the local market. The *market occupancy* rate for a particular type of property is the percentage of that type of property available for occupancy that's currently rented. For example, you may find data telling you that there are 2,312 total residential rental units in apartment buildings in a local market, and the occupancy rate is 97 percent (or 2,242 are occupied), which would mean that 3 percent (or approximately 70) of the units are vacant. For commercial, industrial, and retail properties, the occupancy level is calculated based on square footage.

With commercial, industrial, and retail properties, determining the occupancy levels is relatively easy. A quick look at the directory or a walkthrough of the property can give you a lot of information.



The true occupancy rate is actually much more difficult to determine with apartment buildings. With apartments, the vacancies aren't as obvious, and obtaining accurate information can be challenging — most professionally managed properties don't advertise their occupancy levels or volunteer this info (nor do they post tenant directories anymore due to safety and privacy concerns). But fear not, we have some suggestions:

- ✓ **Trade organizations and industry service providers:** Some of these groups track this data. For example, the local affiliates of the National Apartment Association (www.naahq.org) and the Building Owners and Managers Association (www.boma.org) often publish vacancy and rent surveys for apartments and office buildings, respectively.
- ✓ **The do-it-yourself approach:** You can contact owners of comparable properties and offer to collect this data and give them a copy of the results.

After you acquire the info, here's how to use it:

- ✓ **Low vacancy rates:** When combined with a low number of building permits, low vacancy rates generally foretell future real estate price appreciation. If you find minimal vacancy in your market, it's a landlord's market with higher demand from tenants for existing units, which is a good sign for real estate owners. And good for real estate investors, if the market prices remain reasonable.
- ✓ **High vacancy rates:** High rates indicate an excess supply of real estate, which may put downward pressure on rental rates as many landlords compete to attract tenants.



Concessions, which typically include free rent, often indicate weakness in the rental market. However, some types of real estate and rental markets almost always have concessions, no matter how strong the rental market. This practice is very common in larger professionally managed apartment communities where a prospective tenant's first question when calling to inquire about a potential rental unit is inevitably "What's your special?" Apartments in Phoenix and many other areas of the Sunbelt may be able to raise their rents and maintain occupancies at or above 95 percent, but they can't eliminate the rental concessions or their rental traffic will simply evaporate. In commercial properties, the TI or tenant improvement allowance is similar, with many markets requiring certain levels of dollars per square foot in custom build-outs or upgrades when the rental rate is actually less negotiable. (Check out Chapter 12 for more information on concessions.)

Rental levels

The trend in *rent levels*, or *rental rates*, that renters are willing and able to pay over the years also gives a good indication as to the supply/demand relationship for income properties. When the demand for real estate just keeps up with the supply of housing and the local economy continues to grow, rents generally increase. This increase is a positive sign for continued real estate price appreciation.

Of course, you need to be careful to make sure that you're getting the true and complete story on rents. Owners and their property managers are very smooth and savvy and don't allow their quoted rental rates to fall when the market shows some signs of softening. This strategy is logical because other tenants may have recently leased at a higher rate and would be upset to see the new tenants getting a better deal. So owners and property managers offer concessions or other perks to make sure that they're competitive in the current market while maintaining the perception of stable rents.



As a prospective rental property owner competing against these owners, you need to evaluate the current rent levels on a level playing field, so you want to calculate the *effective rental rate*. For example, if you see a comparable rental property available at \$1,200 per month, but the owner is offering a concession of one month free rent on a 12-month lease, the effective rent is really \$1,100 per month (the \$1,200 loss spread out over the rest of the year).



An advantage of investing in commercial real estate is that there are few governmental regulations and controls, and the relationship between tenants and landlords is essentially a free market. However, residential *rent control* or *rent stabilization* (local laws regulating how much rents may increase) is an issue in some cities and towns. Investing in markets with rent control, or even with a pro-tenant environment where a landlord has difficulty terminating a lease, may not provide adequate returns on investment, and appreciation will be more limited. Although occupancy levels are usually strong in such areas,

your overall cash flow may be threatened because the property's expenses may rise faster than you can legally raise the rents. In these communities, landlords who invest in major upgrades or capital improvements to a rental unit may not be able to raise rents or recover their costs because any rent increases must be approved by the local rent control board. Then, even if allowed at all, the approved capital improvements are amortized or spread over many years. Don't put your real estate future in the hands of others!

Path of progress



Buying real estate in up-and-coming areas with new development or renovated properties not only greatly enhances the ease of finding and keeping good tenants but also leads to higher occupancy, lower turnover, and higher rates of appreciation.

In virtually all major cities, some areas are experiencing new construction and growth — and have the reputation of being *the* area to live in. But by the time most folks feel this way, you've lost an opportunity to get in when prices have more appreciation potential. So, here are a few indicators to use to stay ahead of the game:

- ✓ **Follow the retailers:** You can often take a clue about where you should invest by looking for major retailers who do extensive research before making a decision to open in a given neighborhood. For instance, maybe a new Costco or Sam's Club is anchoring the new shopping center.
- ✓ **Follow the highways:** One of the best and most obvious indicators of where new development is headed is transportation. But make sure that the roads or mass transit projects actually get built. With so many funding and environmental challenges today, it can be extremely risky to invest in real estate based on proposed transportation projects. But after they're built, you're sure to find real estate investment opportunities.

But the path of progress isn't limited to new development. Many cities have areas that have seen better days and local leaders are doing their best to revitalize these tired and even blighted sections of town. A key component can be redevelopment districts that are formed with the property tax revenues being diverted to a special redevelopment agency that promotes new projects through a streamlined approval process and financial assistance. Often, the traditional downtown areas are being redeveloped with many incentives for developers and owners willing to be among the first ones in.



Although redevelopment areas can be great opportunities, significant risk is associated with investing in areas that are dynamic and changing. Like transportation projects, sometimes the best intentions of local leaders and redevelopment agencies can hit a snag.

Stepping in the path of progress

One of Robert's best real estate investments was a 30,000-square-foot, two-story medical center complex on three acres in Santee, California, a suburban bedroom community of San Diego. The building had been a hub of activity before the large medical group that occupied the property disbanded. The building was foreclosed on by the lender and was virtually vacant for several years, because the area didn't easily attract new tenants due to the lack of nearby sit-down restaurants and shopping.

However, Robert found out that major redevelopment was planned around the new trolley and transportation center located within a half mile. Besides a multiscreen cinema as the anchor tenant, the brand-new center would include everything from clothing stores to bookstores, plus several new restaurants. Robert was confident that the new center would be a catalyst for the entire area, so he quickly purchased the rundown and neglected two-building center for less than the assessed value on the property tax rolls. His investment plans included significant

renovation — including complete exterior painting, parking lot repairs, installation of a large monument sign for tenant promotion, plus cleaning and upgrading the vacant suites. He also renamed the complex Santee Professional Center to improve its image, build identity in the community, and attract nonmedical tenants.

Lest you think that Robert made the perfect investment that had no snags, soon after his purchase the national cinema chain filed bankruptcy and the developer halted plans. But a new developer came in and signed the national department store Target as the anchor tenant, and within 18 months, they had built and fully leased the new 500,000-square-foot shopping center. Now there are several other new office buildings completed or planned, as well as major upgrades to the other buildings in the area. The Santee Professional Center has been running at high occupancy and was recently appraised at nearly three times the acquisition price!

Considering barriers to entry



Investing in real estate in an area that has strong demand and limited supply is likely to enhance your profitability. One of the trends to follow is the creation of more roadblocks to new development and thus severe limitations on the construction of additional buildings to meet even the increasing demands for real estate from natural population growth.

For example, maybe your chosen area has inhabitants with strong anti-apartment sentiments or concerns about the environment. If you currently own or quickly invest in existing apartments in such areas, these factors can actually work to your benefit, because they make the addition of more housing units (competition) difficult.



