

the
Unofficial
Guide[®] to
Real Estate
Investing

Second Edition

*Spencer Strauss
and Martin Stone*



Wiley Publishing, Inc.

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Spencer Strauss dedicates this book to Marty Stone for his friendship and never-ending support and to his late father

Marty Strauss: "Dad, today I am a fountain pen."

Martin Stone dedicates this book to his wife Lori for her love and encouragement and to his longtime teacher, mentor, and friend Jack Buckingham.

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Spencer Strauss makes his living as an associate real estate broker working side by side with his writing partner, Martin Stone. In that capacity, Spencer has bought, sold, traded, and managed countless buildings and has helped scores of investors get their start in real estate. Besides *the Unofficial Guide to Real Estate Investing*, Spencer also co-authored *Secure Your Financial Future Investing in Real Estate* (Dearborn Trade Publishing, 2003). He has been featured on television on KABC's *Eyewitness News*, as well as on radio stations KFI, KLAC, and KABC, all in Southern California. Additionally, Spencer's analysis has been featured in *USA Today*, the *New York Post*, the *Chicago Tribune*, the *Long Beach Press Telegram*, and the *Los Angeles Times*. For a free audio cassette on real estate investing, you can contact him via e-mail at spence@spencerstrauss.com.

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Introduction

Whether you are a novice real estate investor or a seasoned pro, *the Unofficial Guide to Real Estate Investing*, Second Edition, is a guide that will help you prosper faster and easier. Notice that we didn't say "fast and easy." This is because anyone who promises that they will help you get rich fast and easy by investing in real estate isn't telling you the truth. Real estate by nature is not a get-rich-quick investment. Rather, it's a long-term proposition — a proposition, however, that can pay off beyond your wildest expectations if you're willing to put in the time.

So from the get-go, here is our promise to you: If you make the effort to read and understand this book, we will impart to you a money-making methodology that works, period. A baker uses a bread recipe to create the same loaf time and again. In fact, if you think about it, that's probably why money is called "dough." You too need a good money-making recipe to create your dough. Now you have found it. In this book we will share the same recipe that countless people through the ages have used to create their dough. Follow the recipe, and you too will get the same result.

Since the first edition of *the Unofficial Guide to Real Estate Investing* was published in January 2000, the real estate market in America has risen sure and steady. In that time, countless Americans who have taken a risk and invested in property have sown the seeds of an abundant tomorrow for themselves and their families. What's more, they have done it in a world and an economy that has been anything but

certain. As anyone who has been paying attention to the news over the past few years readily knows, what many of us thought was safe and secure — for ourselves, our families, and our futures — is now anything but.

For survival in this new world, a new way of thinking has taken hold. Americans have realized that when it comes to the safety of our nest eggs, the only person any of us can really rely on is ourselves. It is no secret to anyone that the global economy has seen its share of turmoil over the past several years. It appears as though we have corrected our own course, and now with the twenty-first century upon us, the rest of the world looks like it will follow suit. This economic downturn taught us a lot, specifically about the problems that come with rapid growth, business overhead, the effects of inflation, and a host of other basic business principles that somehow got lost over the years. To right our ship, we were forced to rethink our way of doing business.

Looking back at the early 1990s, one of the industries that suffered mightily was real estate. We could devote the next 375 pages to a discussion of whether the economy caused the problems in the industry or vice versa. Instead, we choose to believe that the real estate industry fell prey to the same excesses as the rest of the economy. That is, when the tough times hit, owners who weren't invested based on sound economic principles simply couldn't stay afloat, causing a domino effect. In a short span of time, a lot of real estate owners became statistics, just as a host of other business owners did.

Since the market began turning the corner in the middle '90s, we have experienced some of the longest growth in America's history. In fact, many experts are referring to this as a "golden era." Federal Reserve Chairman Alan Greenspan was quoted as saying, "I don't recall as good an underlying base for the long-term outlook . . . in the last two or three decades." Part of the reason for our country's success is that we have cut the fat and gone back to the basic principles of running our country like a profitable business. Energetic entrepreneurs who still believe in the American dream are opening up shop again all over the country. These new businesses are lean and mean and are ones in which everyone pulls his or her own weight.

As we have recently learned, many of the young entrepreneurs that have come out of the golden era have a great ability

to attract capital to their ideas. But, even great ideas sometimes fail to produce a profit. The collapse of WorldCom, other high tech ventures, and the dotcom bubble in general, all point to the necessity to invest in proven investment vehicles. Thankfully, real estate investing has proven itself as a winner year after year after year.

In fact, as long as anyone can remember, experts have agreed that investing in real estate is the best and safest bet you can make. Today, the market has grown to like all the attention it's getting. A recent article in *USA Today* said, "Not since the 1960s has the housing market been so uniformly strong across the USA." The article added that "the market is largely devoid of extremes," and "today's hot markets can be found in all regions of the country." In January 2003, existing single-family home sales climbed more than 3 percent over 2002, which had set the previous record. David Lereah, the chief economist for the National Association of Realtors[®], gave credit to lower interest rates and the fact that, "real estate has become the safe haven for investment." As long as this investment is looked upon as a long-term wealth builder and not a fly-by-night get-rich scheme, investors will make out great.

To that end, the goal of this guide is to highlight the legitimate business side of real estate. Because real estate is a cyclical commodity, it's possible to get caught investing with your pants down — just as a host of other get-rich-quick hopefuls have done through the years. In contrast, our belief is that if you approach real estate as a business and use sound business principles in running and investing in it, the probability of failure is minimal.

Here you will learn the differences between legitimate real estate investing and speculative ventures. The profits generated by speculating on foreclosures and zero-money-down deals seem to get the most press, but we feel this kind of investing should be undertaken only after you have gained some good hands-on experience. Even a beginner, however, can combine the sound principles of compound interest and leverage and generate exceptional returns over the long run without taking any undue risk at all.

Here's a quick illustration of the goldmine that's available if you're willing to be patient: A modest 2 percent growth rate in value translates to a 20 percent return on a property purchased

with just a 10 percent down payment. That's right, a 20 percent return. When it comes to work, most of us slave away for 25 or 30 years to receive a small retirement package and a token gift at the finish line. Conversely, if you were to invest \$30,000 and were able to maintain a 20 percent return for that same period of time, due to the combination of compound interest and leverage, your initial investment would be worth well over two million dollars — two million dollars!

You see, real estate is a rare investment vehicle. For starters, it can provide you with a place to live while it's working as an investment. What's more, this investment offers several kinds of return including cash flow, equity growth from loan payoffs, equity growth from appreciation, and great tax benefits. How does \$250,000 of tax-free profit sound? Probably pretty good. Well, a new twist in the tax laws allows homeowners that exact benefit. (We promise to tell you more about it in Chapter 7, "Subdividing Your Options.")

How about what value appreciation can do for you? Rone Tempest wrote an article for the *Los Angeles Times* about urban renewal in Beijing. There, the Chinese were being forced to raze the old buildings because land prices had escalated to a whopping \$6,000 per square meter. That translates to more than \$24 million per acre. The question then is, if it can happen in Beijing, why not here? You may not live to see those kinds of prices, but you can still make a fortune by simply taking advantage of the modest value appreciation that takes place in your own area. We'll show you how.

We'll also devote some of our writing to a few key economic principles that affect real estate investing. This might seem like a foreign language lesson as you try to understand how this can impact your need to buy your first modest three- or four-unit building. That's understandable, but come back to these principles after a few years of ownership. Chances are they'll mean more to you then. Understanding how real estate fits into the overall picture of the economy will help your profits multiply in the long run.

A large portion of this guide is dedicated to teaching you some of the hard-earned lessons from our years of experience in this business. In Part VI, "Property Management Essentials," we have outlined many property-management techniques that will allow you to start your career head and shoulders above

most of your competition. These principles should help you get your career off on the right foot and should give you the foundation to ask the important questions of the professionals you seek out for assistance.

Above all, our most important message will be to make a plan and then to simply work your plan to achieve your goals. Planning is a common principle for every successful business, but it is sorely lacking when it comes to real estate. You don't have to be Donald Trump or Ted Turner to need a plan. A plan simply gives you the opportunity to catch up to (and eventually pass) them.

For many of you, retirement investments in real estate might be the salvation of your retirement. The recent debacles of company pension plans like those of Enron and WorldCom only prove the point that it's time for you to take charge of your own future. If you don't, it's possible that you will helplessly watch your 401(k) account, company pension plan, and Social Security dwindle until they offer you little to help you survive in your later years. To that end, we implore you to make your real estate investments the centerpiece of your retirement plan.

Finally, beyond reading this guide, we encourage you to continue to educate yourself about this business. A separate book could be written about every section in this guide. Some are listed in Appendix C, "Recommended Reading List." Find and read them with a keen eye. Never stop your search for knowledge. We know that if you learn the business of real estate, believe in your abilities, enjoy the adventure, and take a risk every now and then, real estate investing is the best and safest field for you to make phenomenal profits.

Now, go grab a yellow highlighter pen and start reading.

The image shows two handwritten signatures in black ink. The signature on the left is for Spencer Strauss, featuring a stylized 'S' and 'S' that are interconnected. The signature on the right is for Marty Stone, written in a more cursive, flowing style.

Spencer Strauss

Martin Stone

Special Features

Every book in the Unofficial Guide series offers the following four special sidebars that are devised to help you get things done cheaply, efficiently, and smartly.

1. **Moneysaver:** Tips and shortcuts that will help you save money.
2. **Watch Out!:** Cautions and warnings to help you avoid common pitfalls.
3. **Bright Idea:** Smart or innovative ways to do something; in many cases, the ideas listed here will help you save time or hassle.
4. **Quote:** Anecdotes from real people who are willing to share their experiences and insights.

We also recognize your need to have quick information at your fingertips, and have provided the following comprehensive sections at the back of the book:

1. **Glossary:** Definitions of complicated terminology and jargon.
2. **Resource Guide:** Lists of relevant agencies, associations, institutions, Web sites, and so on.
3. **Recommended Reading List:** Suggested titles that can help you get more in-depth information on related topics.
4. **Important Documents:** “Official” pieces of information you need to refer to, such as government forms.
5. **Important Statistics:** Facts and numbers presented at-a-glance for easy reference.
6. **Index**

PART I

Understanding Real Estate As an Investment

GET THE SCOOP ON...

Why living and working in the 2000s requires a new way of thinking ■ The reasons working for others will always be a dead-end job ■ The difference between speculation and investing ■ How the government becomes your best friend and partner in investing ■ The beauty of compound interest and leverage ■ Creating wealth using other people's money

Planting the Seed

Congratulations! Today your life has changed. By buying and reading this book, you have taken the first step toward making your dreams come true. As any successful real estate investor knows, buying, owning, trading, and selling investment properties are the surest and smartest ways to prosper. It doesn't matter what your long-term goal is; whether it be to finance your children's education, save for retirement, or eventually quit your day job, investing in real estate offers a realistic, tried-and-true way of getting ahead—way ahead.

It is also a good use of your time. In fact, one of our goals in this book, aside from showing you how to use real estate to change your life, is to respect your time. The novice, uninformed investor can make mistakes that cost time and money. By educating yourself from the onset, chances are good that you'll be able to avoid many pitfalls. Our plan is to

cut years off your learning curve by sharing the things we have learned the hard way. This way you will prosper quicker, and with less effort.

But we won't promise that it will be easy or effortless. You are not going to be led to believe that buying and flipping distressed properties or placing tiny classified ads in the newspaper is going to make you rich. No, what we are offering here is the chance to learn the same proven methods of success that all prudent real estate investors use to get ahead. Let there be no doubt; it takes work. But it is a system that works. Think of it like a recipe. A chef uses the same recipe time and again to get the same result. Well, here, we want to teach you a real-world, money-making recipe. Learn it and reap the rewards of a more abundant future.

A new world order

Now that we are well into the 2000s, we are living in an era of rapid change. In fact, our world is changing at a faster pace than ever before in human history. This kind of comment surely has been made before, but most of us don't stop to consider the impact these changes might have on us. Think about Mr. Spock from *Star Trek*; he would envy our cell phones. He could only use his communicator to talk to others; we, on the other hand, can talk on our cell phones, see the face of the person we are talking to, and even use our cell phone to check our e-mail.

What about the computer? Back in the early 1970s, it used punch cards, and the computer itself took up an entire room that needed to be air-conditioned. Today, a computer with umpteen times the capacity of that 1970's machine weighs less than two pounds and can easily fit into a small briefcase. Sadly, due to the effectiveness that computers bring to the working world, most of the lower-level jobs of the 1970s are gone. Today, in some companies, the lunch-box worker has been left out in the cold, and computers handle the lion's share of the work. These changes should be an eye-opener for everybody.

In order to preserve our futures, many of us have stood stubbornly firm in the belief that the best way to eliminate risk is to put in a lifetime of service at a good job. Our idea has been to get in at 8:00 a.m., work diligently without complaint until 5:00 p.m., and then do it again tomorrow. In fact, our hope was that we could do this week after week and year after year, ultimately punching the same clock for the next 30 or 40 years.

During our parents' day, this strategy worked. You decided on a career, got an education, and then found a company to call home until your retirement. It was a job. It became part of your social life, and your years of loyal service were rewarded at the finish line with a gold watch and a satisfactory retirement package. Not anymore. With rapid change, the old ways are gone—in fact, long gone. How many engineers have lost their good, high-paying jobs when changes in technology over the last 20 years made their expertise outdated? We recently spoke to a woman with 25 years in the computer industry who couldn't find work. Her experience in DOS was a language that few industries still use.

“By investing in some small apartment buildings, my wife was eventually able to quit her job. She now manages our properties from the house and is able to be a full-time mom for our new baby girl.”

—Kirk M., investor

It's now survival of the fittest

Today, lean and mean is the way companies survive. Unfortunately, these new rules apply to you now, too. You will need to be financially smarter than workers who came before you. This is because the job security they enjoyed isn't available anymore. What's more, with the stock market tumble that occurred in the early 2000s, too many of us have seen our retirement slip further and further away. The same goes for inappropriately named Social Security; these days, it is anything but secure.

So, with the lifetime career a thing of the past, capital investments less certain than ever, and the government unable to make up the difference, the burden is now squarely on you to create a financial foundation that can carry you for the rest of your life.

It is a new world order, indeed.

Trading time for dollars

In a capitalistic society such as ours, the big rewards are given to those who take the chances—the entrepreneurs. They have the vision, they take the risks, and, consequently, they get the big benefits. The problem for the average person is that, rather than being a risk taker, most of us have gotten into the habit of putting in eight hours a day working for someone else. At the end of the week, we look forward to cashing our paycheck and then doing it all over again. After enough years of this routine, we've programmed ourselves to believe that trading our time for a paycheck is the way to get rich.

Consider your boss, the guy who owns the company for which you work. He's not hurting for money, is he? He knows something that you are just figuring out. That is, working for someone else doesn't work. It certainly doesn't make you rich. Being the employee just makes you the employee. Being the boss can make you rich. In fact, the erroneous idea that you can create real wealth by trading time for dollars is the biggest barrier you can have to achieving it.

Instead, it's time for you to get brainwashed—the kind of brainwash that cleanses you of your beliefs about what it takes to get ahead. Here is the first step: Tap into the mindset you had when you went to school, the concept of investing your time for knowledge, not trading it for dollars.

Think back to your school days. Aside from the fun of hanging out with your friends, school was tough. You always were tight for money, never ate right, and endured many a sleepless night getting term papers done on time. No one paid you a salary to go

**Watch Out!**

Don't walk out on your job tomorrow because you've decided to invest in real estate today. Creating wealth from real estate is a long-term proposition. In the beginning, it is something you should work at in addition to your day job; that is, until you're so successful in real estate investing that you don't have to.

to class. You just worked at it and received one lone letter grade at a time for your efforts. After a while, the grades added up. In time you got a degree, and that degree got you the job that pays your salary. In school, you didn't trade your time for dollars; you invested it for knowledge. As you can see, the concept worked.

Given that you chose this book and are reading it, odds are you recognize that you're ready for a brainwash of your own. That's good. It is now time to go back to school—time to invest your effort and mental energies into learning the entrepreneurial skills necessary to take back control of your financial house. It's going to require taking some chances. Odds are that some of your loved ones will burst your bubble and tell you why it can't be done. But it can. The difference this time is that it will be with the wisdom of having lived and struggled in the adult world. You now know there is no free lunch. Moreover, you see that punching the time clock day in and day out is not the winning proposition you had hoped for.

This endeavor is about taking back control of your destiny: new cars, nice homes, vacations, security, less stress, more fun, and more time—they all are attainable and within reach.

Investing versus speculating

Once you have mentally graduated from the ranks of a wage earner, one who previously traded time for dollars, it becomes imperative that you understand the difference between the concepts of speculating and investing. The differences are critical, especially when it comes to the security of your hard-earned investment dollar.



Moneysaver

Be wary of late-night TV infomercials that tell you how you can make millions by speculating on distressed real estate. There may be money to be made there, but it is best left for later in your real estate career, after you have had some hands-on experience. Think. Distressed real estate is property someone else has abandoned after losing his or her money.

Speculate: To enter into a transaction or venture in which the profits are conjectural or subject to chance; to buy or sell with the hope of profiting through fluctuations in price.

Speculating seems to be a natural human characteristic. Think about the raffle tickets we used to sell as fund-raisers. The prize offered for the winner usually was pretty enticing: a new car, some money, or perhaps a Hawaiian vacation. Because the tickets were for a good cause (charity, schoolbooks, or another such cause), this began a mindset that speculating is an acceptable way of getting a return.

As we get older, speculation becomes a way of life. On a small scale, who hasn't participated in a football or Academy Awards pool at the office? By participating, we are hoping to make a profit; but in reality, the outcome is completely out of our control.

Because we so willingly speculate with our money, most states have caught on and have lured us to spend our money on their games of chance. Not surprisingly, a vast majority of people in our country spend dollar after dollar on lottery tickets each week hoping to get lucky someday.

Now, consider Las Vegas. Las Vegas was founded as the first legitimate American location for legalized speculation. Most of the nation has caught on to this, too. Whether it be horse racing, organized bingo, blackjack, or slot machines, if you want to play, it's pretty easy to find someone in America willing to take your bet.

How does investing differ? Let's see:

Invest: To commit money or capital in business to earn a financial return. The outlay of money for income or profit.

When it comes to our finances, investing doesn't come naturally. It seems as though we understand investing when it comes to investing our time for education or investing our labors to do work around the house. Investing our money, however, needs to be learned.

Understanding the difference between speculating and investing is simple once you analyze dictionary definitions. The key word in the definition of speculation is "hopes." The key word in the definition of invest is "earn." As you can see, these two concepts are at the opposite ends of the money spectrum. When something is based on hope, it implies that someone or something else is in control of the outcome. When it is based on earning, it requires action on your part to attain success.

Our number-one goal is to teach you how to invest your money in real estate so that you can create something tangible for yourself. The game is not about speculating on buildings with nothing down, buying and repairing run-down fixer-uppers, or flipping foreclosures because to succeed in those ventures often requires hope and luck. No, here we are going to show you the actions needed to reach your dreams through investing—actions like buying fair-market-valued properties and working them like a business for the long haul.



Bright Idea

Start a savings account into which a small percentage of your paycheck gets deposited automatically. In time, you can painlessly accumulate some extra money to help pay for a down payment on your first investment in income property.

When it comes to succeeding in real estate, investing, action, and earning are the keys to winning. Speculation, on the other hand, relies on luck and hope. As far as we are concerned, rolling the dice is best left for weekends in Las Vegas or Atlantic City.

Taking a chance

Getting started always is the toughest part when taking on anything new. Investing is no different. Perhaps you will breathe easier if you look at people who have a lot of money. In fact, if you look at people who are really, really rich, you quickly will see that real estate is one common denominator many of them share. People such as Donald Trump, Dr. Jerry Buss, Marvin Davis, Donald Sterling, and Merv Griffin all owe their fortunes to this commodity. Of course, some of them started out with a large pot to begin with, but many of them didn't. Most important is to recognize that the principles they used to grow their real estate empires are exactly the same ones we are teaching here.

The beauty of real estate is that a small investor will earn the exact same percentage return that any large investor will earn. In many cases, you might even earn more. There aren't that many grandiose trophy properties available, and even fewer buyers out there who could pull the trigger on them. What's more, the chances of someone like Donald Trump making a mistake when he sells a property and leaving some profit on the table for the next buyer is remote, at best.

So, how do these wealthy people keep making so much money in real estate? The answer is they keep buying it. They know it's the

“Buy land. They ain't making it anymore.”

—Mark Twain

best place to invest, even if they have to pay top dollar. Check the records; Marvin Davis bought Fox Plaza in Los Angeles twice. He paid a good price both times but

still made a great profit each time. He knows the secret of making money in real estate; you buy it.

Most people get their start in real estate investing by purchasing their first home. Others who really understand the long-term benefits of real estate start out living in a small set of units that they own. This lowers the cost of living while giving them valuable experience in managing a property. In a few years, the savings and other benefits enable them to move into a single-family home while retaining the units as a pure investment. Others get their start by providing housing for a relative in need or a child away at college. After this need has passed, the equity is transferred into a regular rental investment. In short, the reason for the purchase is to provide a very basic human need—housing—but the result is the start of a new and profitable career.

One great advantage of an investment in real estate is that it allows you as much or as little control as you desire. You can choose to be an active manager of your property, or you can subcontract all the day-to-day operations to a management company. By using a management company, you avoid the daily hassles of being a landlord but still maintain control of your asset. If you have other types of investments, such as stock in a corporation, you know that the destiny of your capital is in the hands of someone else. These corporate managers or “experts” may do a good job, but if things go wrong, you can’t jump in to help run the company like you can with a real estate investment. The bottom line here is that you are the CEO of your business, and you decide who does what, when, and for how much.

The roots of lending

Most people don’t realize that the minute they earn some extra money and put it in the bank, they become an investor. A savings account is the simplest investment you can make. To most of us, making a deposit into our savings account is nothing more than putting money away for a rainy day. In reality, the small amounts of cash deposited by millions of people form the foundation for most lending in our country.

In the classic film *It's a Wonderful Life*, Jimmy Stewart plays a young man who takes over the family building-and-loan business. At their inception, building and loans, now called savings and loans, were started by the little people of a community as a safer place to put their extra money when their mattress just would not suffice anymore. When they were fortunate enough to do a little better financially, they went to the building and loan and borrowed enough money to buy or build a first home. Until that point, they were forced to rent a place to live from someone else.

From simple beginnings, as seen in the movie, savings and loans have grown in huge proportions. Nonetheless, they still are based on the simple economic concept of small investors banding their money together and then having that institution lending the money to others to purchase property—lending it to people like you.

Bankers know that real estate is one of the safest products to loan against. To begin with, they are aware of all the basic economic facts previously mentioned. Second, unlike a car loan, you can't drive their asset away if you quit making payments. For this reason, they can get their security back fairly quickly if something goes wrong. Finally, lenders do an appraisal and check your credit to ensure that you and the property are qualified for the loan they are making. The message here should be clear; if bankers are confident that their loans are safe (for you and them), shouldn't you help them out and use their money to buy some properties?



Moneysaver

Real estate loans usually get the lowest interest rate, the longest repayment term, and the lowest down payment requirements of any bank loan. This is because bankers are convinced that these loans have the lowest risk of loss to the bank.

Great government subsidies

They say America is a great country in which to live, a true land of opportunity. One of the reasons we have it so good is that we all have an uncle that watches over us. His name is Uncle Sam. Many live in fear of him because they think he is always looking over their shoulder, but these people aren't seeing the whole picture. To the real estate investor, Uncle Sam is our best friend and our staunchest supporter.

When we're just starting out, Uncle Sam gives us quite a hand. First, he loans us the money (at great terms) to buy our first property. He then tells the guy who collects the taxes on the money we earn (the IRS) to give us as many breaks as he can. Finally, in areas where it's tough for some people to pay the fair market rent, Uncle Sam pays it for them (HUD subsidies). What a guy!

Even if you're young, energetic, and ambitious, the fact remains—you still need cash to get started investing. If money is tight and all seems lost, the federal government has two excellent programs geared toward helping the beginning investor get started. These programs are administered through the Federal Housing Administration (FHA) and the Veterans Administration (VA). We will discuss all the specifics of the FHA and the VA in Chapter 5, "Borrowing Big Bucks," but knowing some of the basic details at this point will give you the encouragement you need now.

The FHA is a government loan-insurance program that is open to any citizen who can meet some basic qualifying guidelines. These guidelines are very generous and give most of us the opportunity to buy our first property. And by *first property*, we mean residential real estate, which means anything from one to four units. The most important advantage of this program is that it only requires a minimum down payment of 3 percent of the purchase price. So, for the purchase of a \$200,000 piece of property, you need only \$6,000 down to get started. There usually are some other costs associated with a purchase, but the

FHA requires that the seller assist you in paying most of them. In the case of the purchase of small units, the transfer of the

rents and security deposits at closing can lower your actual out-of-pocket cost even more.

“By using an FHA loan, I bought my first home and made an investment at the same time. I bought a four-unit apartment building. It has a three-bedroom owner’s unit that I use for my family, and it also has three attached rental units. The income from those units pays for almost all of my mortgage payment. Yee-ha!”

—Brad S., investor

The second program the government provides is Veterans Administration loans. The VA guarantees loans to people who have served in the military. Because home ownership is one of the most important tenets of our society, there is no better way to reward someone who has served their country than to help

them buy their first home. An eligible veteran can purchase a qualified property with no down payment and, in most cases, with no other out-of-pocket costs. What a country!

Contrary to popular belief, Uncle Sam is also on your side when it comes to keeping your taxes owed to a minimum. Once you are a property owner, the government steps in every year with some extra help in making your new business work through various tax breaks and incentives offered by the IRS. Most of these benefits are mirrored by the states in our country that have a state income tax.

As a property owner, you now will be filing a Schedule C with your regular tax returns, wherein you will be reporting all income and expenses from your real estate business. The money you spend to run the property will be a deduction from the rental income you receive in determining your taxable



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The IRS offers extra benefits to people who own historical properties. Rather than a normal depreciation deduction, the IRS gives these property owners tax credits against any money due come tax time.

profit. This then is taxable, just as any other earnings are. Any legitimate expense of running your property can be a deduction including the money you spend to upgrade the property to increase its value. Major expenses need to be deducted over several years, but they still can help decrease your taxable profit.

The most important tax incentive Uncle Sam provides is the ability to sell a property and trade all your equity into another property while deferring the taxes due on any profit you have made. This is called an IRS 1031 tax-deferred exchange. The number 1031 refers to the code section that contains all the rules governing such an exchange. We will tackle 1031 exchanges in earnest in Chapter 10, “Planning for the Tax Man.” For now know that because you can defer the taxes owed, you can have more equity available to trade in for bigger and better buildings in the future. The end result will be a better chance at a higher return. The beauty is that, under the current code, an IRS 1031 exchange can be done over and over again for as long as you choose to grow your nest egg through real estate.

Here is an illustration of how a 1031 exchange may pencil out: Let’s assume you just sold a duplex that you have owned for several years. You are getting back your \$20,000 initial down payment and a net profit of \$30,000. Assuming you are in the 30 percent tax bracket and are going to buy another property with 10 percent down, the following table shows the difference in the property you can purchase:

	Tax Paid	Tax Deferred
Down payment	\$20,000	\$20,000
Profit	\$30,000	\$30,000
Tax	\$9,000	\$0
Equity for purchase	\$41,000	\$50,000
New property value	\$410,000	\$500,000

It is important to note that you are not escaping the payment of your tax due; you are just postponing the payment to some time in the future. In a sense, Uncle Sam now becomes your partner in the next property you purchase. This is because you are investing his money (the taxes owed) along with your own. If you do a good job with it, you actually will be increasing his investment, too.

Leveraged compound interest

The biggest little secret of them all is leveraged compound interest. Albert Einstein, when asked what the most powerful force on Earth was, answered without hesitation, “Compound interest!” Ben Franklin defined the term as “the stone that will turn lead into gold.” You all know about compound interest because it is the concept the banks and savings and loans talk about when they tell you how your money will grow when you leave it with them. You leave the interest in the bank along with your original investment. In a short period of time, the interest earned on the interest of your original investment makes your return multiply significantly.

We will go over the compound interest formula in great detail in Chapter 9, “Building an Investment Plan,” but we want you to get a glimpse now of the reason this works so well with leveraged real estate. The truth is that the return you get on real estate if you pay for your purchase using all cash (without getting a loan) isn’t much higher than you get on most other types

of investments. With real estate, however, you usually don't pay using all cash. Instead, you use leverage to buy properties. That is, you put down a small down payment on the property, usually 10–20 percent, and you then finance the balance.

The great mathematician Archimedes said, "Give me a lever long enough and a fulcrum on which to place it, and I shall move the world." As investors, we don't want to use a lever to move the world; we just want to use it to buy as much of it as we can. The ability to finance 80–90 percent of your real estate business is the rule, not the exception.

On the other hand, most commodities in which you can invest require that you pay all cash to purchase them. At best, you can obtain some financing that usually requires a substantial down payment and exceptional credit. Take the stock market, for example; unless you are buying on margin, you are required to pay all cash for the shares you want to purchase. This is true whether you're buying stocks, bonds, or mutual funds. This also is true for most investments in coins, stamps, art, and commodities. If you want to own it, you'll be paying for it with your own hard-earned money.

The ability to use leverage with real estate significantly increases the percentage of profit you can make, but more importantly, it allows you to purchase a significantly larger investment than you normally would have been able to. If you have \$9,000 to invest, for example, you could buy 9,000 worth of stocks, bonds, coins, or art. With \$9,000 to invest in real estate, however, you could purchase a four-unit FHA apartment building worth \$300,000. You'd achieve this because \$9,000 is 3 percent of



Watch Out!

Leverage is a wonderful way to multiply the profit on the dollars you invest. Remember, however, that because leverage increases your potential profit, it will also increase your risk because you are obligated to pay back the entire debt on the borrowed money. You can do it, but it will require running your real estate business in a professional way.

\$300,000. And 3 percent is all an FHA loan requires you to put down. The structure of this kind of deal could look like this:

Property	Four-unit apartment building
Property price	\$300,000
Down payment (3% of price)	\$9,000
FHA loan	\$291,000

By buying a property with a low down payment and financing the balance, you thereby significantly increase the percentage return on your money invested. To illustrate how this works, let's say you have \$100,000 to invest, and you decide to use the entire \$100,000 to buy a small two- or three-unit apartment building outright. Your cash flow might look like this:

Property price	\$100,000 investment
Gross income	\$14,000
-Expenses	-\$4,000
Net cash flow	\$10,000

Your profit as a percentage of your investment would be calculated using the following formula:

$$\frac{\text{Net income}}{\text{Investment}} = \% \text{ return}$$

Therefore, your profit would be

$$\frac{\$10,000}{\$100,000} = 10\% \text{ return}$$

Ten percent on your money isn't bad, especially if you're used to the return you get from your savings account—but now let's use leverage. For the purposes of this example, let's say you put 10 percent down and borrow 90 percent of the purchase price. The loan on the property at 7 percent interest costs you \$598 per month. Your cash flow on the building is now:

Gross income	\$14,000
Expenses	-\$4,000
Loan payment	-\$7,176
Net cash flow	\$2,824

(Obviously, you will need to adjust these numbers, or any others you see in this book, to meet the interest rate you get.)

Compared to buying the property outright, you see that your cash flow drops from \$10,000 to \$2,824. At first glance, this doesn't seem so good—that is, until you see what it means in terms of a percentage return on your investment. Because your down payment is only \$10,000 (rather than \$100,000), the return now looks like this using the formula you just learned:

$$\frac{\text{Net income}}{\text{Investment}} = \% \text{ return}$$

Or:

$$\frac{\$2,824}{\$10,000} = 28.2\% \text{ return}$$

You see, that's what leverage does for you. In this scenario, it would give you a 28.2 percent return on your money. If you buy 10 of these properties with your same \$100,000, your annual cash flow would be \$28,200. As you will learn later, when you put the power of leverage together with Ben Franklin's "stone that will turn lead into gold," compound interest, you can—and will—make phenomenal returns.

Just the facts

- The old "work 40 years and retire" system no longer applies to the average person.
- To create wealth, you must rid yourself of the belief that trading time for dollars is the way to go.

- Because an investing mentality is not inherent in human behavior, it is a skill you will have to learn in order to get ahead.
- When it comes to investing in real estate, Uncle Sam is your best ally.
- The opportunity to use leverage to buy property is the greatest advantage real estate has over all other investments.

GET THE SCOOP ON...