We suggest that you look for markets where natural and even man-made barriers to entry exist.

The popular board game Monopoly taught most people from an early age about the importance of location and barriers to entry. When you control the playing field and prime properties, you dramatically improve your odds of successfully building wealth. In the following sections, we cover some of the more prominent factors that limit the supply of real estate and enhance cash flow and future appreciation for those who already own existing properties.



But, in the long term, the lack of buildable land in an area can prove a problem. Real estate prices that are too high may cause employers and employees to relocate to less expensive areas. If you want to invest in real estate in an area with little buildable land and sky-high prices, run the numbers to see whether the deal makes economic sense. (We explain how to do this in Chapters 11 and 12.)

Environmental issues

Individuals and organizations concerned about the environment aren't a new trend. Environmental issues are now a key factor in the potential development of real estate projects in just about every area of the country.

Those concerned about the environment are expressing their disapproval of new and proposed projects with more authority and success because federal and state laws require excruciating investigative reports on all aspects of proposed land development. It's extremely difficult in most urban areas to find land suitable for development that doesn't have some limitations or require remediation, such as the relocation or preservation of endangered species or plants. (Remediation can also include the cleanup and removal of contaminants.)

Many of these laws or guidelines find universal support — no one wants to live in a concrete world or destroy our beautiful countryside. And nearly everyone wants clean air, clean water, and the highest quality of living possible.

But preserving and protecting our environment comes at a cost: A large portion of potential developable land is being taken out of production or even consideration for use. The land that isn't available for development is being broadened and now includes much of the government-owned lands and virtually all land that can be classified as a hillside, wetland, or *vernal pool* (seasonal or temporary wetland). In many areas, additional swaths of public and private land are being designated and set aside by governmental agencies to protect endangered plants and wildlife.

These man-made decisions to preserve land, combined with other factors, can lead to a shortage of buildable land.

Shortage of buildable land

Economics 101 teaches that strong demand and a limited supply lead to rationing through higher pricing. Well, that is exactly what's happening over the decades in many of America's major metropolitan areas as people exhaust the supply of buildable land (notwithstanding the general decline in real estate prices in the late-2000s).

Upward pressure on real estate prices tends to be greatest in areas with little buildable land. This characteristic was one of the things that attracted Eric to invest in real estate in the San Francisco Bay Area when he moved there in the mid-1980s. If you look at a map of this area, you can see that the city of San Francisco and the communities to the south are on a peninsula. The ocean, bay inlets, and mountains bound the rest of the Bay Area. More than 80 percent of the land in the greater Bay Area isn't available for development because state and federal government parks, preserves, and other areas protect the land from development, or the land is impossible to develop. Of the land available for development in San Francisco and the vast majority of it in nearby counties, virtually all of it had already been developed.

CANES: Citizens Against Nearly Everything

Many cities are now putting more authority into the hands of local and even neighborhood planning boards that exercise their influence and control over proposed new developments. Although many of the representatives on these local planning boards are just interested in maintaining the aesthetics or compatibility of proposed developments with the existing land uses, some are motivated by another agenda.

The term CANES — *Citizens Against Nearly Everything* — was coined by then-San Diego Padres President Larry Lucchino, whom Robert interviewed on his weekly radio show many times while the baseball team proposed and fought for the development of a new ballpark. Various groups claiming to represent taxpayers, citizens, and environmentalists objected at every opportunity. Ultimately, after years of delays and dozens of lawsuits, the ballpark finally opened in downtown San Diego.

This trend isn't unique to San Diego. Across the country, those opposed to growth seek to avoid increased traffic, congestion, and overcrowding of their schools and parks. In many communities and neighborhoods, homeowners are expressing their disapproval of new multifamily development. (If you want a big turnout at city hall, just announce that 300 new low-income apartments are being built across the street from the new for-sale housing tract.)



Such resistance to new development or even redevelopment isn't new. But it does seem to be a trend that should be considered by even a real estate investor with a duplex or a couple of rental homes. Unbridled growth isn't the answer (nor are stagnation and decline), but our point is that you need to evaluate the impact of such attitudes on your income properties. Barriers to entry are a reality that you shouldn't overlook.

For example, increased demand in a community opposed to growth results in higher prices, so investing in these areas certainly enhances your prospects for appreciation. However, well-planned or *smart* growth can also lead to a higher quality of living and greater long-term returns on your investment.

Condo conversion and construction defect lawsuits



Carefully evaluate the impact of the condominium market in your area because it can have a material effect on the overall supply of rental housing. Apartments converted to condos often result in fewer rental units because condo conversion units are typically purchased by owner-occupants that find such housing to be a financially viable entry-level opportunity. But the reverse trend is also a concern because many areas have a significant number of failed condo conversion projects where only a portion of the units are sold; the remaining units are in foreclosure or bankruptcy and are being sold in bulk to owners who rent them until the market improves. New condominiums are often purchased by investors to use as rentals that will compete for tenants. Some of these projects were financially unsuccessful and are in the hands of court-appointed receivers or lenders. These are supply and demand factors that can affect your real estate market and should be part of your real estate strategy.

Many apartment buildings in urban areas were originally built as condominiums, but market weakness or the threat of construction defect legislation (discussed later in this section) led to a business decision by the developers to operate these condos as rental units. There isn't much controversy about the ultimate conversion of these rental condos to owner-occupied units; it's just a function of market timing, with most remaining as rentals in the current market environment.

However, a dilemma faced by many cities is the excessive number of conversion projects of apartment rental communities into condominiums. On one hand, the severe shortage of affordable entry-level housing in many cities made the conversion of apartments to condominiums an excellent opportunity for first-time home buyers. The concern was that conversion of apartments to owner-occupied condos reduced the supply of rentals.

How are condo conversions typically handled? The most common game plan for a conversion of an existing apartment community to a condominium project almost always consists of extensive exterior renovation, including painting,

landscaping, and other cosmetic items. Occasionally, local ordinances require some structural repairs or upgrades, but the exterior work is primarily limited to the cosmetic issues. In other words, rarely do developers spend a lot of money on a new roof!

The unit interiors also receive a complete overhaul and upgrade — new flooring, window treatments, new and often upgraded appliances, and solid countertops and other decorative touches to really make the unit shine. These converted condos can be quite attractive as reasonably priced investments that look great and are well located, many times in areas where new development is difficult because the area is completely built-out and the cost to acquire the land would be prohibitive. But you need to look deeper than the smoke and mirrors that create the attractive façade of quality construction.



The problem is that in most cases, the existing building systems, such as the roof, plumbing, electrical, and HVAC, haven't been upgraded or replaced. So you may have a brand-new interior that looks sharp, but the major structural systems are quite old. Also, properties built under the code requirements in effect at the time of original construction usually have lower standards for weatherproofing, insulation, and noise reduction. If you buy one of these converted apartments as a rental property, you may not know that your tenants can hear everything (and we mean everything) that goes on in the adjacent unit. That is, until they call to complain!

This conversion of apartments to condominiums can impact the rental market in one of two ways.



- Some of the condos are purchased by individuals that intend to live there personally. In this case, that reduces the rental housing stock, which means less competition for apartments.

Further, a good balance of owner-occupied housing units (with their inherent increased pride of ownership) can be healthy for the overall rental market. We strongly advise real estate investors to purchase rental homes in areas that are predominantly owner-occupied.

- Other converted condos aren't owner occupied, with many investors snapping up the reasonably priced units, speculating that they'll enjoy good returns. These units will be rented out, so there is no reduction in the rental housing stock.