- The profit you see in the beginning
- What to expect in the middle years
- Retirement realities
- Why a systematic approach is critical
- Research—the key to success

The Process and the Plan

In Chapter 1 we covered some of the basic reasons why an investment in real estate can work for you. Now we will explain what you can expect over the entire span of your investment career.

As you are learning, real estate is a long-term investment. With the liquidity of stocks, bonds, or mutual funds, you can get in and out very quickly. Real estate investing, however, requires you to invest with a different mindset. That is, you need to be committed to invest for the long haul. To that end, your goal can't be to buy a property and then hope to flip it and turn a windfall profit overnight. This is because real estate, by nature, doesn't lend itself to making a quick buck. However, by making a long-term commitment you'll come to see that this investment has longevity. In fact, levelheaded real estate investing is destined to pay great returns over the entire course of a lifetime.

What's unique about this investment is that the profits you'll earn through the years are distinctly

different; a feature you can't find in other investments. You'll note that these different types of profits all build on each other. You retain your short-term profits into your middle years, and you carry both of these profits into your retirement.

We'll begin this chapter by talking about the earnings you can look forward to in the short term.

Short-term profits

You can expect to earn two types of profits in the short term: cash flow and tax benefits. Either one of these by itself can give you just as good a return as most other investments. Taken together, the return they offer usually is far superior to any other investment you might choose.

Cash flow

Cash flow is probably the most sought-after return from any investment. Simply stated, cash flow is the monthly or annual cash return you receive from your investment. Take your savings account, for instance. When you deposit your excess earnings in your account, the bank pays you interest on your money; this interest is your cash flow from that investment. Generally speaking, the greater the cash flow you desire from any investment, the greater the effort and sometimes the greater the risk you will need to take to obtain your goal.

With real estate, it's important to understand that cash flow is a direct function of how much you put down on a property. If you bought a property without the aid of a loan, for example, your cash flow would be substantial. This is because all the



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Negative cash flow exists when your payments are greater than your income. It may sound simple, but one way to avoid negative cash flow is to make sure your rents are at least at market rate. Some investors get too friendly with their tenants. In turn, the investors' big hearts keep them from charging the market rents for their properties that they truly deserve.

money you take in from rent, less operating expenses, would be yours to keep. Conversely, if you buy a property with a minimal down payment and take out a loan to cover the balance, your cash flow will be adjusted accordingly. This is because paying back the loan reduces your cash flow.

To calculate cash flow, use the following formula:

$$\begin{array}{r} \text{Gross income} \\ -\text{Operating expenses} \\ -\text{Loan payments} \\ \hline \text{Net cash flow} \end{array}$$

Cash flow doesn't mean much unless you relate it to the amount of money you have invested. Most investors like to talk about the cash-on-cash return they get on their money. Your percentage cash-on-cash return is calculated as follows:

$$\frac{\text{Net cash flow}}{\text{Cash investment}} = \% \text{ Cash-on-cash return}$$

With an investment in real estate, you can structure your financing to obtain the cash flow you desire. Smart investors have the most financing on their properties when they begin their investment careers and have the least when they retire. This is intelligent because when you're working full time, a good goal is to have your steady paycheck cover your current standard of living. That way, your investments can do the job they are supposed to do. Once you retire, however, and aren't getting paid on a regular basis, you will have a greater need for steady monthly income. Reducing the amount of your mortgage by the time you retire is the best way to achieve this result.

Tax benefits

The second short-term benefit in real estate investing relates to taxes. You should view the tax benefits you receive from property ownership as frosting on the cake. With real estate, you can receive a nice cash-on-cash return from your property at the end



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Ordinary and reasonable expenses connected to real estate are deductible as investment expenses including interest, utilities, insurance, property taxes, maintenance, supplies, legal fees, and more.

of the year. This is because you are allowed to deduct your losses from operating expenses on your federal taxes. Most states that have state income taxes also offer a state tax benefit.

The theory behind the tax deduction for operating expenses is rooted in the costs most companies incur to replace expensive equipment needed to produce durable goods. Because machines wear out or become obsolete in just a few years, the IRS allows companies to take a deduction against profits to replace equipment. The business is allowed to deduct the cost of the machine over its useful life so that it can be replaced when it wears out. With real estate, you can produce a positive cash flow and still have a loss as far as the IRS is concerned.

We'll be reviewing ongoing and capital expenses in detail in Chapters 14 and 15, but we want you to understand the benefits to the real estate investor now. As a real estate investor, you will have an opportunity to take a deduction against earnings for an expense that probably will never occur. That is, you will never have to replace your building because it wore out. In truth, real estate never wears out. Structures that sit on land do, but the dirt itself does not.

Note that this depreciation deduction, especially in the early years of ownership, usually shelters all cash-flow profits. In addition, there usually are enough extra write-offs to offset taxes on some of your earnings from your regular job.

Middle-years payoffs

The middle years of ownership should keep you both busy and happy. You'll be busy because you will have the responsibility of

running your real estate business each day. You'll be happy because you will be making money. Lots of it.

During the middle years, you can expect to spend most of your time on three phases of operation:

1. Running the day-to-day operation of your properties like a business.
2. Utilizing the equity in the properties like a savings account to provide for some of the finer things in life.
3. Fine-tuning your investment plan to make sure you reach your stated goals according to your set timetable.

The day-to-day operations

You'll recognize that you are in the middle years of ownership when certain clues pop up time and again. For one thing, you'll find yourself skipping over the front-page and sports sections of your newspaper to get to the real estate ads. Perusing that section of the paper, you'll become a bloodhound for rental rates, upcoming vacancies, and any other kinds of information that could impact your business. Additionally, in these years, you'll discover that your Home Depot or Orchard Supply credit card bill is consistently larger than your Macy's or Nordstrom's bill. Finally, when you travel to your favorite vacation spots, you'll always be checking out rental rates and the price of small units. Your master plan will be to buy a vacation home there and let tenants pay the mortgage when you're not on holiday.

At this point, you have arrived. You're in business for yourself, and you're enjoying the challenges and the profits. This is

“We worked hard on our properties, and after five years, we were able to refinance. Because of the appreciation that took place in that time period, we were able to pull out enough money to help build ourselves a brand new home.”

—Jim S., 54

when all the things you learn in this book will be the most meaningful to you. You will see this business as just that—a business. The profit plans you have designed will become as important as your paycheck is at your day job. Going to your property won't seem like a chore; instead, it'll feel like an opportunity to check on your investment. Did the gardener do his job? Does anything need to be painted or fixed? Are the tenants happy? Can I charge more rent?

You'll start taking trips around the neighborhood to see what the competition looks like. Yes, you will now see all the other buildings in your neighborhood as competition. How do they look? What are they charging for rent? Which ones always seem to stay full and why? Just as grocery stores and department stores compete for customers, you'll begin to compete for tenants with the other building owners in your neighborhood.

The first few days of the month will now have a new meaning for you; they will be the days you collect your rents and pay your bills. The first challenge will be getting all the rents in on the first of the month. Even in the best areas, it takes work to get your tenants trained to pay on time. After collecting rent, you'll have to pay out a lot of it to cover bills. This will become a game to you, and you will constantly be asking yourself, "How can I keep the most for myself?" At your day job, your boss asks you to increase revenue and to do what you can to cut down on expenses. You do it there because it is your job; now you'll do it because the money you save is yours to keep.

Utilizing your equity

As your real estate holdings move into the middle years, the cash flow and equity grow. This is because, by this time, you will have raised your rents and found ways to curtail expenses. Now is the time when you can use your property as you would use a savings account—to buy things you couldn't afford on your salary alone. These middle-years items should be the kind of things that will give you the extra incentive to work that much harder at this second career.

**Watch Out!**

Avoid the idea of buying a property for your child to live in while he or she is away at college. Prices in college towns usually are pretty high, and kids are known to transfer schools or drop out all together. What's worse, college-age tenants tend to trash your units.

Providing an education for their children is one of the first things many people do with the money they make from real estate. Indeed, education comes with a large price tag. A recent study predicts that the cost of a public college education in the year 2018 will be more than \$70,000, and the cost of a private university education will be more than \$180,000. These are staggering numbers, especially when you multiply them by the number of children you have.

There are, however, some more pleasurable things you can look forward to doing with your money. The equity in your properties can be tapped to help provide for that larger home in the better neighborhood where you have always wanted to live. You also might choose to invest some of the money you're making into a vacation home in the mountains or the desert. Instead of sitting vacant while not in use, it becomes another holding in your investment portfolio. You earn income from renting it when you're not vacationing there.

A vacation home offers an interesting mix of benefits. You might be able to take depreciation, but if not, then you may be able to deduct expenses as a second home. The best news is that you can probably use the 1031 tax-deferred exchange to shelter your profit. We'll tackle this subject in detail in Chapter 7, "Subdividing Your Options."

Finally, let's talk about all the other luxuries you would like if you had a few extra thousand dollars at your disposal. How about a couple of jet skis like your neighbor has? What about a trip to Hawaii or Europe with the family? In short, your properties should provide you with the funds to pay for all those

“if only I had the extra money” things about which most people only dream.

Of course, new water toys and vacations sound great, but do you want to know how it is realistically possible? Here’s how: Your real estate is going to produce some income through cash flow, and it will also provide you with a nice cushion come tax time. But, in truth, your nest egg will grow to truly astounding heights due to two other areas of return. They are

1. Appreciation in value (inflation + demand)
2. By paying down your mortgage

Let’s first talk about value appreciation. Inflation has always been a part of our economy. In the past, you weren’t happy during high inflation because the cost of everything you needed to live seemed to correspondingly grow. Now, however, higher inflation will be your best friend. This is because not only will the value of your property increase because of inflation, but you also can increase your monthly income by raising rents during inflationary times.

Additionally, your equity will increase as you pay off your mortgage. In the beginning, principal reduction will only constitute a small portion of the pie. But as the years go on it becomes a significant part of equity growth. It takes longer to see the big dollars add up from this component of return, but every dollar paid off increases your net worth correspondingly.

This increased equity also gives you borrowing power at the bank. Your banker should gladly loan you money based on the appreciation that has taken place on your property as well as the increased value you have created by paying down



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Be sure to contact your existing lender when it’s time to refinance. Many times, you can save on loan fees, escrow fees, and other costs by using the same lender the second time around. They want your business, so don’t be afraid to try and negotiate their fees down.

your loans. Any new loan you get will first be used to pay off your old loan. Then, if there is money left over, you can do with it what you choose.

One of the greatest advantages of refinancing is that the funds you pull out are not taxable. Conversely, if you sell stock and realize a profit, you will have to pay the tax. But when it comes to refinancing real estate, because you are borrowing your profit, there is no tax to pay. This is because you are obligated, at some point, to pay the loan back. The good news is that you will be doing that with tenant income. If you have increased your rents to keep up with the market, these increased rents usually will pay any increase in your payments because of the higher loan you now have.

Tweaking your plan

You will use the middle years to fine-tune your knowledge of any and all real estate investment opportunities. The more you get involved, the more you will want to know about real estate and the business of owning it. This should lead you to seminars, books, lectures, tapes, and discussions with other investors.

Through the years, you probably will be following in your mind various types of properties you might consider buying. There are single-family homes, small units, commercial buildings, and developable land that you might try your hand at. Additionally, you might consider buying distressed properties. Situations such as fixer-uppers, mismanaged properties, bank repossessions, use conversions, and development deals all provide opportunities to make more money (see Chapters 7 and 8)—that is, after you gain the proper knowledge and experience from taking a more traditional route to wealth-building through real estate first.

At some point, you will make a decision whether real estate will remain a secondary career to you or whether you will quit working for someone else and hire yourself to manage your real estate holdings full time. Whatever your choice may be, you will find that the middle years of property ownership will provide

you with plenty of flexibility. In Chapter 10, “Planning for the Tax Man,” you will see that there are some great tax advantages to being directly involved in your real estate ventures. The IRS calls this being “in the business” of real estate.

The retirement years

As you make your decisions about your future in real estate, you’ll also be setting the stage for your retirement. For some people, real estate will be one part of a diverse retirement portfolio, a true passive investment. Many investors choose to purchase only one property in their careers and to manage the financing so that it is paid off by the time they retire. This isn’t such a bad idea. By the time they retire there is no mortgage to worry about, which will provide plenty of positive cash flow.

Other investors purchase many properties in their careers and decide that they just want to call it quits. For them, a perfect life would be fishing in the mornings and golfing in the afternoon. If that is their goal, their properties can be sold, they can settle up with Uncle Sam, and then bank the remaining cash. From that point forward, they can fish and golf to their heart’s content.

Another option is to sell the properties and become the banker by carrying notes against the property. This strategy will be discussed in detail later in this book, but in short, carrying notes against your properties offers two distinct advantages over an outright sale:

1. You don’t pay your taxes until you receive your profit. This means you can carry interest-only notes and defer any taxes due for the entire term of your contract. As you can see, by utilizing this technique you can earn interest on all your equity including the money you eventually will give to the IRS for taxes.
2. You will find out that you will earn a greater interest rate on your money by being the banker than by letting the banks pay you interest. Remember, early on we learned

that the banks pay you interest when you give them your money, and then they lend it to others to buy property. By carrying the financing yourself, you cut out the middle-man (the bank) and keep the profit all for yourself.

Many people find that their real estate holdings make a great part-time retirement business. Managing the properties is just enough to keep them busy, but doesn't require a daily 9 to 5 commitment. For others, real estate might grow into a family business, with the kids learning at a young age the lessons you had to learn while working two jobs.

A last option is to relinquish all the operations of your business to a property management company. At this point, your new job will be to supervise your management company rather than your properties. The management company will have all the duties of running the properties and paying the bills. They will then send you a check each month for your profit. Even better, they can easily deposit your funds to the bank of your choice, and you can draw on them from anywhere in the world.

A systematic approach to investing

Now that you understand the kinds of profits you can expect, you need a plan for attaining the biggest return. What we introduce to you now is a *systematic plan* for investing in real estate that works—period. We don't make that claim idly. We know that the plan works because we have *seen it work* for years for ourselves and for our clients. You need not reinvent the wheel. Instead, learn the plan here, and then implement it for yourself. The wheel will then roll for you too.

This approach to investing has five phases. They are

1. **Learn** about real estate as an investment vehicle.
2. **Research** the market in your local area.
3. **Plan** how to invest your money.
4. **Invest** your funds according to your plan.
5. **Manage** your investment to meet your plan's goals.

Let's touch on each of these phases one at a time.

Learning about real estate as an investment vehicle

For starters, recognize that the education you are putting yourself through now isn't meant to be a course called "Real Estate 101" that goes in one ear and out the other. Instead, you must think of this kind of learning as if it were a continuing-education class—one that you chose and will be involved with for the rest of your investment career. Just as you educated yourself for your day job, we want you to educate yourself for this investment career. You go to work each day and trade your time for dollars. In your real estate career, you will be letting your investments do most of the work, but you need to be the brains behind the operation.

We know that this learning phase can be the most difficult step for lots of people. This is because learning anything new requires lots of personal effort and time. The truth is, not many of us have the time to brush our teeth in the mornings, let alone the time to learn all about a new business venture. As a partial cure, what about spending your morning commute listening to books on tape about real estate and investing? You can literally turn your daily drive into a classroom by listening to educational tapes instead of more sports talk or a Top-40 station. It would be a trade-off, but one that could get you that much closer to catching the golden goose.

The truth is, if you want to take this game seriously, there are literally thousands of books, tapes, newspaper articles, magazine articles, classes, and seminars available to help you get educated. Even better news is that most of the books, articles, and tapes will probably be available free at your local library. Your only job will be to seek them out.

**Watch Out!**

Make sure to do some stringent checking before you pay big money to attend some of the “get rich quick” real estate seminars offered. Be especially wary of the ones that are free; often they are designed to just get you in the door so that they can sell you some expensive books, tapes, or additional training.

To supplement your independent study, there are plenty of colleges and adult-education schools that offer courses on everything from basic accounting to property management to buying and selling every kind of real estate you can imagine. What’s great is that these classes usually don’t cost much, especially at the community-college level. The biggest advantage is that people who have hands-on knowledge of the subject matter usually teach the classes. In addition, if you have an apartment owners association nearby (see Appendix B), it might offer property-management seminars where you can learn management skills and the latest rules and regulations for your local area.

Finally, many authors and lecturers offer weekend seminars covering a range of real estate–related subjects. Often held only in larger cities, these courses can be a great source of information.

The lesson here is to take this road seriously. By turning yourself into an expert, you will shave years off your learning curve. The end result will be more money in your pocket—way more.

Researching the market in your local area

While you are learning about real estate in general and real estate investing specifically, you need to begin educating yourself about the actual market for property in your area. Our book, and most others, can only provide a broad overview of real estate investing. Markets can change drastically within a few miles, let alone across the entire country. Therefore, it’s critical to truly understand your own market and how it performs before you start buying.

Begin by finding a real estate agent who is willing to help long before you are ready to buy. Don't worry; you won't have to pay him anything because he will earn a commission paid by the seller only if, and when, you purchase a property. Your goal at this stage is to get a basic understanding of the pricing of properties in the area where you expect to buy. You won't be calculating returns or looking for something to actually buy at this point. Your goal is simply to get a basic understanding of what properties sell for. If you can answer the question "What would a duplex cost in my neighborhood?" or "What is the price per unit for a fourplex?," you're well on your way to a solid foundation. If, when asked those questions, you said, "I need to know whether the units are one or two bedrooms and how many bathrooms they each have," you probably have an excellent handle on value.

While you are researching value, it also is important to become familiar with rental rates in your market area. Working with an agent, you'll be able to see what current properties rent for, but this is only part of the picture because all of those rents are based on units that have rented at some time in the past. You also will want to find out what owners are asking for units currently on the market.

Keep in mind that many small-property owners don't do a very good job of keeping up on rental rates. In fact, it's not unusual for some owners to rent a vacancy at the last rate they were getting without verifying the true current market rate. Your goal will be to discover what the trend is. Are rental rates in the area going up or down over a period of time? Is the area stable, improving, or declining?

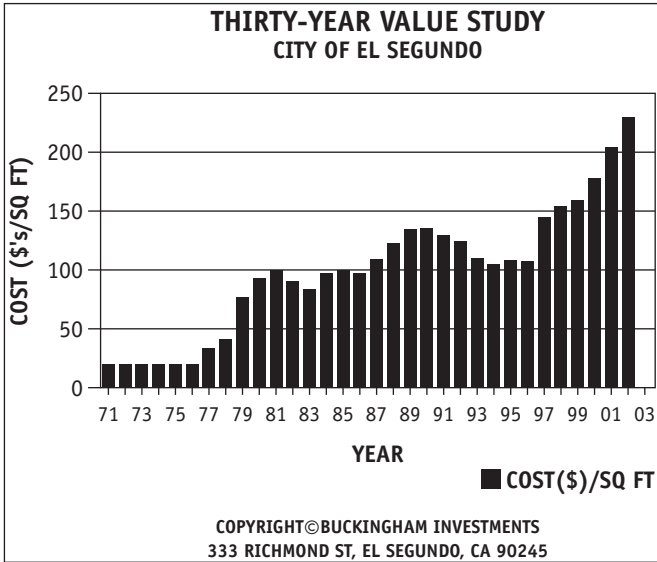
Once you have a current understanding of property values, you'll want to research the historical value in your area. Again, the help of a good real estate agent will be invaluable because most have access to this information through their local Board

of Realtors. If you can find an agent who specializes in investment property, he may have the data you want readily available for the asking.

You will want to look for the same information about properties in the past as you got for the properties on the market today. Information about rental rates also will be helpful because you want to see the trends for increase over the years. The further back you can get information, the better. You then will be able to see how trends in real estate values in your area compare to the trends in our economy in general.

The accompanying chart shows the historical trends of real estate values in the city of El Segundo, California. This chart uses a mathematical calculation called linear regression analysis to determine the change in the values from the first year to the last. This is the kind of historical data that would be helpful for your own market. At the very least, the most important facts you want are the trends in values for as many years as you can get. Knowing this percentage increase is important when doing forward projections for an investment plan. Although past history is no guarantee of the future, it often is a prologue and therefore is a better way to make an estimate than picking one out of thin air. In Chapter 6, "Real Estate, the Economy, and Your Target Market," we'll illustrate a specific technique that you can use to estimate value appreciation for yourself.

Once you have a handle on the present and the past, it's time to start worrying about the future. This is when you have to go back to school for a review of some basic economic principals. When doing this kind of study, you will learn that lots of outside factors can impact your real estate business. Therefore, in order to protect your bottom line, you will have to have the skill necessary to recognize changes in the economy that can affect you both positively and negatively.



You should be reading the business section of the paper with a new perspective. Finding out about future business expansion, for example, will mean that there will be more people to rent your units. Likewise, a new shopping mall in your area should bring both more revenue to the city and more employees who need a place to live close to work. Increased inflation means higher prices for goods and services and, best of all, higher rents for you.

In addition to the newspaper, you also should look for other publications that will give you insight into changes in your local economy. Most chambers of commerce have information about what is happening in the local economy. Some banks and savings and loans have research departments that compile this kind of information. Finally, most cities have departments designed for the sole purpose of attracting new businesses. These city departments can be a good source of information about the existing state of your local economy and what they project for the future.

Remember, the goal of all this research is to keep you tuned in to what's going on out there. This way, you can take advantage of any positive changes in the economy and can make provisions to protect your investments if you see that negative changes are on the way.

Planning how to invest your money

Now that you have accumulated the knowledge to invest and you understand the product, it is time to put a plan together. The foundation of the plan will be your goals. For many years, we have observed investors and—with very few exceptions—the most successful all had very well-defined goals. There is nothing unique about this observation. Hundreds, if not thousands, of authors, scholars, teachers, and so on have, over the centuries, touted the need for goal orientation as a key to success. It's amazing how many of us have a job that requires us to make plans at work for our performance and the performance of the department we head up, but we don't ever do the same for our own lives. Until now, most of us have really been missing the boat.

Chapter 9, "Building an Investment Plan," will teach you how to put your investment plan together. Nonetheless, it is important at this point to start thinking about some specific things you want to accomplish through investing in real estate. It's not enough just to say that you want to find some "good deals," or that you want to get rich. These concepts don't have anything personal to hang on to. Instead, getting specific is the key. A new house overlooking the park in five years or \$75,000 set aside for Sydney and Mara's college education are specific goals that have meaning.



Moneysaver

By properly defining your goals, you will avoid paying extra for a property to satisfy an unfounded emotional need. We always say to buy the ugly property for less; spruce it up with flowers, paint, and awnings; and then manage it into profitability.

Finally, have you ever heard an interview with someone who just won the lottery? The reporter invariably asks, “What are you going to do with the money?” The answer usually is a list of things like a new house, a car, trips, and doing something nice for a relative or friend. It’s not the money; it’s what you can do with the money that keeps people buying the tickets. The right set of personal goals will give you the incentive to work your new business, and in a few years, you’ll have the payoffs just like you’d won the lottery yourself.

Investing your funds according to your plan

The last step in our plan is where you make your move. This is when you get to put that knowledge and research to work by investing and buying a piece of rental property. Know that this is where the real work starts because it’s not just a mental game now—it’s the real McCoy.

When you’ve finally decided that it’s time to buy something, this can be as exciting as your first kiss, and as scary. At this

“It was tough to make the decision to buy that first property. My agent, Eve, suggested that we start with just half the capital we planned to start with. This cushion gave us the courage to make the move on that first one.”

—Victoria P., investor

point, take a deep breath and review all you’ve learned and researched. The first investment will be a big step, but you should have a higher level of confidence than most. You have educated yourself about investing, you are knowledgeable about your target market, you have a plan that lays out what you are trying to accomplish, and you know

the kind of property you need to get started. As they used to say in the Old West, “Just go ahead and pull the trigger!”

Though you’ll surely be excited at this point, you must also be prudent. To that end, we don’t recommend trying to hit a

home run on your first purchase. Many beginning investors make a colossal mistake in the beginning by seeking out bank-owned repossessions or fixer-uppers right out of the gate because they have heard how much money they can make by doing so. Money can be made, but it takes the experience of many years in the business to find success that way. On the other hand, a mistake in buying one of those kinds of buildings from the onset could sour you on real estate investing long before you ever get out of the starting gate. Instead, we recommend that you use your first purchase to apply the sound business skills you are learning here.

By starting smart, you will help ensure your success.

Managing your investment to meet your plan's goals

Once you are trained, the good news is that you will own the property and you can do as much or as little of the work as you like. You are in charge of the building, the rents, and the tenants. Of course, you can subcontract the management of your property if you so choose. This can be very tempting, especially because the cost of management usually is just a small percent of the gross income collected. We strongly recommend, however, that you don't hire out management on your first few properties. It's important to experience firsthand the duties of running a property yourself. You need to put the knowledge you have learned to the test to see how the real world works.

This hands-on experience will also be invaluable to you later, when you do turn your properties over to a management company. At that point, your job will be to manage the management company. To do this effectively, you need to have had the actual experience doing the job yourself. It's one thing to read about something in a book; it's another thing to actually have gotten your hands dirty down in the trenches.

You'll find that if you are doing your job right as the manager, you'll be constantly revisiting the first four steps of the

systematic approach we're laying out here. As you manage, you learn—not from books this time, but from the actual doing of the job. Running a property is really an on-the-job research project. You'll become quite an expert as you handle the day-to-day operations of your property.

Along the way you'll take the time to assess the current market and compare your position with the goals of your plan. At some point you will make the decision as head of this company that it's time to trade up or refinance. Either way, you may realize that the time is ripe to acquire more property and you are going to use your prior properties to help you do it. When this happens, it's back to step 4 all over again as you'll have a new building to manage. The party is just getting started!

Just the facts

- Real estate ownership has three phases of profits—short term profits, middle-years payoffs, and retirement rewards.
- One of the greatest advantages of real estate is the fact that it is a business you can start while you keep your regular job.
- As your property equities grow, you can use them to finance luxuries you never thought you could afford.
- Don't swing for the fences on your first purchase; make it a learning experience.

PART II

The Secrets of Real Estate Investing

GET THE SCOOP ON...

Determining cash flow ■ Loan reduction and how it adds up ■ Why value appreciation is the real money maker ■ The tax benefits of real estate ownership

Elements of Return

With an investment in real estate, four elements of return will help you reach your goals. These elements are cash flow, equity growth from loan reduction, equity growth from appreciation, and tax benefits. In this chapter, you will learn about each of these elements of return individually, and how to calculate the combined effect of all four to give you an estimated overall return on your investment.

Learning how to do this properly will tell you two things. First, it will show you what kind of profit you can achieve on any potential investment. Once you are able to do an apples-to-apples comparison and have a benchmark on which to consider potential purchases, your decision on which property to actually buy should become easy. Second, by knowing how to calculate return yourself, you can make sure your percentage return always stays high enough to ensure that you reach your investment goals on schedule.

Chapter 3

**Watch Out!**

Remember that the four elements of return don't arrive at the same time. As a result, many investors fail to pay close enough attention to all of them and end up missing out on earning the highest possible return on their equity.

333 Richmond Street

To help us demonstrate each element of return, we will use an example property that we will come back to time and again. We'll call our example "333 Richmond Street," in honor of the building that has housed our own real estate sales office for the past 30 years. For purposes of this book, the Richmond Street property is a 20-year old, four-unit apartment building that is listed for sale at \$225,000. The building is in good condition and it has a unit mix that consists of four two-bedroom/one-bath apartments. The units bring in \$550 per month, and the expenses on the building are calculated at 30 percent of the gross income. These details of the example lay out as follows:

Address: 333 Richmond Street, El Segundo, California

Asking price: \$225,000

Number of units: 4

Unit mix: 4 units at 2 bedrooms/1 bathroom each

Income: \$550 per unit = \$2,200 per month = \$26,400 per year

Expenses: 30 percent of gross income = \$7,920 per year

Square footage: 3,200 square feet

Lot size: 50 × 150 feet

Age: 20 years old

Features:

- Newer carpets and drapes
- Built-in stoves
- Natural stone fireplaces
- Four garages

Cash flow

The first of the four elements of return is cash flow. Simply put, cash flow is the money left over after you pay the bills. To determine cash flow on any property, you need to know three key pieces of information:

1. The annual gross income
2. The annual expenses
3. The total debt payment on your loans

We will use the example property at 333 Richmond Street to illustrate. Let's say we negotiated the asking price of \$225,000 down to a purchase price of \$220,000. Our down payment was \$30,000, and we financed the remaining \$190,000 at a 9 percent interest rate. This gave us a monthly loan payment of \$1,450 and an annual debt payment of \$17,400 ($\$1,450 \times 12 = \$17,400$). We have four units that rent for \$550 each. This gives us an annual income of \$26,400 ($\$550 \times 4 \times 12 = \$26,400$). Finally, remember that our annual expenses are \$7,920 (30 percent of the gross income). Knowing all this, we can compute our annual cash flow by subtracting the annual operating expenses and annual loan payments from the gross annual income, as follows:

Gross annual income	\$26,400
Less annual operating expenses	-\$7,920
Less annual loan payments	-\$17,400
<hr/>	
Annual cash flow	\$1,080



Watch Out!

Many investors think cash flow is the ticket to getting rich. In reality, a high cash flow at the onset of property ownership, more often than not, indicates that the investor isn't taking advantage of as much leverage as he could.



Bright Idea

Don't buy into the mistaken belief that a big cash flow is the most important element of return. While you're young and still able to work, it might be wiser to structure your deals so they will produce a large cash flow only after you retire. That way, you will have cash available when you truly need it.

After we know the cash flow, we then can use it to determine the percentage return on the investment. This is achieved by dividing the cash flow by the down payment, as follows:

$$\frac{\text{Annual cash flow: } \$1,080}{\text{Down payment: } \$30,000} = 4\% \text{ return}$$

As you can see, this is a fairly simple process; however, in the real world of buying a property, making sure the components of this calculation are correct often creates confusion. The first thing to decipher is how much money a building really brings in.

The annual gross income

There are three ways to look at the income stream of a building. The first way is by examining the scheduled rent. The scheduled rent is the total of all the agreed-upon-rents in the building, assuming that all the tenants are paying and that there are no vacancies.

The second way to look at the income is by analyzing potential rent. Potential rent is the income you feel you could earn based on the rents other property owners are receiving in your market area. Alternatively, potential rents are those you feel you could earn provided that your building had more attractive amenities, and you could charge more than the competition.

The third way to analyze the income of a building is by evaluating the collected rent. The collected rent is the actual amount of money the current owner took in over a given period of time. It reflects the market, but more than that, it reflects the current owner's ability to manage in that market. You may do



Moneysaver

Make sure you get into the habit of inquiring about available units in your area. By knowing what the competition is charging for rent, you can avoid underestimating the market when it comes time to market your own vacancies.

better, or you may do worse. Collected rent is impacted by the vacancy factor and credit losses incurred from tenants who did not pay.

The annual expenses

The second thing you must do in order to calculate a building's cash flow is to determine the building's true expenses. As the owner of residential income property, you will encounter the following three types of expenses:

1. Fixed expenses
2. Variable expenses
3. Planned capital expenses

Fixed expenses are the regular recurring costs encountered in holding a property. These expenses include items such as property taxes, insurance, and city business-license fees. They are called *fixed expenses* because the amount you pay does not fluctuate, or if it does, it usually is only a nominal change one time per year.

Variable expenses do fluctuate. They are all the other costs you might incur while managing your rental property. The biggest variable expenses you will encounter will be utility payments, necessary repairs, general maintenance, and vacancies in your building.

Planned capital expenses are major items that have a useful life of more than one year. These are items such as a new roof or exterior paint. According to the IRS, these expenses must be capitalized for tax purposes. This means you must write the expense off over a period of years. To account for these types of

expenses in your cash flow, you need to include a reserve of a certain percentage of the income based on the condition of the property. We will cover this in greater detail in Chapter 14, “Managing the Expenses.”

The management of all these expenses will play a major role in how much cash flow your property produces. Reviewing the former owner’s records before you buy can give you insight into how the property might perform, but this information also can be misleading. The seller might be a great manager who has been able to keep expenses under control, or he might be an awful manager who can’t control a thing. Therefore, it is important for you to do your homework on the types and cost of normal expenses for your area. Your ability as property manager to use the information you gain from your research will determine whether or not your property outperforms that of your competition.

The debt payment on your loans

The final component of the cash flow equation is the payment on your loan or loans. Recognize that there is always a direct correlation between the amount of your down payment (your *equity*) and your cash flow. It stands to reason that if you pay for a property without getting any loans at all, your cash flow will naturally be significantly larger than if you have loan payment obligations. Conversely, if you buy property with leverage (by means of a loan), your cash flow will be much less, but your percentage return will be much higher.