In the long run, we believe that investing in condominiums that began life as apartments isn't wise. In the early years, when the appliances and surface interior and exterior cosmetic finishes are relatively new, not much can go wrong. But after the true age of the building begins to show through increased

repairs and maintenance, the volunteer association board of directors will face a real challenge. Will it be willing and able to dramatically increase the monthly assessments to cover the increased costs and to accrue the funds necessary to handle major capital items? Robert has managed associations for 30+ years, and his experience is that the assessments stay artificially low and the property condition declines over time. You don't want to own a unit in an association with major physical problems and no reserves.

The construction of new, attached, for-sale housing (or condominiums) has been severely restricted since the 1990s in many parts of the country due to *construction defect lawsuits*. The building industry claims that such lawsuits are unnecessary and extremely wasteful, and the attorneys representing homeowners insist that litigation would be unwarranted if the builders simply didn't build such shoddy and poorly constructed housing units. At the end of the day, the reality is that construction defect lawsuits are reducing the number of attached housing projects that are being built, because insurance is virtually nonexistent for developers and subcontractors.

Government's effect on real estate

This country offers many examples of the importance of state and local government on prospects for prosperity. The following are key governmental and quasi-governmental factors to consider when researching a prospective community in which to invest:

✔ **Tax considerations:** For decades, California had an unbeatable combination of great weather and job growth that attracted millions from around the world. In the early-2000s, California suffered from a declining economy and what some real estate investors and business owners felt was excessive government regulation and taxation. After the recall of Governor Gray Davis in 2003 and the election of Arnold Schwarzenegger, there was a lot of reason for "Kali-fornians" to be optimistic. Unfortunately, the last few years have seen increasing tension between political factions and an ever-increasing litany of pro-tenant, anti-investment, job-killing legislation policies that offset many of the natural attributes of California and are being exploited by other western states.

California real estate investors and others with means are establishing legal residency in Nevada, Texas, Washington, Florida, and other states without state income taxes in increasing numbers. It can make a significant improvement in a person's overall income tax liability, and it may not even be that much of a sacrifice. For example, a California real estate syndicator that attended one of Robert's property management courses found that living on the east side of beautiful Lake Tahoe (in the state of

Nevada) was just as nice as the west (or California) side, where the top income tax rate can add up to another 10 percent in addition to the federal income tax.

You should also have a detailed understanding of the property taxation system and appeals process. Be sure to determine whether a proposed income property acquisition is in a special assessment district where additional taxes are assessed against properties. Such special assessment districts may offer some advantages like better schools, parks, and fire and police services and may be well worth the additional annual investment. But you should know in advance how much the additional costs will be, how long you'll be required to participate, and exactly what you're getting in return so that you can properly evaluate whether you'll be able to generate a commensurate increase in your rental income.

- ✔ **Economic development incentives:** The economic development groups for many of these states are advertising in business publications and major newspapers and aggressively encouraging employers to relocate with incredible real estate incentives such as virtually free land or lower property and/or income taxation. Besides lucrative offers of real estate and tax incentives, as the global economy becomes ever more competitive, businesses are being lured to locations that can reduce their costs of labor, energy, and transportation.
- ✔ **Community's reputation:** Your local chamber of commerce, tourism bureau, and city hall all work very hard to establish the right reputation and attract the top employers. These organizations can have a real impact on the market environment for businesses and thus create more jobs in the long run, which leads to increased population and higher demand for all types of real estate.
- ✔ **Business-friendly environment:** You can't underestimate the importance of a probusiness attitude among state, regional, and local governments to help create a vibrant economy where your real estate investments can prosper.

Comparing Neighborhoods

The reputation of particular neighborhoods can be based on many factors. Certain key or essential elements differentiate the neighborhoods with good reputations and positive trends from the areas that are stagnant or trending the wrong direction.

Schools



If you don't have school-age children, you may not initially be concerned about the reputation and test scores of the local schools. Think again. Whether you're investing in residential or commercial income properties, schools matter. The demand for residential and commercial property (and the subsequent value of the property) is highly correlated to the quality of local schools.

Ask any real estate agent about the impact of schools on the demand and sales price for a home in a great school district. Likewise, employers use the quality of local schools in recruiting their key personnel — and sometimes even relocate company facilities to be near areas known for their schools.

The Internet can be a very useful tool in determining the quality of local schools. Most school districts have Web sites that include information on the test scores of their students for mandatory state and federal testing. Unfortunately, many people make snap judgments about school quality without doing their homework. Visit the schools and don't blindly rely on test scores. Talk to parents and teachers, and discover what goes on at the school.

Crime rates

Crime can have a significant and sobering effect on the demand and desirability of all types of income properties. No one wants to live in a high crime area, and commercial tenants and their customers neither work at nor patronize unsafe businesses. No areas are going to be crime-free, but you don't want to find out after the close of escrow that you have purchased a rental property that is claimed by rival gangs. Before you make your investment decision, consult these sources:

- ✓ **Local law enforcement:** Contact local law enforcement and obtain the latest and historical crime statistics.
- ✓ **Local newspapers:** Newspapers often have a police-blitter section that provides information on major and even petty crimes in the community.
- ✓ **Sexual-offender databases:** Laws require certain convicted sexual offenders to register with local law enforcement. These databases allow you to identify the general locations of convicted sex offenders who have committed sexual offenses against minors and violent sexual offenses against anyone.



These databases aren't foolproof. The states haven't been consistent in their efforts to maintain and make them available. Also, persons required to register don't always follow the requirements, but at least you can find out about the known ones.

Be sure to advise your tenants to check the database; this information is dynamic, and everyone needs to make their own decision about the safety of his or her family. You should always disclose any known registered individuals in the neighborhood (but that doesn't mean that you need to do the research).

Pride of ownership



Pride of ownership is an intangible attitude that has tangible results. Pride of ownership also has no economic boundaries — even modest-income areas can really look sharp. Look for rental properties in neighborhoods that reflect pride of ownership — well-kept and litter-free grounds, trimmed plants, beautiful flowers, fresh paint, and so on. This curb appeal helps you attract and retain your tenants.

Although everyone may have a different perception of exactly what constitutes a well-maintained property, pride of ownership is readily apparent, and the effort made by business owners and homeowners to keep their properties looking sharp is important to real estate values.

You may find that some of the more aesthetically pleasing areas look that way for a reason. Homeowner's associations and business parks typically have a board of directors and architectural review committees that routinely inspect the properties under their jurisdiction, as well as review and restrict improvements to meet certain standards.

Other areas may have informal committees of neighbors who band together to keep their properties in tiptop condition. This tendency is also true of multifamily residential and commercial properties, and these properties usually must also submit to local laws and regulations enforced by the building or code enforcement departments.

You can control the appearance, condition, and maintenance of your own property, but your options are limited if the properties surrounding it fall into disrepair. Your purchase of a fixer-upper and the investment of time, money, and sweat equity won't be rewarded financially if the surrounding properties are in a state of disrepair and have owners that don't really care.



Property values, occupancy, and rental rates all sag when property owners no longer take pride in their property. Avoid declining neighborhoods that display the red flags of dispirited owners — poorly kept properties, junk-filled vacant lots, inoperative cars in the parking lot or street, graffiti, vandalism, and deferred maintenance. Neighborhood deterioration is a blight that spreads from one property to another.

Role play: What attracts you to the property?

One of the best ways to evaluate the prospects for a particular neighborhood is to play the role of a residential tenant looking for the best place to call home. Go back in time to when you made the decision to live in your neighborhood. What were the primary criteria you used to make that determination? You're probably typical of many of your potential tenants. They prefer rental properties in close proximity to various amenities, all of which can be captured in a property knowledge sheet.

Property knowledge sheets

One of the best ways to have the answers to the questions that may be raised by your rental prospect is to prepare a property knowledge sheet for each of your rental property locations. A *property knowledge sheet* contains all the basic information about your rental property, such as the size and type of the rental unit and the unit number (for multiple-unit properties), plus the age, type of construction, and other important details about the unit.