Watch Out!

You cannot build an investment plan for your area based on expectations from other areas of the country. Your own market will dictate the amount of cash flow you can expect based on typical down payment amounts and financing.

Equity growth from loan reduction

The second way your equity will grow is through loan reduction. When you first close escrow on a piece of property, your initial equity is your down payment. Know that this equity will change over the years as you make monthly payments on your mortgage. The principal portion of your payment decreases your loan balance, which increases your equity. At first, the lion's share of your mortgage payments will go toward paying off interest, but don't fret. As the years go by, principal reduction accelerates considerably and becomes a significant cause of equity growth.

For the purposes of the following calculation, assume that the loan payoff is a constant amount. Note that you will be able to get the exact payoff at the end of each year when your lender sends you the 1099 form that you use to file your tax return. Recall that on the Richmond Street example, we put \$30,000 down and financed the balance of the purchase. Our loan on the property was for \$190,000, payable at \$1,450 per month. That payment included principal reduction and interest at 9 percent per year. The total payments on the loan for the year are \$17,400 ($12 \times \$1,450 = \$17,400$). Roughly speaking, the interest paid to the bank would be 9 percent of \$190,000, or \$17,100 ($.09 \times \$190,000 = \$17,100$). The calculation looks like this:

Total loan payments:	\$17,400
Less interest paid:	-\$17,100
Principal reduction:	\$300



Bright Idea

As your cash flow improves, you might choose to pay off some extra principal each month on your mortgage. This way, you will get your loan paid off early, and you will have that much more cash flow available for retirement.



Watch Out!

A common mistake many investors make is to calculate their return after many years of ownership by using the original down payment in the calculation. You must remember that, with a pay-down on your loans, your true equity will be much larger than your original down payment.

As you can see, the difference between the \$17,400 loan payment and the \$17,100 interest is \$300. This \$300 is the approximate principal reduction the first year. To find out your percentage return on your investment due solely to reduction of the principal balance of your loan, divide that reduction by your down payment as follows:

$$\frac{\text{Principal reduction: } \$300}{\text{Down payment: } \$30,000} = 1\% \text{ return}$$

Don't let this modest 1 percent return the first year scare you. As mentioned previously, principal begins to pay off at a much faster clip in future years of ownership, and your percentage return dramatically increases.

Equity growth from appreciation

The third, and most significant, way you are going to earn money in real estate is through value appreciation. Value appreciation results from two factors:

1. Inflation
2. Demand

Inflationary appreciation

Inflationary appreciation sounds just like what it is—the increase in a property's value due to inflation. This is the same phenomenon you see in supermarket prices. Even when the number of items you purchase at the store stays the same, the prices nonetheless continue to go up every year. This appreciation rate is related to the general inflationary rate of our overall

economy. When the country's inflation rate is up, the appreciation rate of property is usually also up.

Two components make up the value of any piece of property: the structure itself and the land. Although land never wears out, structures do. Inflation affects the cost of both of these items, but this component of appreciation can be stagnant when it comes to the structure. This is because the structure is deteriorating (as 2×4s do over time) at the same time the property as a whole may be appreciating. A number of factors combine to give a structure a limited useful life. They include

1. Wear and tear from usage
2. Wear and tear from the elements
3. Changes in building advances

The factor that makes the biggest difference in inflationary appreciation is the value of the land itself. Except in rare cases, usually caused by toxic waste problems, land increases in value over time. Therefore, the value of the land as compared to the value of the structure itself has a great impact on the increase in value from inflation. This is called the land-to-improvement ratio.

The land-to-improvement ratio can shift dramatically depending on what area of the country or what area of a city you are in. In many metropolitan areas, for example, the land value can be as much as 90 percent of the value of the entire property. In smaller, more rural areas, these numbers can be entirely reversed: The structure might represent 90 percent of the value and the land a mere 10 percent.

To see how this can affect the increase in value, we will look at the example of 333 Richmond Street as if it were in both areas. We will assume that the inflation rate is 3 percent and that there is no inflation increase for the structure because of the offsetting depreciation.

In the smaller community, let's say the value of the land is \$22,000 ($\$220,000$ purchase price \times 10 percent land value = \$22,000). This gives us a return from inflation on the land of

\$660 ($\$22,000 \times 3$ percent inflation rate = \$660). In the metropolitan area, we'll assume the value of the land is \$198,000 ($\$220,000$ purchase price \times 90 percent land value = \$198,000). This puts the inflation return at \$5,940 ($\$198,000 \times 3$ percent inflation rate = \$5,940). Again, because we put down \$30,000 to purchase the property, we can illustrate the appreciation return from inflation as follows:

	Small Areas	Metropolitan Areas
Appreciation	\$660	\$5,940
Down payment	\$30,000	\$30,000
Return	2.2%	19.8%

Demand appreciation

Demand is the second reason your property will make you money because of value appreciation. Demand appreciation is related to four different economic principles. They are

- Scarcity
- Transferability
- Utility
- Demand

The combined effect of these four economic components pushes property values up at a greater rate in some areas while pushing values down in others. Let's look at each component one at a time.



Moneysaver

Densely populated metropolitan areas usually have the greatest appreciation from demand. This is due to the lack of land available for new construction.

The *scarcity principle* can best be seen when comparing a metropolitan area to a rural one. In the metropolitan area, there is very little undeveloped land available. In many cases, an existing older structure must first be demolished before a new building can be constructed. Therefore, developers first have to find someone willing to sell. When they do, they'll be paying for both the land and the structure that sits on it. Naturally, this increases the cost of any property under those circumstances. Rural areas, on the other hand, tend to have large amounts of vacant land. This greater availability of land makes it a lot easier to find willing sellers and lower prices.

Transferability refers to the ease of buying and selling a commodity. As you know, investment vehicles such as stocks and bonds are fairly liquid; that is, you can transfer them from one owner to another pretty quickly. Real estate, on the other hand, can't be transferred as fast. This fact usually is related to the number of potential buyers and the ability—or lack thereof—to find adequate financing. There might be many buyers and hundreds of lenders for the duplex you are trying to sell, but how many buyers and lenders might there be for the purchase of the Empire State Building? Not too many.

Utility refers to the usability of the property. The value of a property is directly related to its highest and best use. A commercial lot close to a railroad-loading yard, for example, could be a valuable location for a manufacturing plant. Rule of thumb: The greater the utility value, the greater the value of the property.

Demand is the last economic principle that drives prices. Demand correlates to the upward desirability of the property. This is the same phenomenon that affects the price of tickets to major sporting events, music concerts, or top Broadway shows. Think about the scalpers that roam the parking lots of these events. The reason they are able to get top dollar for their tickets

is because the demand for the product is so great. For example, scalped tickets to see a long-running Broadway show or the seventh game of the NBA Finals would certainly be pretty pricey. If scalpers were selling tickets to see a high-school production of *Grease*, however, the tickets wouldn't cost nearly as much.

Demand can increase or decrease due to general trends in the economy. Many investors move from one investment vehicle to another based on the investment's ability to produce a profit. When stocks are hot, their money is there. When bond yields go up, they sell the stocks for bonds. When real estate is moving, they start buying. This sends the message to small investors that it is time to buy. This increased demand for a limited supply causes the appreciation rate to increase.

We can illustrate demand appreciation with our example property. Remember that we bought 333 Richmond Street for \$220,000; we put down \$30,000, and it brings in an annual income of \$26,400. The investor purchasing this property is paying 8.33 times the gross income for the property ($\$220,000 \div \$26,400 = 8.33$)—see “The Gross Rent Multiplier” section in Chapter 4, “Appraising Like an Appraiser.” Let's say the demand for the property increases. If so, and investors will now pay 9 times the gross income, the value would now be \$237,600 ($\$26,400 \times 9 = \$237,600$). Note that this is a \$17,600 increase in the value of the property with no increase in rental income whatsoever ($\$237,600 - \$220,000 = \$17,600$).

There is another way that demand can affect the value of your property. You see, investment real estate prices are directly related to the net income the property produces. An increased income stream should produce an increased value, even in a



Bright Idea

Most local newspapers publish statistics about increases in property prices in the Consumer Price Index. Make sure you check these statistics often because they are a good indicator of appreciation.



Watch Out!

Each component of return can vary greatly by geographical area. One location might offer a high cash flow but a lower return from value appreciation. Another might offer good appreciation but minimal tax benefits. Furthermore, these components can vary not only from state to state but from neighborhood to neighborhood.

market where there is no increase in demand from investors. In this case, the demand would come from the tenants' willingness to pay more rent for your property. This usually happens because of an increased number of tenants in an area with a limited supply of places to rent.

Here's how an increased income affects the Richmond Street example. Let's say we raised the rents from \$550 a unit to \$600 a unit, and therefore increased the gross income from \$26,400 to \$28,800 a year. If investors were still willing to pay 8.33 times the annual income of the property, Richmond would now be worth \$239,904 ($\$28,800 \times 8.33 = \$239,904$). This is an increase in value of \$19,904 ($\$239,904 - \$220,000 = \$19,904$).

Now that you understand the impact of both inflation and demand, we will do a value appreciation illustration with the example property. Let's assume that the 333 Richmond Street fourplex appreciates at a total of 5 percent per year from all the components that affect value. This means an additional \$11,000 in profit the first year from appreciation ($\$220,000 \times .05 = \$11,000$). Remember, we put down \$30,000 to purchase the property, so we can compute the appreciation return as follows:

$$\frac{\text{Appreciation} \quad \$11,000}{\text{Down payment} \quad \$30,000} = 36.6\% \text{ return}$$

As you can see, 333 Richmond Street earned a return of 36.6 percent the first year, due to value appreciation alone. Not too bad considering the appreciation rate used for this example was only a modest 5 percent.

Tax shelter benefits

The final return on your investment from real estate is tax shelter benefits. These are the paper losses you can deduct from the taxable income you receive from the property.

As the owner of an investment property, the IRS gives you an annual depreciation allowance to deduct against your income. The theory is that this deduction will be saved up and will be used to replace the structure at the end of its useful life. This is a necessary deduction in most businesses because equipment wears out quickly. Because most property owners rarely keep their buildings long enough for them to wear out, however, the tax savings from the deduction are a profit you can keep.

Determining depreciation via your tax bill

There are a couple of methods you can use to determine your annual depreciation allowance. The first is to use your property tax bill as your guide. This bill is broken down into two components:

1. The assessed value of the improvements (the structures on the land)
2. The total assessed value of the entire property

Don't be alarmed if the actual dollar amount shown on the tax bill does not agree with what you are paying for the property; it is the ratio we are looking for. You will use these numbers to get the percentage you need to determine the value of the improvements. To do this, use the following calculation:

$$\frac{\text{Assessed improvement value}}{\text{Total assessed value}} = \% \text{ value of improvements}$$



Watch Out!

Be sure to do your homework on your depreciation. As your income increases, you will need the write-off.

The percentage you get from this calculation will be used to determine the amount of improvements as follows:

$$\% \text{ value of improvements} \times \text{price} = \text{depreciable improvements}$$

The good news is that the IRS rarely challenges this method of determining depreciation because if they did, they would be challenging the county tax assessor (another government entity), which probably wouldn't bode too well. The bad news, however, is that the ratio from your tax bill is not always accurate. If this were the case, your deduction could be unfairly limited. Thankfully, the IRS also allows alternate methods of determining your depreciation allowance.

Determining depreciation via your appraisal

A second way to determine the percentage of depreciable improvements is to use the appraisal that was done when you purchased your property. In the section of the appraisal that covers the reproduction cost method, you should find the appraiser's opinion of value for both the land (the dirt) and the improvements (the structures). The appraiser will estimate the cost to build the improvements as of the date of the appraisal. This is called the *reproduction cost*. An allowance is then made for any depreciation, and the remainder is the appraiser's value of the improvements. Assuming the appraiser is licensed or otherwise qualified in your state, this should be a good estimate to use. Just use the same formula as follows:

$$\frac{\text{Estimated value of improvements}}{\text{Appraised value}} = \% \text{ value of improvements}$$

Like before, the percentage you get from this calculation will be used to determine the amount of depreciable improvements. To do this, use the same calculation:

$$\% \text{ value of improvements} \times \text{price} = \text{depreciable improvements}$$

Note that the depreciation schedule you pick when you put your real estate investment "in service" stays with you until you



Moneysaver

When you get a loan from a lender, make sure you get a written copy of the appraisal. You will need it when it comes time to calculate your annual depreciation allowance.

have used up the entire write-off. Therefore, it pays to find an acceptable method that gives you the best deduction. Thankfully, you don't have to establish your depreciation schedule until you file your tax return. There is usually enough time, therefore, between the closing and the filing deadline for you to determine which method to use. Regardless, you should discuss all the alternatives at your disposal with your accountant or tax professional.

Modified Accelerated Cost Recovery System

The second step in determining your percentage return from tax benefits involves utilizing a tax-code change from 1986. At that time, the IRS established the Modified Accelerated Cost Recovery System (MACRS). This code established the recovery period, or useful life, of assets to be depreciated. Like much of the tax code, these periods usually bear no relationship to reality with regard to the useful life of an asset. In the case of improved property (land with structures on it), there are two classes and two recovery periods to know about:

Type of Property	Recovery Period (Useful Life)
Residential	27.5 years
Nonresidential	39 years

When using the MACRS method, remember that it does not matter what the true age of your property is. For residential, you use 27.5 years. For nonresidential, you use 39 years.

To arrive at the annual expense, you simply divide the value of the depreciable improvements by the recovery period, and this gives you the deduction as follows:

$$\frac{\text{Value of depreciable improvements}}{\text{Recovery period (useful life)}} = \text{Annual depreciation allowance}$$

Now let's take a look at the calculation using the Richmond Street example. Remember that this is a two-step process. First find the value of the improvements and then divide by the correct recovery period. In this example, we are paying \$220,000 for the Richmond Street property and have decided to use the tax bill to do the calculation. The tax bill shows the land assessed at \$20,000, the improvements assessed at \$35,000, and the total assessed value of the property at \$55,000. We then would calculate the depreciation allowance as follows:

$$\frac{\$35,000 \text{ (improvements)}}{\$55,000 \text{ (total assessed value)}} = 63.6\% \text{ improvements}$$

$$\$220,000 \text{ price} \times .63.6\% \text{ improvements} = \$139,920 \text{ depreciable improvements}$$

In order to make things simple, we'll round up the depreciable improvements to an even \$140,000. Therefore, we can determine our annual depreciation allowance as follows:

$$\frac{\$140,000 \text{ (depreciable improvements)}}{27.5 \text{ (years)}} = \$5,090 \text{ annual depreciation allowance}$$

Now that we know how much of a depreciation allowance we can get, let's go back to our example to determine our overall



Bright Idea

Many inexpensive software programs will allow you to keep accurate records and file your tax returns electronically. If you can use one of these systems, it could save you a lot of aggravation come tax time.

tax shelter savings. We will assume that you are an active investor and that you are in the 28 percent federal tax bracket. To calculate tax savings, we first need to shelter the taxable profit from our property. As you will recall, we have a taxable cash flow of \$1,080 and a taxable equity growth from loan reduction of \$300 per year. We calculate the carryover loss as follows:

Depreciation allowance	\$5,090
Less cash flow	-\$1,080
Less equity growth	-\$300
<hr/>	
Tax benefit	\$3,710

The tax savings is calculated by multiplying the tax bracket by the shelter benefit as follows:

$$.28 \times \$3,710 = \$1,039 \text{ tax savings}$$

Many states have a state income tax. Their rules usually are similar to the federal rules when it comes to deductions and depreciation. If you live in a state with a tax, you will receive additional savings, and you can use this same formula to estimate them.

Calculating the return

Congratulations, you've made it this far through a tough, but critical chapter in your education. Now, let's look at our total first year return on our investment combining all four elements of return. To recap, we have a cash flow of \$1,080, equity growth from loan reduction of \$300, equity growth from appreciation of \$11,000, and tax savings benefits of \$1,039. Our total tax-deferred return on investment is

Cash flow return	\$1,080
Equity growth (loan reduction)	\$300
Equity growth (appreciation)	\$11,000
Tax savings	+\$1,039
<hr/>	
Total return on investment	\$13,419

We can then compute the total percentage return on the investment by dividing the first year return by the down payment as follows:

$$\frac{\text{Total return: } \$13,419}{\text{Down payment: } \$30,000} = 44.7\% \text{ return}$$

At 44.7 percent for the first year, we're off to a pretty good start with the Richmond Street fourplex. A good growth-oriented strategy might be to keep the building running well until our return drops below, say, 20 or 25 percent. At that time, we could refinance and start earning a higher percentage return again. Or, if the building was giving us problems for one reason or another, we could sell and trade up via an IRS 1031 exchange (see Chapter 10, "Planning for the Tax Man").

Use the accompanying Property Analysis Work Sheet to calculate the components of return on any property you are considering. All you need is a forefinger and a calculator. If math gives you a headache, though, there are many computer-generated systems for calculating return that will be just as easy. One example is Turbo Tax, which does a great job with depreciation. Some are proprietary systems written by the firms that own them, and many are just modified spreadsheet systems. If you have access to one of these systems, it will save time, but having an automated system is not necessary.

PROPERTY ANALYSIS WORK SHEET

Address: _____

1. Value of Property _____
2. Loans on Property _____
3. Equity in Property _____
4. Gross Income _____ Mo. \times 12 = _____
5. Expenses _____ Mo. \times 12 = _____
6. Loan Payments _____ Mo. \times 12 = _____
7. Interest (_____ Loan Amt. \times _____ %) = _____
8. Loan Payoff (Line 6 - Line 7) = _____
9. Cash Flow (Line 4 - Line 5 - Line 6) = _____
10. Depreciation Deduction _____
11. Tax Shelter (Line 10 - Line 9 - Line 8) = _____
12. Tax Savings (Tax Bracket _____ % \times Line 11) = _____
13. Building Profit (Line 8 + Line 9 + Line 12) = _____
14. Basic Return (Line 13 \div Line 3) = _____ %

RETURN ON EQUITY

15. Cash Flow (Line 9) _____
16. Loan Payoff (Line 8) = _____
17. Tax Savings (Line 12) = _____
18. Appreciation _____ % \times Line 1 _____
19. Total Investment (Lines 15 + 16 + 17 + 18) _____
20. Return on Equity (Line 19 \div Line 3) = _____ %

Just the facts

- Cash flow is calculated by deducting the mortgage payments and other operating expenses from the rent you collect.
- A key element of return is the reduction in your loan balance paid from rental income.
- Your property might increase in value just because of the effect of inflation.
- An increase in demand from investors to buy properties in your area can increase the value of your building.
- The Modified Accelerated Cost Recovery System allows you to write-off a residential property in 27.5 years and a nonresidential property in 39 years.

GET THE SCOOP ON...

Determining fair market value ■ Doing a comparative market analysis ■ Capitalization rates ■ How to use the gross rent multiplier ■ The concept of “highest and best use”

Appraising Like an Appraiser

For people just getting started in investing, picking that first property can be a nerve-racking experience. Of course, the goal is to make your decision based purely on financial parameters, but that becomes pretty hard to do, especially on the first purchase. Usually, your emotions will kick into gear and try to dictate what you should buy. Many first-time investors indignantly declare, “I’m not going to buy anything that I wouldn’t live in myself.” If you recognize yourself in this statement, however, know that your emotions have taken over and you’re on the verge of investing with your heart rather than your head. What’s worse is that you may be leaving some good opportunities behind for the next guy to discover.

Don’t fret; it’s easy to figure out why emotions come into play—you’re scared of losing your money. In fact, fear of losing money is as much a motivator (if not radically more so) as is the promise of gain from investing it. To illustrate, let’s say you were

invited to a meeting at 10 p.m. tonight to learn about an opportunity that could make you \$1,000 on a \$10,000 investment. After a bit of thought, you might decide to spend that hour watching TV instead. If you got a call, though, and were told you would lose \$1,000 if you didn't go to that 10 p.m. meeting, what do you think you'd do? Exactly.

There is no shame in being a little scared. Buying a piece of property is a big deal. In fact, the purchase of an investment property will probably be the largest dollar investment you make in your lifetime. For this reason alone, you have a right to be nervous. But it doesn't have to be that way.

When investing in anything, there are concrete steps you can take to minimize risk. The first, and most prudent way to quiet your mind, is to thoroughly educate yourself about the commodity in which you are investing. In this chapter, your education continues with a lesson on appraising value. Here we will teach you how to appraise like an appraiser. The goal is to make you completely self-sufficient when it comes to valuing real estate. In fact, the fear of ever paying too much for a property should soon become a nonissue.

Methods of valuing property

From an investment standpoint, the two most important aspects of property are its value as an asset and its return on your invested capital. Your goal is to invest your money and obtain an annual return on that invested capital until you sell or otherwise dispose of the property. Naturally, at the time of sale, you will



Moneysaver

If you are in the market for a property with an investment of \$30,000 down, don't consider buying that "great deal" you just found that requires \$50,000 down. Even if you have the money, stick to your game plan and you will sleep better at night.

expect to recover your original investment as well as some equity growth and appreciation. Learning how to buy at “fair market value” will ensure that you will be able to recover your original investment along with the other profit you expect.

Unfortunately, unlike buying a used car, there is no Blue Book for establishing the value of used property. In addition, individual properties always have unique components that can affect their value. The question then becomes, how do you as an investor determine what is fair market value for a used piece of real estate? It’s tricky, but doable. Let’s begin by looking at the definition of fair market value itself:

Fair market value: The price a willing buyer will pay a willing seller for a property that has been on the market for a reasonable period of time.

As you can see, there are a number of variables to this equation, two of which are completely subjective in that they have to do with the motivation level of the buyer and the seller. The truth is that it is nearly impossible for you or even a professional appraiser to look at the information on a closed escrow and know the motivation of the principal parties. At best, you can get a feeling for the market from looking at the trends you see from comparable sales that have recently closed.

Like many things in life, appraising can be described as more of an art than a science. Nonetheless, whether you are a professional appraiser or a novice real estate investor, there are a number of acceptable appraisal techniques that you can learn for establishing value estimates. The three commonly accepted appraisal methods are

1. Comparative market analysis
2. Reproduction cost approach
3. Capitalization of income approach

Let’s review each of these appraisal techniques one at a time and see if we can get our arms around this subject.

**Bright Idea**

Your real estate agent is a great source of information about the seller. Pick her brain to find out the seller's motivation for selling. Once you know what it is, you might just be able to offer exactly what the seller is looking for.

Comparative market analysis approach

Comparative market analysis is the easiest method for the average investor to use when estimating value. In essence, it is the same technique most of us use when making any big purchase. Simply put, before you make a deal on, say, a car or some new furniture, you should check with several other vendors to get an idea of what they each are charging for the same item. The same premise holds true here. When doing a comparative market analysis for real estate, you need to compare and contrast the major features that affect the value of property between the subject building and some comparables. The major features to consider are

- Price of the most recent sale
- Date of the most recent sale
- Square footage of living area
- Number of units
- Mix of bedrooms and bathrooms in each unit
- Lot size
- Age of building
- Income-producing capability (current rents vs. market rents)
- Overall condition of building and lot
- Expense factors (master-metered utilities vs. tenant pays)
- Parking (garages vs. carport, or none)
- Extras (views, fireplaces, multiple baths, patios, or decks)
- Proximity to subject property



Watch Out!

Comparative analysis can be tricky in areas such as beachfront communities, resorts, or high population areas. In these areas, the properties are not usually “like properties.” This will throw off sales prices and make the accuracy of your analysis suspect.

The goal is to find recent sales in the same, or a similar, neighborhood in which these features are as close to being the same as possible. Because time has an effect on value, the sales should be within the last six months or so, with the greatest weight given to the most current sales. This method of appraisal is not difficult and, with a little practice, can be used by anyone.

We will show you an illustration of the comparative analysis method using our example property at 333 Richmond Street. Remember that this property is a 20-year-old, four-unit apartment building. It is on a 50×150 lot. The units are unfurnished and in good condition with new carpets and drapes. They all have built-in appliances and even have fireplaces. The neighborhood is good in terms of the condition of all the surrounding properties and their maintenance. The current owner is asking \$225,000 for this property. After checking with local brokers and appraisers, you have been able to locate three sales that appear to be comparable to this property.

- **Property A:** This property is identical with respect to the building and looks like it might even have been built by the same contractor. However, it is on a larger lot, 75×150 , with nicer landscaping. This property sold two months ago for \$270,000.
- **Property B:** This property does not have the same floor plan, but it is the same age, size, and condition as your property. The units lack fireplaces, and they have open parking instead of garages. This building closed escrow three months ago for \$200,000.

- **Property C:** This property is another just like yours in every way except it sold a year ago for \$215,000. We shouldn't use this sale because it was so long ago, but it is the only other comparable property we can find.

See the chart on the next page for a recap of the facts we have on the properties.

There are enough variations that we will have to make some adjustments to come up with an estimate of value. This is when the comparative market analysis method becomes a bit more difficult to use, especially for the first-time investor. The adjustments take the experience of watching enough sales in the market area to be able to estimate the financial impact of the differences. Have heart, though; with a little practice, you will be able to do it, too.

For the purposes of comparing the subject property at 333 Richmond Street to Property A, an adjustment will have to be made in the price of Property A because it is on a much larger lot. To do the adjustment, the value of lots in the area needs to be determined. This can be achieved by contacting local builders and real estate professionals, and asking how much lots are selling for in the area. For our example, we will assume that we did that kind of investigation and discovered that 50×150 foot lots zoned for apartment buildings sell for approximately \$100,000. The lot on which Property A sits is $1\frac{1}{2}$ times larger than the lot the Richmond Street building is on. Therefore, it would have a value of $1\frac{1}{2}$ times the value of the Richmond lot, or \$150,000 ($\$100,000 \times 1\frac{1}{2} = \$150,000$). From this, we can conclude that Property A is worth \$50,000 more than the Richmond property because of the additional land. For the purposes of estimating the value of the subject property on 333 Richmond Street, we will decrease the value of Property A by \$50,000.

Item	Subject Property: 333 Richmond Street	Prop A	Prop B	Prop C
Price	\$225,000	\$270,000	\$200,000	\$215,000
Footage	Same	Same	Same	Same
Condition	Same	Same	Same	Same
Location	Same	Same	Same	Same
Lot Size	50 × 150	75 × 150	50 × 150	50 × 150
Features	Fireplace	Fireplace	None	Fireplace
Garages	4	4	None	4
Sale Date	Unsold	3 Months	2 Months	1 Year

**Watch Out!**

Investors should not blindly trust any appraisal offered by the seller as justification of value. Although such an appraisal might be accurate, smart investors should do their own homework as well.

Property B also needs to be adjusted because, unlike 333 Richmond Street, Property B doesn't have fireplaces or garages. These items can be estimated by researching the cost of these components with local builders. For our example, we have determined that the cost of installing a fireplace is \$1,000. This makes the loss in value of our four missing fireplaces \$4,000 ($\$1,000 \times 4 = \$4,000$). We have also determined that the cost of building a garage in this area is \$30 per square foot. The four missing garages would have been 600 square feet, so the total cost to build them would be \$18,000 ($\$30 \times 600 = \$18,000$). To compare the sale price of Property B to the subject property on Richmond Street, we would have to add the value of the missing items, or \$22,000 ($\$4,000$ for fireplaces + $\$18,000$ for garages = $\$22,000$).

The adjustment to Property C is tougher because a year has gone by since it sold. Appraisers do not like to use comparables that are this old because so many things can happen in that time span to affect the value of property. Because we cannot find another sale, however, we will use this one. To be able to use it, we need to know how much property has appreciated in the last year. For our example, we have determined the appreciation rate over the last year to be 5 percent. This means that Property C would have increased \$10,750 over the last year ($\$215,000 \times .05 = \$10,750$). To do our comparison, we would have to add the \$10,750 to the sale price of Property C.

Let's do a recap of the adjustments:

Item	333 Richmond Street	Prop A	Prop B	Prop C
Price	\$225,000	\$270,000	\$200,000	\$215,000
Adjust	0	\$-50,000	+\$22,000	+\$10,750
Value	?	\$220,000	\$222,000	\$225,750

The last step in doing a comparative market analysis is to make an estimate of value for the subject property. This will be based on the adjusted prices of the comparables. Appraisers usually take an average value of the comps. Therefore, if we averaged the three values of those properties, the indicated value is \$222,583 ($\$220,000 + 222,000 + 225,750 \div 3 = \$222,583$). Rounded off it would be \$222,500.

Because of its relative ease, comparative market analysis is the appraisal technique of choice for many investors. But it isn't the only method of determining value. Let's move on and learn how to do the reproduction cost approach.

Reproduction cost approach

The reproduction cost approach to appraising is the "what would it cost to build it today?" method. Basically, you establish value by pretending to buy a lot at today's value and then constructing a "used" building to match the existing building. This method requires a good knowledge of the market for land and an even better knowledge of construction and the current costs of building. Because we can't build a "used" building, we then need to depreciate it based on the fact that it is not new. This requires significant skill and experience. Nonetheless, let's give it a try.

The first step is to determine the value of the lot. To do this, you need to contact brokers and builders in the area to find out

what they are paying for similar lots. If there aren't enough lots of the exact size of the subject property, some adjustments will have to be made. You would then use the same comparative analysis method we just used. It would be easier to do, however, because you would only be making an adjustment based on the price per square foot differences.

Next you will take a survey of the building to determine the square footage of the living areas and the square footage of the garages and other utility areas. These footage costs are based on the type of construction, the size of the building, the quality of construction, and the part of the country in which the property is located. Builders or bankers might be able to give you a general idea of the cost for your local area.

For the purpose of our example, we will assume that the cost to build a standard wood frame and stucco two-story building is \$60 per square foot and that the cost to build the garages is \$30 per square foot. Now let's return to our example on Richmond Street and estimate the value using the reproduction cost method.

The first item to value will be the land. In our example, our lot is 50×150 , or 7,500 square feet. We previously determined in the comparative analysis method that the land is worth \$100,000. This works out to \$13.33 per square foot ($\$100,000 \div 7,500 = \13.33).

Now we need to determine the value of the structures on the property and all the other amenities such as landscaping, walkways, and driveways. Each of the four units in our example building is 800 square feet and includes two bedrooms, one



Bright Idea

Building cost tables should be available at your library. These tables provide the current cost per square foot for building the living areas, the garages, and all the other components you might find in a property.

bathroom, a kitchen, and a living room. There are four garages of approximately 150 square feet each. This gives us a living area of 3,200 square feet ($800 \times 4 = 3,200$) and a garage area of 600 square feet ($150 \times 4 = 600$). In addition, we have determined that the other amenities (driveway, landscaping, etc.) would cost approximately \$15,000. The following chart shows the total cost to build our building in today's market:

Item	Square Feet	Cost	Total
Building	3,200	\$60 sq. ft.	\$192,000
Garages	600	\$30 sq. ft.	\$18,000
Amenities	N/A	N/A	\$15,000
Total			\$225,000

We have a problem, though. The building and the garage are not brand new; they were built 20 years ago. Our task is to determine the amount of value that has been used up, or depreciated. For this example, we will use a method based on the estimated useful life of a property. For apartment buildings of average quality with wood frame and stucco construction, a useful life of 40 years is commonly accepted.

The Richmond Street property is already 20 years old, so using a 40-year useful life, we see that this building has lost half its useful life and, therefore, half the value of these improvements. Because the new value of the building is \$210,000 ($\$192,000$ building + $\$18,000$ garages = $\$210,000$), the remaining value of these improvements is \$105,000 ($\$210,000 \div 2 = \$105,000$) given that the property has lost half its useful life. An appraiser would call this the depreciated value of the improvements. Note that we did not take depreciation into account on the amenities because they are usually items that do not depreciate.



Watch Out!

One drawback to the cost approach is that builders' costs can vary greatly depending on the number of units produced and the individual builder's profit margin. You might have to make market comparisons of builders' costs in the same way that sellers' prices are compared.

We can now finish our estimate of value using the reproduction cost method as follows:

Cost of lot	\$100,000
Cost of amenities	\$20,000
Depreciated value of buildings	+\$105,000
<hr/>	
Total	\$225,000

Capitalization of income approach

A third accepted method of appraising value is called the capitalization of income approach. This technique sets value based on the building's profitability. This is the "what would I make on my money if I paid all cash?" appraisal method. This is probably the most difficult of the methods to use properly, but it is the preferred method when valuing income property.

The concept of a capitalization rate is well known to most of us but under a pseudonym. We recognize capitalization rates as interest rates. When you think of putting your money in a bank, the first question you ask is, "What interest rate will I get?" In truth, what you are asking for is the capitalization rate on that bank account.