A thorough property knowledge sheet also contains important information about the local neighborhood and general area. Like the chamber of commerce or visitor's information bureau, you want to be able to answer questions about the area. Rental prospects are generally interested in knowing about employment centers, transportation, local schools, child-care, places of worship, shopping, and medical facilities. You can really make a positive impression on your rental prospect if you can tell them where the nearest dry cleaner or Thai restaurant is located.

With all this vital information from your property knowledge sheet at your fingertips, you can be ready to answer your rental prospect's questions. The more you know about your property, the easier it is for you to offer important reasons for a prospect to select your rental over the competition.

Property knowledge sheets can definitely give you the edge over your competition. Because you're often competing with large multifamily rental properties, you need to be prepared to answer important questions about the area. Often, immediately knowing a detail such as whether a certain child-care center is in your area can make the difference between success and failure.

Check out Figure 10-1 for an example of a property knowledge sheet.

Property Knowledge Sheet			
Property Information			
Rental address _____	Unit # _____	City _____	Zip code _____
Office hours (if any) _____	Square footage of unit(s) _____		
Unit mix—Studios _____	1 Bedroom _____	2 Bedroom/1 Bath _____	2 Bedroom/2 Bath _____ Other _____
Rent—Studios _____	1 Bedroom _____	2 Bedroom/1 Bath _____	2 Bedroom/2 Bath _____ Other _____
Application fee _____	Security deposit _____	Concessions _____	
Age of rental _____	Type of construction _____	Parking _____	
Recreational facilities _____	Laundry _____	Pets _____	
Storage _____	Utilities (who pays?) _____	AC/Heat _____	
Appliances _____	Floor coverings _____		_____
Special features/comments _____	_____		
Community Information			
School district _____	Grade school _____	Jr. high _____	
High school _____	Jr. college _____	College _____	
Trade school _____	Pre-school (s) _____		
Childcare _____	Places of worship _____		
Police station _____	Fire station _____	Ambulance _____	
Electric _____	Natural gas _____	Telephone _____	Cable _____
Water _____	Sewer _____	Library _____	Post office _____
Hospital _____	Pharmacy _____	Vet _____	
Other medical facilities _____			
Nearby employment centers _____			
Transportation _____			
Groceries _____	Other shopping _____		
Local services _____			
Restaurants _____			
Comments _____			
Rental Market Information			
Rental competitors/rental rates/concessions _____			
Our competitive advantages _____			
Our disadvantages _____			

Figure 10-1:
Property
knowledge
sheet.

Commercial property considerations

Looking at a property from a tenant's perspective is also useful if you're investing in commercial properties. Remember that your commercial tenants are in business to make money — and their location is often a key factor. Have you ever seen a small retail center that includes several vacant suites with butcher paper in the windows? That is the universal sign that a property is in financial trouble and in need of proactive ownership, management, and leasing — or the spiral toward foreclosure will continue.

Right down the street from a failing property, you may find another retail property with long-term leases and a waiting list, because successful retailers almost always flock together. That explains the success of many regional shopping malls that command high rents. Sometimes, just getting the right anchor or primary tenant in a commercial, industrial, or retail income property is all it takes to start the chain reaction toward the dream for any landlord — high occupancy, high rents, and low turnover!

Finding well-situated properties is easier when you're considering investing in an area where you've lived your entire life, but not as easy for investing in other locales. Nonetheless, every area has potential if you know what you're looking for and are willing to take the time to do the research.

Mastering Seller's Markets and Buyer's Markets

Some real estate investors make the mistake of not continuing to research the economics of their real estate markets after they've made their investments. Even if you plan to buy and hold, you need to pay attention to the market conditions. As we have seen, the criteria we advise you to consider in making decisions about which markets are the best for investing are dynamic and can fluctuate.

Savvy real estate investors monitor their markets and look for the telltale signs of real estate cycles. These cycles present opportunities for expanding your real estate portfolio or repositioning from weaker markets to stronger markets because not all areas experience peaks and troughs at the same time. That is why you need to know and track the timing of seller's and buyer's markets.

Understanding real estate cycles

We believe that real estate is cyclical and that successful real estate investors always remain aware of the real estate cycles in their areas. First, we need to define what we mean by seller's or buyer's market:

- ✔ A **buyer's market** occurs when current property owners are unable to sell their properties quickly and must be more flexible on the price and terms. This is a great opportunity to seek seller financing.
- ✔ A **seller's market** is almost like the classic definition of inflation — “too much money chasing too few goods.” In this case, the goods are real estate properties, which are in high demand. When sellers are receiving multiple offers within 24 to 48 hours of a listing or you see properties selling for more than the asking price, you're in a strong seller's market.

Real estate traditionally experiences cycles as the demand for real estate leads to a shortage of supply and higher rents and appreciation. That leads to the building of additional properties, which, along with changes in demand due to economic cycles, usually results in overbuilding and a decline in rents and property valuation.

However, not everyone agrees that real estate cycles are relevant to residential real estate investors. Some of the real estate infomercial gurus claim that real estate investing in homes and apartments is recession-proof because people always need a place to live. Although that is partly true, we think that the economic base of the community where you invest does have a direct impact on all aspects of your operations — occupancy, turnover, rental rates, and even quality of tenant.

For example, when times are tough, residential tenants are the first to improvise, with some finding that “doubling up” or even taking in roommates is palatable if it results in lower costs for housing. Some renters are even willing to move back in with Mom and Dad or another relative when their personal budgets don't allow them to have their own rental unit.

Robert has managed all types of income properties throughout the western states and has observed a broad cross-section of economic activity. He has seen how real estate cycles may be similar in a particular region but often vary from region to region. For example, when some areas of the country were setting records for rents in the mid-'80s, landlords couldn't give away their apartments in Texas. Even venerable California was a miserable place to own real estate in the early-'90s. In the late-2000s, areas where real estate speculation and condo converters went crazy have suffered.

Can real estate investors who track these real estate cycles make investment decisions based on this information? Absolutely. That is where most successful and knowledgeable real estate investors see potential for increasing their real estate investment returns by timing the real estate market.

Timing the real estate market

Although the length and depth of the real estate cycles vary, there are clear highs and lows that real estate investors need to consider.

In some real estate markets, the double-digit appreciation over the first half of this decade brought record prices for homes and income properties. In the mid-2000s, the most common question for Robert on his live Southern California NBC call-in feature was “Should I buy income properties in Southern California at these seemingly high price levels, or should I invest elsewhere?” These callers didn’t want to miss out on what they thought was almost guaranteed price appreciation. But what goes up must come down, so when the market corrected in the late-2000s with significant price declines in most areas of the country, the question Robert hears is “When will we reach the bottom of the market?”

No one-size-fits-all answer solves this critical question. A key factor is the *investment horizon*, or planned holding period for a particular investor and that specific investment. If the holding period is long enough, even purchasing income properties in today’s overpriced markets will probably look good 15 to 20 years from now.

The alternatives are to identify those markets with excellent economic fundamentals where prices have remained low and invest there. The concept is similar to the “buy low, sell high” truism for stocks, except you sell in overpriced markets and reinvest in the lower priced markets. Such markets do exist, but the question is whether the properties in the lower priced markets are going to provide the same or better investment returns in the long run versus alternative markets.



Unlike the stock market, real estate transactions entail significant transaction costs (as a percentage of the market value of the property). That’s why selling and buying property too frequently undermines your returns.

It’s our contention that even in the few markets where such “bargains” exist, they aren’t really great opportunities. We are reminded of the business concept that in the long run you usually get what you pay for! There is so much more than just the projected rent and the selling price. Without going into

a detailed analysis of property condition, expenses, and other invaluable criteria, you should simply consider whether these areas pass muster after performing the economic analysis described earlier. Probably not.