Before we move on to understanding the capitalization rate in real estate, let's look at the formula for calculating the interest rate from a simple savings account and then expand it to the form we need to use for real estate appraising. Let's assume you have \$10,000 in your savings account, and at the end of the year, you earned \$500 in interest. The following formula will show your profit percentage:

$$\frac{\text{Interest earned}}{\text{Amount invested}} = \text{Percentage profit}$$

Or:

$$\frac{\$500}{\$10,000} = 5\%$$

Translated to the language of appraising, this becomes

$$\frac{\text{Net income}}{\text{Price}} = \text{Capitalization rate}$$

When dealing with real estate and other investments that have various expenses associated with their operation, we need to expand the equation to the following:

$$\frac{\text{Gross income} - \text{Operating expenses}}{\text{Capitalization rate}} = \text{Price}$$

Simplified, this becomes

$$\frac{\text{Net income}}{\text{Capitalization rate}} = \text{Price}$$

Keep in mind that when appraising property we are not trying to find out the profit; we are trying to estimate its value. In the case of investment property, what better way to estimate the value than by using its ability to produce a profit as a guideline? This ability to produce a profit is expressed as the interest rate you earn on your investment. Once we know the interest rate we should be getting on our money when we buy a property, we can use it to project a value.

Therefore, to estimate the value of a property using this method, you need to know a few things, including

1. The gross scheduled income
2. The operating expenses
3. The capitalization rate investors expect in the area where the property is located

**Watch Out!**

A higher cap rate means you can make a greater return on your money. But, be careful, properties like these usually require more intensive management than ones with a lower cap rate. It's an okay trade-off if you are up to the job; just be aware of what you are getting yourself into before you do it.

We will review each of these items as well as some of the things for which you need to watch out.

The gross scheduled income

The gross scheduled income (GSI) is the total amount of rental income collected in the year plus any other income such as laundry income or garage rentals. One problem that arises here is how to handle the income from a building in which the current owner has under-rented some or all of the units. This is very common with smaller units because most absentee investors seem to get happy with a certain level of profit and then don't want to rock the boat by changing things.

This problem is a common source of debate between appraisers, bankers, and investors that we won't attempt to solve here. In practice, appraisers will sometimes make an allowance for market rents, bankers won't use the market rents when calculating their loan amounts, and investors look for under-rented properties with lower sales prices.

The operating expenses

The next component you need to know is the annual expenses on the property including property taxes, insurance, utilities, gardening, management fees, repair cost, vacancies, and so on. You do not include interest expense because the capitalization of income approach presupposes that you paid all cash. We are sure you can appreciate the difficulty in getting a clear picture of what a potential property's true expenses might be. One

owner might do all the management and maintenance himself; another might hire a management company that subcontracts all the work to the most expensive contractors in the area. One owner has low rents and has not had a tenant move in five years; the owner next door is charging market rents and has had some tenants move out. The units have higher rents, but the owner lost some revenue and has had all the fix-up expenses of getting the unit ready to rent.

What this dictates for appraisers is a method of estimating expenses based on the type of property being appraised and the area of the country in which it is located. Take the following two examples, for instance:

- A small four-unit building with no amenities will have far less expense as a percentage of the income than a large, full-security building with swimming pools, tennis courts, elevators, and extensive landscaping.
- The cost of heating a building in Southern California will be far less than the cost of heating a building in Minnesota.

You see, factors like these translate into higher operating costs and higher repair costs when the units break down. To attempt to equalize these differences, appraisers use tables of expenses based on a percentage of the gross. The following chart is typical for property in Southern California. Remember, expenses will vary by area, so make sure you check with your local experts.



Bright Idea

Many lenders have several approved appraisers at their disposal. When it comes to appraising your purchase, encourage your lender to choose the appraiser with the most experience appraising income property. That way, you can ensure that you'll get the most accurate result.

Number of Units	Expenses
2-4	20%-25%
5-15	25%-35%
16 and up	30%-45%

The range gives appraisers a way to make an allowance for variations in the expenses associated with operating the building and the amenities it has.

The capitalization rate

The last item necessary for this appraisal technique is the capitalization rate based on what kind of return investors expect to get in that market area. This rate not only will vary in different parts of the country, but it also can vary in different parts of a city, even in buildings within a few blocks of each other.

In addition, different kinds of properties (residential, commercial, and industrial) will have a different expected cap rate, even in the same location. Remember, the capitalization rate is the measure of the profitability of an investment. Different types of properties have different risks and, therefore, a different expectation of profit for taking that risk.

Now let's return to the example at 333 Richmond Street and see how this method is used. We determined that the total rental income for the property is \$26,400 (\$550 per unit \times 4 units \times 12 months). A rental survey of the area shows that this rent is in line with the market. The expenses are reported at \$7,920 for the year. This is 30 percent of the gross income



Bright Idea

You probably can obtain the cap rate you need to use from a local investment real estate agent or appraiser. Be sure to ask the person to show you how he or she arrived at the rate provided. It is important that this figure be accurate because most investors give considerable weight to this method of estimating value.

$(\$7,920 \div \$26,400 = .3)$. We contacted several local appraisers, and they told us that the expected capitalization rate was 8.4 percent. Remember that a capitalization rate can be expressed as a percentage (8.4 percent) or as a decimal (.084). Be sure to clarify this when someone tells you the rate. If the person gives you the rate as a percentage, you will need to convert it to a decimal before you do your calculation.

Putting this all together, we would calculate the value estimate with the following steps. The first step is to determine the net income:

Gross annual income	\$26,400
Less operating expenses	-\$7,920
Net income	\$18,480

The formula to find value is

$$\frac{\text{Net income}}{\text{Capitalization rate}} = \text{Price}$$

To complete our calculation, substitute the following information into the equation:

$$\frac{\$18,480}{.084} = \$220,000$$

A summary of value

The question you might be asking now is, “Which method of appraisal should we rely on to determine the value for our four-unit example on Richmond Street?” You will learn that in the real world of appraising, it is not always practical or prudent to rely equally on the values obtained using each method. Depending on the type of property being appraised, one of the methods usually gets the most weight in the final value. With single-family homes, for example, the comparative method works best because in most areas there seem to be plenty of similar houses. For that reason, it is easy to find enough current sales to come up with an estimate of value.

On the other hand, the reproduction cost method carries the most weight for specialized properties and for new construction. For a special property such as a church building, this method constitutes the only practical way to estimate a value. This method also works fine for new construction because the land probably was just purchased, and the cost of the structure is easy to determine because there is no depreciation to estimate.

Finally, for all types of investment property, the capitalization of income method carries the greatest weight. You should use the reproduction cost method and the comparative analysis method to check the value arrived at by capitalizing the net income.

In this instance, we will do what many appraisers do, and take an average of the three methods previously illustrated to determine the value of the fourplex at 333 Richmond Street, as follows:

Comparative analysis value	\$222,500
Reproduction cost value	\$225,000
Capitalization value	+\$220,000
<hr/>	
Total	\$667,500

$$\frac{\$667,500}{3} = \$222,500 \text{ average value}$$

With a value of \$222,500, we can see that the list price of \$225,000 was right on the mark.

The gross rent multiplier

Now that you are aware of the three classic methods of appraising real estate, here's another way to value property. Real estate isn't much different from any other industry where people "in the business" have developed a quick and easy way to get things done when time is of the essence. In real estate we use a number called the gross rent multiplier to value property when this

is the case. This is similar to the use of the PE, or price earnings ratio, in valuing stocks. It presupposes that there is a number, the gross rent multiplier, that you can multiply by the gross income of a property to estimate its value.

Let's look at our example to see how to arrive at the gross rent multiplier:

$$\frac{\text{Price of property}}{\text{Gross income}} = \text{Gross rent multiplier}$$

For our example on Richmond Street, the calculation is:

$$\frac{\$220,000}{\$26,400} = 8.33 \times \text{gross}$$

For estimating value, the equation is changed as follows:

$$\text{Gross income} \times \text{Gross rent multiplier} = \text{Value of the property}$$

The following chart shows the effect of several gross rent multipliers on the value of our example:

Gross Income	Gross Rent Multiplier	Value of Property
\$26,400	× 8.0	= \$211,200
\$26,400	× 8.5	= \$224,400
\$26,400	× 9.0	= \$237,600

As you can see, it's easy to see how a small difference in the gross rent multiplier can make a big difference in the value of a property.

Although helpful in a pinch, or when you are first comparing properties, there are times when a gross rent multiplier analysis will fail to tell you anything valuable at all. Inaccuracies in a gross rent multiplier analysis are usually due to one of three factors:

- 1. The owner of the property has kept the rents well below market value.** In such an instance, the gross rent multiplier will not be an accurate appraisal technique.

- 2. The property's expenses are too high.** The gross rent multiplier does not take into account the expenses of the

“For me, the gross rent multiplier is the quickest and easiest way to value property. I've always been bad at math and numbers, but even I was able to learn how to use this simple method of appraisal.”

—Sandra B., Investor

property. Some properties have far higher expenses than others, which would affect the net income to the owner. The most typical reason for high expenses is that the utilities are paid for by the owner rather than the tenants. If you were to pay the same price for a master-metered building

with high expenses as for one with normal expenses where the tenants pay their utilities, you would end up with a substandard return.

- 3. The property consists of furnished units or units that have all the utilities included in the rent.** These kinds of units usually rent for substantially more than unfurnished rentals. If you were to apply the same gross rent multiplier to this type of property, you would be paying a premium for the right to pay someone else's utilities or to own used furniture.

It is important to remember that the gross rent multiplier is a rule of thumb that should be used only when you fully understand all the financial details of the area in which you are looking and the property you are considering. It does, however, provide a quick way to rank properties when you are first looking around. You then can review the income and expense figures and determine which property will give you the better net return on your investment.

Finding hidden value

When an appraisal is ordered on a piece of property, the person making the appraisal will want to know the purpose for the appraisal. For instance, the valuation for a loan will be different than the valuation to settle an estate. Likewise, the valuation of a lot with a home might be less than the valuation of the lot alone if it had the potential to build something more valuable on it such as an apartment building. These variations point to the importance of understanding appraising as a tool for finding hidden value in property.

Knowledge of appraisal methods can be very helpful when it comes time to negotiate the purchase of a property. Most sellers list their property at the price they want, which may or may not be related to its true value when compared to current sales. If you present your offer at a lower price without facts to back it up, the seller might take it personally and dig in his heels when considering your lower offer. If you come in with an offer based on recognized appraisal techniques, however, you have a much better chance of obtaining the property at the lower price.

Let's make a small change in our example on Richmond Street and see how lower-than-market rents will affect its value. Instead of an annual income of \$26,400, which is \$550 per month per unit, let's assume the owner has not kept the rents up to market. In this example, we'll say the rents are \$495, \$510, \$500, and \$525, for a monthly total of \$2,030. Multiplying \$2,030 by 12 months gives us an income of \$24,360. Remember, our



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By fully understanding the techniques of appraising, you can learn to use the appraisal as a tool to drive down the price you pay. At the same time, you can use it as a tool to dig up some hidden profit.

annual expenses are \$7,920, and the capitalization rate we are using is 8.4 percent. In preparing our offer, we include an attachment with the comparable sales information and an estimate of value based on the capitalization of income method. The valuation now looks like this:

Gross annual income	\$24,360
Less operating expenses	-\$7,920
Net income	\$16,440

Remember, once you have the net income, the formula to estimate value is

$$\frac{\text{Net income}}{\text{Capitalization rate}} = \text{Price}$$

Or, substituting in our values, we get

$$\frac{\$16,440}{.084} = \$195,714 \text{ offered price}$$

Our estimate using the three classic appraisal methods indicated a value of \$222,500, so anything you can save below that price will be an extra profit for you. Of course, there is no guarantee the seller will take the lower offer, but if your agent presents a convincing story about your desire to purchase at a fair price based on your diligent analytical work, you might very well prevail.

Now let's use an appraisal to find some additional hidden profit based on potential rent. You have done all your research on the market area and have found that the market rent for these units is \$575 per month and that garages add a premium of \$15 per month. This gives the building the potential gross of \$28,320. The value estimate now is

Gross annual income	\$28,320
Less operating expenses	-\$7,920
Net income	\$20,400

Let's work the valuation formula again:

$$\frac{\text{Net income}}{\text{Capitalization rate}} = \text{Price}$$

Or, substituting in our values, we get

$$\frac{\$20,400}{.084} = \$242,857$$

With this information in your possession, you could even pay the full asking price of \$222,500 and still have found some hidden profit because of your knowledge of the market. It will take some effort and time to get the rents up to market, but once you do, the profit is there for the picking.

Highest and best use

An important concept to understand in real estate is “highest and best use.” Have you ever driven through a commercial area with office buildings and retail stores only to see an old single-family home that looks like someone still lives there? If that home comes up for sale, should it be appraised as a single-family residence or as a commercial lot? The answer is probably as a commercial lot because this is now the “highest and best use” of the property.

Understanding that developed property can have more than one use often will yield a hidden profit. The following are some situations that would warrant valuing a property for its highest and best use rather than its current use:

- A house or small units is on a commercial or industrial lot.
- A house or small units is on a large lot zoned for multi-units in an area with many new buildings.
- A parcel map of the property shows that the building sits on two separate lots.
- A four-unit property consists of two side-by-side duplexes on two separate lots according to the parcel map.

- The apartments in the building currently have one bedroom, but the bedroom is very large and could be made into two simply by adding one wall and a door for much greater rent.
- A small house is on a multi-unit zoned parcel where extra units can be added.
- A vacant commercial building can be converted to loft apartments or live/work lofts.

In all of these cases, the property can be valued in more than one way. The highest and best use for the property might not be its current use. Remember, property not being utilized at its highest and best use will have less value than other, comparable properties based on this standard. The highest and best use might not always be obvious, as in the case of the building that sits on two lots. In that case, the land value of the two lots might be significantly higher than the value of the building alone.

The lesson here is that real estate is a multidimensional asset. If you fail to look at all its facets, you might fail to realize the full potential of your investment. Finding the hidden value in a property does not mean you have to immediately realize it by making a sale. This hidden profit should give you extra confidence in the security of your investment.

In addition, you now have two chances to make more profit in the future. In the example of the building on two lots, the building and its income stream probably will be worth more as the market increases. In addition, the land will be worth more for development purposes, and that value might increase faster than the building value.

Just the facts

- Knowing the fair market value of any property under consideration will help to ensure your success as a real estate investor.
- Comparative analysis is an easy and effective method of appraisal that even the most novice investor can do.

- The reproduction cost approach is the most difficult method for the nonprofessional to use when trying to estimate value.
- Capitalization rates tell you how much you will make on your investment if you paid all cash for it.
- The gross rent multiplier is just a rule of thumb, but it will give you a great head start on your analysis.

GET THE SCOOP ON...

Great government lending programs to help you get started ■ The qualifying criteria used by conventional lenders ■ The facts behind fixed- and adjustable-rate loans ■ Why the “neg-am” adjustable could be your ticket to wealth ■ Finding and negotiating private-party loans

Borrowing Big Bucks

For the Average Joe or Jane, plunking down all cash for a piece of property is simply beyond what is reasonably possible. Besides the whopping negative number it would create in most of our checkbooks, it would actually defeat the best part of real estate investing. That is, it would eliminate leverage from the equation. As a result, to buy real estate we must find outside sources willing to finance our investments.

In theory, this sounds great. But, of course, finding someone to loan you hundreds of thousands of dollars probably sounds like an overwhelming prospect. In fact, you probably have some burning questions that need answers: “Can you qualify?,” “How much will you have to borrow?,” “Where will you find a lender?,” “Should you go with a fixed or variable rate?,” and so on. But fear not; in this chapter we’ll break down all the intricacies of borrowing big bucks. Here, we will explain how real estate is

financed, tell you about the three major sources of money, and give you inside tips on how to make sure the loan you find is all it's cracked up to be.