Carleton Sheets, plus many other well-known infomercial gurus, have traditionally advised their followers that you should seek income properties where the projected gross monthly income is at least 1 percent of the purchase price. This strategy would mean that if you acquire a rental property with a projected monthly income of \$2,000, your acquisition costs should not exceed \$200,000. The advice is sound, but there are fewer and fewer markets where such properties exist. You may remember from your reading on investments that risk and return are generally related. That is, the lower the risk you take, the lower your expected return. (That is why short-term government-backed bonds and federally insured money market accounts offer nominal rates of interest or return on investment, and investments with higher risk, such as real estate, demand higher rates of return.)

So the real question is, what are the risk-adjusted returns like for investing in these areas of the country with record high prices versus the risk-adjusted returns available in other, lower-priced real estate markets? You may find a rural property where the monthly rent exceeds 1 percent of the purchase price, but what about rent growth and appreciation? At the end of the day, you may find that your lower priced market with all of those “bargains” provided you with minimal cash flow and marginal appreciation.

Knowing when to sell and when to buy real estate is easier said than done. But if you follow the fundamentals of economic analysis, and remember that “location, location, value” is the key to successful real estate investing, you can do well.

Chapter 11

Understanding Leases and Property Valuation

In This Chapter

- ▶ Looking at leases and their terms
 - ▶ Comprehending valuation
 - ▶ Developing value benchmarks
-

Location, as discussed in Chapter 10, is an important consideration when looking to invest in income property. But what you pay for the property and the cash flow it generates make a significant difference in the success of your investment. Leases generate the income stream you should base your real estate investment strategy on. All the quantitative analysis we guide you through in Chapter 12 is for naught if you don't have a handle on the leases. Therefore, in this chapter, you start your research, analysis, and evaluation of specific properties by analyzing the leases.

We then introduce you to the concepts behind evaluating potential investment properties and explain the key principles behind property valuation that you need to be familiar with. We also provide you with a few quantitative tools you can use to size up prospective properties and determine whether you should move on to other properties or investigate further.

The Importance of Evaluating a Lease

A *lease* is a contractual obligation between a *lessor* (landlord) and a *lessee* (tenant) to transfer the right to exclusive possession and use of certain real property for a defined time period for an agreed *consideration* (money). A verbal lease can be enforceable, but it's much better to have a written lease that defines the rights and responsibilities of the landlord and the tenant.



Owning a nice rental property with attractive and well-maintained buildings may give you a sense of pride of ownership, but what you're really investing in are the leases. Successful real estate investors know that an excellent opportunity is to find properties with leases that offer *upside potential* in the form of higher income and/or stability of tenancy.

Regardless of the type of property you're considering as an investment, make sure that the seller provides all of the leases. And don't accept just the first page or a summary of the salient points of the lease — insist on the full and complete lease document along with any addendums or written modifications with the seller's written certification that the document is accurate and valid. (Verbal modifications to the written lease aren't generally enforceable.) Have your real estate legal advisor review the leases as well (see Chapter 6).



Existing leases almost always *run with the property* upon transfer of ownership and thus are enforceable. The new owner of the property can't simply renegotiate or void the current leases he doesn't like. Because you're legally obligated for all terms and conditions of current leases if you buy a property, be sure that you thoroughly understand all aspects of the property's current leases.

You may find that you're presented with the opportunity to purchase properties with leases that are detriments to the property and actually bring down its current and future value. For example, the leases may be so far above the current market conditions that you should discount the likelihood that the leases will be in place and enforceable in the future.

Other common problems with leases include

- ✓ The leases are preprinted boilerplate forms (as opposed to a customized lease tailored to the specific tenant-landlord agreement) that may or may not comply with current laws or issues relevant for the specific tenant.
- ✓ The charges for late payments, returned checks, or other administrative fees may not be clearly defined or may be unenforceable.
- ✓ The rules and regulations may not be comprehensive or enforceable.
- ✓ There is no *rent escalation* clause, which spells out future rent increases, or it isn't clearly defined.

We're not saying to bypass purchasing any properties with leases with these problems. Just be aware and factor the effect, if any, into your purchasing decision, or just simply note that you need to change the onerous terms upon renewal.

Reviewing a Lease: What to Look For



A seller should be honest and disclose all material facts about the property he's selling, but most states don't have the same written disclosure requirements that are mandated for residential transactions. So even though your broker or sales agent and other members of your due diligence investigation team (see Chapter 6) may be assisting you with inspecting the property and reviewing the books provided during the transaction, remember that at the end of the day, you need to be the one who cares the most about your best interests.

Note the expiration dates of the leases, because any lease that's about to expire should be evaluated based on current market conditions. Future leases may not be at the same rent level, plus you must consider the concessions or tenant improvements necessary to get the lease renewed:

- ✓ Residential lease renewals may require a monetary concession or possibly a perk for the tenants, such as cleaning their carpets or installing microwaves or ceiling fans.
- ✓ Commercial lease renewals can require significant tenant improvements or rent concessions.



Factor these costs into your analysis because renewing a tenant, even with the associated costs, is typically much more cost effective than losing the tenant.

Comprehending a residential lease

The analysis of current leases for residential properties is usually fairly straightforward, but that doesn't mean you shouldn't do your homework! Review *each and every* residential lease to make sure that no hidden surprises are awaiting you, such as future free rent, limits to rent increases, or promises of new carpet or other expensive upgrades. Some sneaky sellers of residential properties know that some buyers don't thoroughly review each lease, so they load the leases with future rent concessions in exchange for higher rents up front, which they use to make the property's financial statements look more desirable. The *net effective rent* is what you're looking for to make your payments. An above-market lease isn't really above market if you're giving away free rent or promising to replace the carpet upon lease renewal.

Making sense of a commercial lease



Commercial leases are much more complicated than residential ones. Thus, the commercial real estate investor must have a thorough understanding of the contractual obligations and duties of the lessor (landlord) and lessee (tenant).

The analysis of commercial leases is typically called *lease abstraction*. A *lease abstract* is a written summary of all the significant terms and conditions contained in the lease and is much more than a rent roll. Although a good *rent roll* covers the lease basics — rent, square footage, length of lease, and renewal date or options — a good abstract covers other key tenant issues such as signage, rights of expansion and contraction, and even restrictions or limitations on leasing to other tenants that offer similar products and services. Have written lease abstracts prepared for any commercial property you're considering to ensure that you understand all the terms.

When obtaining financing for commercial properties, lenders typically require a certified or signed rent roll along with a written lease abstract for each tenant. However, because the income of the property is critical to the owner's ability to make the debt service obligations, most lenders don't simply rely on the buyer's numbers but independently derive their own income projections based on information they require the purchaser to obtain from the tenants. This information includes

✓ **Lease estoppel:** A *lease estoppel* certificate is a legal document completed by the tenant that outlines the basic terms of his lease agreement and certifies that the lease is valid without any breaches by either the tenant or the landlord at the time it's executed. These estoppel certificates also benefit the purchaser of the property; you should seriously consider requiring estoppels from all tenants when you purchase a commercial building — regardless of the requirements of any lender.

Although tenant or lease estoppel certificates are rarely required by lenders or purchasers for residential transactions, there is a strong argument that the benefits of the estoppel certificate also apply in the residential setting. Residential tenants are more likely to dispute the amount of the security deposit or claim that they were entitled to unwritten promises by the previous owner — free rent, new carpet, or waived late charges.

✓ **Financial statements:** The rent provided in the lease is a concern, but the amount you actually collect determines the profitability of your real estate investment. Because of this, many leases require the commercial tenant to periodically provide (or present upon request) a recent financial statement.



✓ **Recent sales info:** Most retail leases have provisions for *percentage rents*, in which the tenant pays a base rent plus additional rent based on a percentage of sales. The percentage rent is often on a sliding scale: The percentage paid by the tenant increases as its sales increase. Be sure that you receive and review recent sales information and ensure that the tenant is current on its percentage rent payments.



Reviewing the financial strength or sales figures for your commercial and retail tenants can be an excellent indicator of the future results of your property. Many of your best tenants in the future will be your small tenants that have successful businesses and need to expand. Also, look at the personal guarantees provided to see whether they're backed by sufficient resources. The compatibility of the tenant mix is also important.



One of the best ways to make money in real estate is to find commercial leases where the person in charge of the property isn't collecting the proper rent due under the terms of the lease. For example, you may find that the rent roll from the seller of a property you're considering for purchase hasn't implemented rent increases when due. Even more common is the failure of landlords and their property managers to correctly calculate and collect the common area maintenance charges or ancillary fees and reimbursements due from the tenant (see Chapter 12). Of course, you may also find that the landlords are actually overcharging the tenants, and thus you never want to purchase a property relying on phantom income that you don't have the legal right to collect.

Understanding the Economic Principles of Property Valuation

Knowing certain economic principles can be useful when seeking to evaluate the current and future value of potential real estate investments. In this section, we supply you with some background information to help you determine which properties are likely to have strong demand.

Have you ever traveled to a foreign country and observed miles of beautiful coastline that you know would be worth a fortune at home? A few years ago, Robert returned from Costa Rica, where he saw dozens of faded "For Sale" signs on mile after mile of unimproved oceanfront property with spectacular water views. Local folks told him that these properties rarely sell and are available at low prices. The weather is humid but not much different than similar weather along the Florida coast, where property is expensive. So what are the factors behind such wide disparities in pricing and value?

Well, you need to consider several important economic principles when evaluating the potential value of a property. The basis of value for any piece of real estate is grounded in the following four concepts:

- ✓ **Demand:** The need or desire for possession or ownership backed by the financial means to satisfy that need.
- ✓ **Utility:** The property's ability to satisfy its intended purpose. For example, a very inaccessible location isn't suitable for a retail property.
- ✓ **Scarcity:** Similar properties are finite, and substitution doesn't indicate that other properties can meet the same needs. *Substitution* is the idea that an investor won't pay more for a property than the price of another, similar property.
- ✓ **Transferability:** The relative ease with which ownership rights are transferred from one owner to another.

In the earlier example, the oceanfront land in Costa Rica wasn't in high demand, was relatively inaccessible (the closest major airport was in the capital city of San Jose — nearly 100 miles away), the availability of so many similar properties made the scarcity a nonissue, and the complications of the government requirements for foreign ownership may limit the ability to transfer the property to non-Costa Ricans.

An understanding of the current value and future potential of real estate investments is based on these four concepts. But three other important economic principles can affect the value of real estate now and in the future:

- ✓ **Regression:** A property's value is negatively impacted by surrounding properties that are inferior, of lower value, or in worse condition. In other words, don't buy the best property in a bad neighborhood.
- ✓ **Progression:** A property's value is positively impacted by surrounding properties that are superior, in better condition, and have a higher value.



This concept is one of the most important for the real estate investor looking for long-term success. Seek a well-built but neglected and poorly maintained property located in a good neighborhood. You then add significant value by repositioning the property up to the level of the surrounding properties through proper maintenance, repairs, and upgrades.

- ✓ **Conformity:** Property values are optimized when a property generally conforms to the surrounding properties, and negatively impacted when it doesn't. Higher or optimized value through conformity is what you're seeking when you purchase the distressed property and renovate it to enhance its appearance and utility. This is also the economic principle that cautions against overimproving the property.

Determining highest and best use

All of these economic principles are based on the premise that the maximum value of real estate is achieved when a property is being utilized in its highest and best use. *Highest and best use* is the fundamental concept that there is one single use that results in the maximum profitability by the best and most efficient use of the property. (This concept focuses solely on financial issues. For example, it says nothing about the impact that a significant, dense property development has on traffic and the local environment.)

The highest and best use of a specific property doesn't remain constant over time. Zoning of a property can eliminate certain possible uses of a property at the time of evaluation. However, particularly for properties in the path of progress, time can create new opportunities. For example, agricultural land in the middle of a rapidly expanding commercial and resort area isn't the highest and best use (financially speaking) of the property. (Check out Chapter 10 for more on zoning issues.)

This was the case for the strawberry fields that bordered the west side of Disneyland in Anaheim for several decades. The long-time owner of the property wasn't interested in selling at any price, so the property wasn't utilized to its highest and best use. However, after the owner passed away, his heirs quickly sold the property, and the Disney resort developed the property.

Comparing fair market value and investment value

When discussing real estate values, most people immediately think of fair market value — basically, the price that the buyer and seller can agree to for a real estate transaction. Determining the fair market value of real estate often seems like an elusive concept much like the old adage “Beauty is in the eye of the beholder.”

A bit more specifically, the *fair market value* is the most likely price a buyer is willing to pay and a seller is willing to accept for a property at a given time. This definition is based on three assumptions:

- ✓ The market for similar real estate is open and competitive.
- ✓ The buyer and seller are both motivated, acting prudently and with knowledge.
- ✓ The buyer and seller aren't under any undue influence or affected by unusual circumstances.

However, real estate investors encounter another type of value — investment value. Although the market value is the value of a property to a typical investor, *investment value* is its value to a specific investor based on his particular requirements, such as the cost of capital, tax rate, or personal goals.

Someday, you may find yourself competing against another buyer for a prime investment property only to be surprised that she seems willing to pay much more. If you've carefully analyzed the property, and the seller provided the same information about the property to all potential purchasers, the other buyer is likely basing her offer on the property's investment value to her.

Maybe the other buyer needs a replacement property for a 1031 exchange and has the strong motivation of potentially losing the deferral of significant capital gains unless she buys property of equal or greater value within certain defined time periods (see Chapter 18). Such buyers are often willing to pay a premium for a property to avoid losing the tax deferral benefits available under federal and many state tax codes.



You don't want to get into a bidding war for a property and overpay, so remember that market value and investment value are two different concepts. Investment value can be higher or lower than market value. For example, an investor who can't use the tax benefits of depreciation would be willing to pay less for a property that would generate large annual depreciation than would an investor that has other passive income and can use the deferral of taxation to reduce his current income tax obligations.

Reviewing the Sources of Property-Valuing Information

As a prospective buyer, you may find that quite a few folks have an idea of what a piece of property is worth:

- ✔ **Professional appraisers:** Owners and lenders hire these property valuation specialists to formulate the value of a property at a given point in time. Sellers rarely consult appraisers unless the sale is the result of litigation or probate, or a government entity is the buyer or seller.
- ✔ **Brokers and agents:** A Competitive Market Analysis (CMA) or a Broker Price Opinion (BPO-V) is an estimate of market value that is generally available from brokers or agents active in the local area where the property is located. Some lenders also use the term Broker Opinion of Value (BOV). Because brokers and agents routinely track the listing and sale of comparable properties, they offer this information to owners with the goal of getting a listing on the property. Their valuation may be fair and reasonable; however, a buyer should remember that the real

estate agent isn't a disinterested third party, but rather only paid if he's involved in a sales transaction — and then he's compensated more for a higher sales price.

- ✓ **Sellers:** Many sellers also do their own informal or anecdotal research by obtaining information about recent sales of properties they know in the area. Ultimately, the seller must make the final critical decision as to the asking price for a property. Because the valuation of real estate has many variables, inefficiencies in the pricing of income properties are common.

As a prospective buyer, the values these folks come up with are merely starting points for your analysis. Much more research is required. We spend the balance of this chapter, and Chapter 12, helping you do your research.



Many real estate investors find that becoming real estate appraisers can be helpful to their success in investing in real estate. You may want to get a certification in real estate appraisal while making your real estate investments. Another benefit of this choice is that you qualify for the favorable tax treatments offered to real estate professionals (as described further in Chapter 18). Or you may just want to have a better understanding of the techniques used by appraisers for evaluating your own properties. For more information on professional appraisers and their education and training, please refer to www.appraisalfoundation.org or www.appraisalinstitute.org.

Establishing Value Benchmarks

The proper analysis of real estate requires due diligence and research, which starts with evaluating the existing leases (see the “The Importance of Evaluating a Lease” section earlier in this chapter) and continues with crunching the numbers (see Chapter 12). However, almost more than any other investment, the real estate industry has relied for years on value benchmarks to set prices and evaluate potential purchases.

One of the reasons value benchmarks are so widely used is that they can easily be calculated by using basic information available on a property. Virtually all properties you encounter for sale include this information in the listing brochures or offering packages provided by sellers or their brokers or sales agents.



These value benchmarks are general guidelines only, and they can be misleading, especially to the novice real estate investor. When you first hear them, they sound impressive, but they're only quick and simple indicators of value. Don't make investment decisions without calculating the Net Operating Income (NOI) (which we cover in detail in Chapter 10). The measures in this section shouldn't be *the* sole basis for the purchase of income-producing real estate.

Some professional appraisers may perform these calculations as a verification test to ensure that their results are in the ballpark and even include them in their appraisal. However, these numbers aren't as accurate at indicating value as the traditional methods of appraising the value of real estate (the cost approach, market approach, and income capitalization approach discussed in Chapter 12). Neither are they formally recognized and mandated by the professional appraisal institutes or federal lending guidelines as approved methods of appraising real estate.

In the following sections, we cover the standard value benchmarks that apply to all types of real estate, as well as some that are unique to a specific sector.

Gross rent/income multiplier

Two important value benchmarks include

- ✓ **Gross Rent Multiplier (GRM):** GRM is most commonly used for residential income properties, such as single-family rental homes and small apartment buildings, because virtually all of their income is in the form of rent payments from tenants.
- ✓ **Gross Income Multiplier (GIM):** GIM includes rent plus all other sources of income and therefore is more widely used to quickly evaluate commercial or industrial real estate investments.

The monthly rent or income is used in some areas of the country, but typically the GRM and GIM are calculated by using annual numbers. Both the GRM and GIM are calculated by dividing the proposed acquisition price by the annual rent or total income. For example, the GRM for a rental home that can be acquired for \$100,000 with a monthly rent of \$750 (\$9,000 annualized):

$$\begin{aligned} \text{GRM} &= \frac{\text{Proposed acquisition price}}{\text{Annual rent}} \\ &= \frac{\$100,000}{\$9,000} \\ &= 11.1 \end{aligned}$$

Likewise, an industrial building that sells for \$250,000 with an annual gross income of \$20,000 has a GIM of 12.5.

These formulas require little information and are a simple way to quickly compare similar properties. Savvy real estate investors glance at the GRM or GIM on a listing sheet and may either eliminate some properties from or earmark



them for further consideration, but they don't write an offer to purchase just because the ratio seems attractive. Experienced investors know that much more analysis is needed because these formulas don't consider future appreciation, financial leverage, the risk of the investment, or operating expenses. They focus on gross income only, which can be deceptive.

Here's how relying on these formulas can be tricky: If the GRM and GIM ratios seem high, you need to check further to see whether the price is too high — in which case you should pass on this property. Or maybe the rents are below market value and the price is reasonable. Conversely, you may see a low GRM and think that you found your next investment prospect only to discover that the property is really overpriced because the seller has projected unrealistic rents based on seasonal rentals for dilapidated furnished studio apartments in a beach community.

Because both GRM and GIM only consider the income side of the investment, these formulas don't differentiate between the operating and capital expense levels of each property. The income is important, but what you're left with after paying the expenses makes your mortgage payment and provides you with cash flow. As we discuss in Chapter 12, the operating and capital expense levels can make a tremendous difference in the overall cash flow and the value of the property.

For example, compare two small apartment communities — both available for \$1 million and each with an annual gross income of \$100,000. On each, the GRM is 10. But which is the better investment? The GRM doesn't give any indication, but further analysis gives you the answer because expenses for each property probably differ.

One apartment building is over 40 years old and has only month-to-month rental agreements with a high turnover of tenants. The property has interior hallways, is poorly maintained, and has an elevator that has never been modernized. This property suffers from above-average annual operating expenses of \$85,000. The other potential investment is also an older property but caters to seniors on long-term leases who rarely move and do little damage. The building is a two-story, garden-style walk-up with annual expenses of \$45,000. Clearly, assuming you use the same financing for each property, the second property (with \$40,000 less in expenses) should result in greater cash flow to the owner.

Price per unit and square foot

For apartment investors, the asking *price per unit* can provide a general feel for the reasonableness of the seller's pricing. Price per unit is calculated by simply dividing the asking price by the number of units. For example, a six-unit building priced at \$240,000 works out to \$40,000 per unit.

Like the GRM calculation, the price per unit does have its limitations. The calculation doesn't account for the location or age of the property, the quality of construction or amenities, or the unit size and condition. You should only use it as a quick indicator of relative value when comparing similar properties in the same market area.

The *price per square foot* is a widely used yet simple calculation most often associated with commercial, industrial, and retail properties (and sometimes used for residential properties). To find this number, take the asking or sales price of a property and divide it by the square footage of the buildings. It's only a ballpark gauge of relative value and can be limited because it doesn't factor in the location or quality of the improvements or other important issues like the parking ratio or the occupancy level and rent collections.

For example, a 5,000-square-foot building going for \$250,000 may seem like a good value at \$50 per square foot in your market until you find that it hasn't been occupied for years and is in a distressed area of town. Or a 10,000-square-foot building for \$1.25 million may seem overpriced at \$125 per square foot until you discover that the U.S. Postal Service just signed a 20-year net lease at full market rent with generous annual cost-of-living increases.

Replacement cost

Replacement cost is another factor that real estate investors should consider prior to making a real estate investment. The *replacement cost* is the current cost to construct a comparable property that serves the same purpose or function as the original property. The calculation of replacement cost is usually done by comparing the price per square foot to an estimate of the cost per square foot to build a similar new property, including the cost of the land.



If you buy an investment property below its replacement cost, you can generally know that a prudent builder probably won't construct a similar new product. This fact minimizes the chance that overbuilding will result in excess supply. It isn't until resale value (minus depreciation) of existing properties equals the cost to construct new properties that a builder will find it financially feasible to build an additional product.

Especially when considering investing in a real estate market that seems overpriced, avoid buying investment properties where the cost for new construction is equal to or lower than the replacement cost of a similar building. When prices rise to the point that it's more economical to build a new product rather than buy existing investment properties, builders know that they can build an additional product and sell it at a profit. And you then have additional properties to compete with.

Chapter 12

Valuing Property through Number Crunching

In This Chapter

- ▶ Getting a return on your investment
 - ▶ Understanding the mysteries of Net Operating Income
 - ▶ Delving into cash flow
 - ▶ Looking at three basic approaches to valuation
 - ▶ Determining what you should pay for a property
-

With the help of your real estate team, you need to narrow your real estate investment opportunities down to just those properties that seem to have the best chance to produce financially in the long run. In Chapter 11, we cover the basics of property valuation and provide you with the information you need to examine the leases of prospective properties.

In this chapter, we get down to the business of running the numbers. We cover the essential elements of understanding and arriving at a property's income and expenses and Net Operating Income — and we explain what that is! We then take these important numbers a step further and show you the best valuation tools traditionally used by appraisers and commonly used by lenders to determine what a property is worth.

But after you've done all of your research and analysis, the reality is that you still need to establish whether a proposed property has the potential to be a good investment opportunity. Overpaying for a good property isn't any better than getting a deal on a bad property. Neither will meet your goals. So we close the chapter by putting it all together to help you decide how much you should consider paying.

Understanding the Importance of Return on Investment



The purchase of an investment property is really the purchase of a future income stream or cash flow. Although pride of ownership or the satisfaction of being the owner of a rental property may be an important issue for some people, most real estate investors focus primarily on the investment returns that they can generate from a given property.

Four elements determine the return you see on your investment:

- ✓ **Net cash flow:** *Net cash flow* is money generated by the property after deducting all costs and debt service from the income. See the “Calculating Cash Flow” section later in this chapter.
- ✓ **Tax benefits of depreciation:** Many investors are able to use these tax benefits to shelter other sources of income (we cover this subject in Chapter 18).
- ✓ **Buildup of equity:** If you acquired the property with debt, the equity buildup from paying down the debt over time is a factor.
- ✓ **Appreciation:** True wealth is created through *appreciation* (buying property and selling it years later for much more than you paid). Significant estates and generational wealth are created through appreciation.



The key to generating a profitable real estate portfolio is finding and purchasing properties that exhibit the potential for high occupancy and growth in income while keeping expenses and turnover reasonable. Success in real estate investing depends on purchasing a property for the right price so that you have the ability to use your management skills to increase the value over time. Don't base your investment decision on emotions. Falling in love with a property can lead to overpaying.

You also need to determine what work needs to be done to the property to correct any deferred maintenance or functional obsolescence. Even if you simply hold the property and look for cash flow and appreciation, you want to be able to evaluate the holding costs during your ownership period.

Then you need to determine the future value of the property to calculate the likely disposition price and determine your return on investment.

Figuring Net Operating Income

Knowledgeable real estate investors begin a serious analysis of a potential property acquisition by deriving the projected *Net Operating Income*, commonly abbreviated as NOI. We find it surprising how many real estate investors don't make the effort to calculate the NOI before buying a property. Instead, the quick-and-easy nature of the benchmarks we cover in the previous chapter seduces unwitting investors into a false sense of security.

The calculation of Net Operating Income is simply

$$\text{NOI} = \text{Income} - \text{Expenses}$$



NOI is the most critical factor in determining the potential for return on your investment in real estate. Determining the NOI of a property is one of the fundamental building blocks to analyzing real estate investments. Any decision — to buy, hold, or sell — should only be made after a careful analysis of the *actual current* and *projected future* NOI for a given real estate investment. Arriving at a reasonable estimate for future NOI is the key to determining the value parameters for your real estate investment. We recommend that you value a property based on the projected NOI for the next year, or preferably next few years.

The current NOI is fairly easy to obtain and is often provided by the seller (although in the rest of this section, we explain common problems with this seller-provided data). Deriving the projected NOI is a more time-consuming and in-depth process. The forecasting of a property's NOI is more of an art than a science. Many times, the estimation of NOI is based on a number of assumptions or projections about future events that are anything but certain. Will your tenants renew their leases (and at what rates)? Will the tenants make their rent payments and other contractual requirements as agreed in their leases? Will expenses stay within the expected range, or will there be significant world or local events that lead to a spike in costs (like the availability and cost of property insurance after the 9/11 terrorist attacks or a significant increase in the price of oil)?



Whether you receive current or projected NOI estimates from a seller, be careful to verify the numbers. Some sellers, and many real estate brokers and agents, prefer to provide a *pro forma NOI* (a projection of future financial performance of the property) that uses higher rents and lower expenses. These fictitious numbers are based on the theory that the new owner will raise the rents to market level and simultaneously lower the costs of operating the property. These assumptions are rarely valid. Unless the property has leases that renew at higher rates or below-market leases that are expiring while the demand is high, you seldom find a professionally managed property with below-market rents. If it were that easy to increase income, wouldn't the current owner do it? Expenses are also unlikely to decrease significantly.

Have you ever seen a projection from a seller, her broker, or her sales agent that projects a lower NOI for an investment property on the market? They act as if the only way for NOI to go is up. Although you want to invest in properties where that is the likely result, the reality is that real estate is a cyclical business, and supply and demand factors have a major impact.



“Garbage in, garbage out” holds true for your projections of your future NOI. Therefore, make a careful and detailed analysis of the property you’re considering. Real estate investing isn’t something you should do by the seat of your pants. Develop your own operating pro forma prior to purchasing any property. And any evaluation or projection of the income stream for a property should begin with an analysis of each lease or rental agreement (which we cover in Chapter 11).

Evaluating income: Moving from fiction to useful figures



To evaluate the income side of your budget, we advise that you painstakingly record and verify all income by using a zero-based budget concept. A *zero-based budget* is where you start with a blank piece of paper (or spreadsheet, if you enjoy computer software) and individually, tenant by tenant, create the projected rents and income stream for the property. (A similar zero-based budget concept is useful for determining your likely or expected expenses and is discussed in further detail later in the chapter.)



Sellers may provide or be asked to sign a certified rent roll or similar document verifying the accuracy of the tenants and rents listed. Although this document may be a great exhibit in your lawsuit against the seller for fraud, we advise that you use this document cautiously and only as a tool in developing your own independent analysis of the current and future rent payments due under the terms of the existing leases. Don’t just gather static data and numbers on your current tenants; you must be able to interpret the data. Evaluate the strength of each tenant. The lease may give you the legal right to future rent payments; however, a tenant who is unable or unwilling to meet his lease obligations won’t be good for your rental collections.

You want a property that has tenants who not only have the current financial strength to meet their obligations under the lease but who will also enhance or increase your income in future years. For example, you may determine that one of your commercial office building tenants will be looking to expand and will probably replace a tenant that is barely surviving and unlikely to renew their lease.

It's truly amazing how little some commercial landlords know about the needs of their current tenants. Be sure to actually talk to your prospective tenants (in addition to getting the estoppel certificates discussed in Chapter 11). Tenants are the key to your future success, and you want to make sure that you can provide the proper environment so their businesses can grow and prosper while you benefit from their rental payments, which ultimately pay for the building you plan to own free-and-clear in the future.



But the income side of the equation involves more than just estimating rents. The typical income and expense statements for reporting in real estate include standard terminology that all real estate investors should know:

- ✓ **Gross potential income** or GPI is the maximum gross income that would be generated from the rent if the property were at 100 percent occupancy and all money owed were collected in full. (This is sometimes referred to as *gross possible income*.)
- ✓ **Effective gross income** or EGI is essentially the money that is actually collected. EGI is calculated by taking the GPI and then subtracting the vacancies, concessions, delinquencies, and collection losses and then adding the other income from late charges, returned checks, and all other secondary sources.

In the sections that follow, we provide the details on what to subtract and add to work your way from GPI to EGI.

Accounting for vacancies

The real estate investment community seems to be locked on using 5 percent as the vacancy factor; brokers and even lenders typically use a 5 percent vacancy factor without any regard for the actual market conditions. This number may or may not be the right number to use; we advise that you carefully determine the most accurate estimate of future vacancy rather than use a standard figure such as 5 percent.



The issue of vacancies is particularly applicable to many new real estate investors who begin either by retaining their current homes as investment properties when they move up to larger homes or by purchasing rental properties as investments. Novice investors often simply compare the monthly rental rate that they plan on charging to the monthly costs for paying the mortgage and any other recurring expenses (property taxes, utilities, homeowner's dues, and so on). This practice can be dangerous if you don't have sufficient cash reserves for the unexpected — like being unable to find or retain tenants or having to evict a tenant who stops paying.

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