Show me the money

As you start shopping for a loan, you'll find that the costs of borrowing money vary widely. Conventional lenders might charge for one thing while the federal government or private parties might charge for others. You'll discover that the two greatest factors affecting your borrowing costs will be first, who makes the loan, and second, what type of loan it is. The following table covers most of the more common fees that different lenders charge:

	Government Loans	Conventional Loans	Private Loans
Good-faith deposit	X	X	
Loan fee—points	X	X	
Appraisal fee	X	X	
Credit report	X	X	X
Tax service	X	X	
Document recording fee	X	X	
Loan processing		X	X
Drawing documents	X	X	
Funding fee	X		
Prepaid interest	X	X	
Mortgage insurance	X	X	
UCC filing	X	X	X
Flood certification	X	X	

	Government Loans	Conventional Loans	Private Loans
Loan escrow	X	X	X
Alta title insurance	X	X	
Setup fee	X	X	
Warehouse fee	X	X	

Thankfully, the government has taken all of the guesswork out of determining which fees apply when borrowing money for real estate. The governing federal law is the Real Estate Settlement Procedures Act (RESPA). RESPA requires that all lenders, except private parties, give the borrower an estimate of all their lending fees.

Along with the RESPA estimate, the lender must also disclose the annual percentage rate (APR) on your loan. The APR will take into account all the fees paid on the loan up front to give you a true picture of the annual interest rate you will be paying

The biggest expense of your loan is the loan fee, or “points.” Each point represents 1 percent of the loan amount. For example, one point on a \$150,000 loan would be \$1,500 ($\$150,000 \times .01 = \$1,500$). This large cash expense is a sore point for most investors. But like anyone who is in business, lenders are there to make a profit; and in the case of lending money, charging the borrower points up front is one of the ways in which they do it.

You will sometimes see advertisements for no-point and no-fee loans. Obtaining a loan like this can be an okay trade-off if



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Don't hesitate to negotiate on points and other lending fees with your chosen lender. They are never set in stone.



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Depending on market conditions, some lenders offer incentives for borrowers to pay points up front. If you plan on owning your property for a long time, paying some points to obtain a loan will probably pencil out better in the long run. Conversely, if you'll be flipping the property soon, low or no-point loans might make better sense.

you need that kind of help to buy, but be keenly aware that the lender will certainly make his money somewhere along the line. We caution you here because the truth is that the only way any institution can give away loans for “free” is by charging you a higher-than-par interest rate. A “par” rate, in lending terms, is the best rate on any given day charging normal closing fees and points.

Keep in mind that you only have to pay for points and loan fees once, but if you get help paying your points on the front-end you will be stuck paying the higher interest rate for the entire life of the loan. The trade-off is yours to analyze.

Locating a lender

When it comes to financing smaller residential real estate, there are three primary sources to find money. They are

1. The federal government
2. Local savings and loans and banks
3. Private parties

Let's see what the federal government offers first.

The Federal Housing Administration (FHA)

The best source for government-supported financing for anything up to four units is through the Federal Housing Administration (FHA). The FHA doesn't actually provide the funds for the mortgages; rather, it insures home mortgage loans made by private industry lenders such as mortgage bankers, savings and loans, and banks. This insurance is necessary because

FHA loans are made with low down payments and have favorable interest rates and terms compared to the conventional lending market.

FHA loans are designed for people just starting out. To that end, they offer the investor fantastic leverage with a minimum requirement of just 3 percent down, while the remaining 97 percent is financed by a lender. As you can see, by just having to come up with 3 percent, most anyone could afford to purchase a small set of owner-occupied units via an FHA loan and be well on the way to achieving their goals in real estate.

The following chart shows the maximum loan amounts available for FHA loans in three areas of Southern California at the time of publication. Make sure you check with your mortgage broker in order to determine the maximum allowable limits in your area.

Number of Units	Orange County	Los Angeles	San Diego
1	\$261,609	\$237,500	\$261,609
2	\$334,863	\$267,500	\$334,054
3	\$404,724	\$325,000	\$404,724
4	\$502,990	\$379,842	\$468,300

Be aware that one stringent requirement of obtaining FHA financing is that the borrower must live in the property as his or her primary residence, usually for a minimum of one year. Therefore, it's essential that you do actually move into your units, at least initially. It's not unheard of for lenders to follow up on their borrowers, and it would be a disaster to have them call your loan due because they discovered you never actually moved into your property, as promised.

If you do opt for an owner-occupied, 3-percent-down FHA loan, the good news is that the two- to four-unit market usually has the largest selection of properties available. This gives you a great probability of finding a property with a unit that will make



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FHA deals are great for the beginning investor. Because you will be living in the property, you can roll up your sleeves and make upgrades that no doubt will improve its value. When it comes time to sell or refinance, you will have created some sweat equity for yourself.

a nice home for you and your family and a nice rental for some tenants. Of course, the American dream is to own your own home. If you can be patient, however, consider having your first purchase be a set of FHA units. By tapping into your equity in just a few years, you can move up to a single-family residence and can own a nice piece of income property to boot.

Another advantage of the FHA program is that it uses FHA-approved appraisers to value the properties. During the appraisal process, an additional goal of the appraiser will be to make sure there are no major problems with the building and that all the basic safety measures have been met. If a property fails to meet these FHA standard guidelines, the seller must either comply with the appraiser's request to fix the problems, or, in essence, lose the deal. Nine times out of ten, sellers comply. By the time you move in, all major repair work will have been fixed and your purchase will sparkle like new.

VA loans

At the end of World War II, congress approved the Serviceman's Readjustment Act of 1944. The common term for this program is the GI Bill of Rights. The purpose of the Act was to give war veterans a new start and to ease their expenses in civilian life by providing them with medical benefits, bonuses, and—best of all—low-interest real estate loans.

VA loans work much the same as FHA loans in a couple of ways. First, VA loans are not made directly by the Department of Veterans Affairs but, rather, are guaranteed by it. Secondly, VA loans are designed for owner/occupant purchasers only. There

is, however, one significant difference between the two programs. That is, VA loans for qualified veterans can be for 100 percent of the purchase price. This means the veteran doesn't have to come up with any money whatsoever for a down payment.

Besides not having to come up with any money for a down payment, the other important things to know about VA loans are

- Favorable rates and terms are available for eligible veterans.
- Loan amounts generally do not exceed \$240,000.
- Eligible properties include single-family homes, including VA-approved condominiums and townhouses.
- VA loans are secured by the Department of Veterans Affairs.
- There are no monthly mortgage insurance premiums to pay.
- Limitations exist on buyer's closing costs.
- You have the right to prepay the loan without penalty.
- The VA performs personal loan servicing and offers financial counseling to help veterans avoid losing their homes during temporary financial difficulties.

Today, more than 29 million American veterans and service personnel are eligible for VA financing. Even though many veterans have already used their loan benefits, it may be possible for them to buy homes or units again with VA financing using remaining or restored loan entitlements.

First-time-buyer programs

Many communities offer first-time-buyer loan programs intended to help people purchase their first homes with little money out-of-pocket. Like FHA and VA loans, these kinds of programs usually require the borrower to be an owner/occupant for a minimum period of time. Remember too, that residential real estate is categorized as anything from one to four units, which broadens the type of investment you can get

started with. Make sure to check with your local city hall to see if there are any programs like this that might work for you.

The conventional route

Conventional loans are the cornerstone of the majority of lending that takes place on residential real estate. These loans are offered by banks, savings and loans, and mortgage companies and most are packaged using the Federal National Mortgage Association, commonly called Fannie Mae, or the Federal Home Loan Mortgage Corporation, nicknamed Freddie Mac. These are quasi-public organizations with the benefit of government sponsorship. All conventional loans fall into one of two categories:

1. Residential loans for one to four units
2. Commercial loans for five units and up

There are significant differences between these two categories including the number of lenders willing to provide loans for them, qualification criteria, and terms. Let's look at residential loans first.

Residential loans: One to four units

Residential loans come in almost unlimited shapes and sizes. Call any major lender or mortgage broker in your area and ask for a list of their loan programs; you'll be amazed at the options that exist. Here, we'll attempt to simplify the list so that you can zero in and sift through the sea of options from the get-go.

The standard conventional loan is for 80 percent of the appraised value of the property. This means the borrower will have to put down 20 percent of the purchase price in cash. They can either pay the 20 percent themselves, or, in some cases, structure a deal with a seller whereby he finances a portion of it for them in a second loan. A common scenario has a buyer paying 10 percent, a seller financing 10 percent in a second loan, and a lender lending 80 percent ($10\% + 10\% + 80\% = 100\%$). Note that some lenders will allow you to get a second loan and some

will not, so be sure to check and see if this is an available option when doing your loan shopping. If so, the extra effort of finding a seller willing to carry some paper might be well worth it.

Sometimes you can find residential one-to-four-unit loans advertised that offer financing for 90–95 percent of the value of the property. Like FHA and VA loans, most of these programs are designed for owner/occupied properties only. If your plan is to buy units to live in, however, putting less money down and keeping more in your pocket is a great option and one you should consider.

For any financing where you put less than 20 percent down, you will normally be required to pay for private mortgage insurance (PMI). PMI is insurance that will guarantee the lender not to lose part of or the entire loan in the event of a foreclosure. With PMI the lender passes on the cost of the insurance to the borrower by increasing the interest rate. This increase can be $\frac{1}{4}$ to $\frac{1}{2}$ percent higher, and the PMI can add another $\frac{1}{4}$ to $\frac{1}{2}$ percent on top of that. Although it sounds expensive, the benefit of more leverage and less out-of-pocket money might make a loan that requires PMI advantageous.

Qualifying for conventional loans

Qualifying for conventional residential loans depends primarily on one criteria, your personal credit worthiness (and thereby, your ability to pay the loan back). Lenders discover this information in two ways. One way is by the use of your FICO score. FICO is a rating system based on a standardized ranking by the three major credit agencies as calculated by the Fair Isaac Credit Organization. The formula they use is not disclosed by the



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Keep track of how much equity you have in your properties. When your equity exceeds 20 percent, you should be able to negotiate an immediate end to your PMI obligations.

credit bureaus, per decisions made by the U.S. Congress. Simply put, the higher your FICO score, the better risk you are, and the higher the likelihood is that you will get favorable rates and terms for real estate loans.

Some known FICO parameters are as follows:

- The number of bank card trade lines
- The worst level of delinquency on an installment loan
- The number of months in the file
- The number of months since the most recent bank card opening
- The number of months since the most recent derogatory public record
- The delinquency on accounts
- The number of accounts with balances
- The length of revolving credit accounts
- The date of inquiries
- The number of retail accounts

The other method of rating credit is based on a ratio system, consisting of a top and bottom ratio. The top ratio is calculated by dividing the monthly principal, interest, taxes, and insurance payments on your purchase by your total monthly income. The bottom ratio adds all your debt payments to the payment on the property and divides this by your total monthly income. This number takes into account how much debt you have, how much credit you have available on credit cards, late payments, delinquencies, judgments, bankruptcies, and so on.

Most lenders also talk about credit and their loan programs based on a ranking system of A, B, C, or D credit. The following is a summary of the criteria they use to determine your credit grade:

- **A credit:** Very few or no credit problems within the last two years. One or two 30-day late payments. A few small

collections, and no more than one 30-day late payment on your mortgage, if you have one.

- **B credit:** A few late payments within the last 18 months. Up to four 30-day late payments or up to two 60-day late payments are allowed on revolving and installment debt, and one 90-day late is allowed.
- **C credit:** Many 30-to-60-day late payments in the last two years as well as late mortgage payments in the 60-to-90-day range. Bankruptcies or foreclosures that have been settled in the last 12 months are also part of this category.
- **D credit:** Open collections, charge-offs, notice of defaults, and so on, as well as several missed payments, or bankruptcies and/or foreclosures.

A conventional lender also will do an appraisal on the property that will figure into the decision on whether or not to lend. Though your lender will certainly be committed to making sure you are not overpaying for the property, make no mistake, their appraisal of you is what is most important when lending on one to four units. In the end, this is what will determine how much and what kind of a loan you qualify for.

Though it sounds like a tough nut to crack, if you have less than perfect credit (like many Americans do), don't let the criteria of the conventional lending market frighten you. Rather, let it inspire you—inspire you to clean up any derogatory past debt and work to get your credit scores as high as they can be. That way you'll always be able to qualify for the best rate and terms for future real estate purchases.



Bright Idea

If you have trouble qualifying for a conventional real estate loan, consider going to the hard-money market. When it comes to hard-money lending, rates are higher, but qualifying is easier. In all likelihood you will still be able to achieve your goals by obtaining a property to fit your plan.

Commercial loans: Five units and up

At some point in your investing career, you might start looking at larger properties. Any property with five units or more falls

“The best advice I can give a potential borrower is to be an informed consumer when it comes to their credit report and credit history. Be aware of your potential problems, and have adequate answers available for the questions that will most certainly be asked by the underwriter.”

—Larry S., mortgage broker

out of the residential loan category and becomes one where you need to obtain a commercial loan. If this is where you're headed, know that at a minimum you will have to put between 25 and 35 percent down on your purchase. Compared to the 0 to 20 percent required down payment on residential loans, this component of commercial lending is often what puts these larger

buildings out of reach for most beginning investors.

Unlike with residential loans, qualifying for a commercial loan (five units or more) is primarily based on the ability of the property itself to generate sufficient cash flow to repay the loan. Most lenders want a debt coverage of 1.1–1.25 percent of the monthly debt payments. This means that the property needs to have a net cash flow after expenses and vacancy reserves of 1.1–1.25 times the loan payment. The building should be able to pay all its expenses, pay the mortgage payments, and have some positive cash flow left over for the investor.

Here is what you need to know about commercial loans:

- Lenders require significant down payments, usually between 25 and 35 percent of the purchase price.
- Commercial loans will always be more difficult to obtain than residential one-to-four-unit loans.
- Loan fees and interest rates are generally significantly higher than for properties in the one-to-four-unit range.

- The appraisal will be considerably more extensive and more expensive than for a one-to-four-unit building.
- The lender will want to see specific, up-to-date information about rents and expenses on the building.
- Commercial loans tend to take much longer to process than loans on one to four units.

Another difference between these loans and smaller residential loans is that most commercial loans for five units and up are nonrecourse loans. A nonrecourse loan is one in which the lender is prohibited from getting any compensation from the borrower for a loss if the lender has to foreclose and take the property back. The exact opposite is true for residential loans.

Fixed-rate mortgages

Two types of interest rates are available on any kind of loan you get: fixed rates and adjustable rates. At a gut level, most people think they'd prefer a fixed-rate loan. You know what the rate is today, and you know what it's going to be tomorrow. This predictability is very attractive and, for that reason alone, makes a fixed-rate loan desirable. The problem is that in the one-to-four-unit market, it's hard to get a fixed-rate loan for nonowner-occupied units. If you plan to live in one of the units you buy, that's one thing. If you plan on just having an investment, however, finding a fixed rate on one to four units will be tough.

For argument's sake, let's say you did find a fixed-rate loan on a nonowner-occupied piece of residential real estate. Here is what you can expect: For starters, the loan usually will be at a much higher interest rate than the typical adjustable-rate loan. This is because, in theory, the lender has to retain the loan at the fixed rate for 30 years and thereby take the risk of having the cost of money for him increase without any recourse. This is great in a stable economy, but during periods of inflation, the cost of funds for the lenders can erode any profit margin they might have had.

Besides higher interest rates, a fixed-rate loan will probably have higher initial fees, the loan won't be assumable, and most will have a prepayment penalty for the first 3–5 years. What's more, some loans also require a balloon payment to be made in 7–10 years from origination. "What," you ask, "is a balloon payment?" Here's how it works: Most government and conventional loans on smaller properties are fully amortized. A fully amortized loan is one in which you make 30 years worth of payments, and at the end of that time, your loan is paid off in full. In the case of many fixed-rate loans, payments on the loan would be made as though you were paying off the loan with a 30-year amortization schedule, but at the end of the agreed-upon time, the balloon would be due. This payment would be equal to the balance of the loan at that time.

Though it seems like the odds might be stacked against you, don't let these hurdles sway you from considering a fixed-rate loan. If you can get one, and the terms work for you, then go that route. If not, educate yourself about the second type of available conventional loans—adjustable-rate mortgages.

Adjustable-rate mortgages (ARMs)

A banking lesson would be in order here: When it comes to making real estate loans on smaller properties, savings and loans and banks are the ones that provide most of the money to borrowers. The loans are made for 10–30 years. The money they lend is money they borrow from their customers. The system works because you bring your money in the front door and open a savings account, on which you earn interest. The interest you get is the cost of funds for the bank. The money goes out the back door when your neighbor goes to that very same bank and gets a loan for a new house or some rental units. The difference between the rate your neighbor pays for his home loan and the rate you get on your savings account goes toward the bank's overhead and profit.

The reality, however, is that most people don't put their money in the bank for 10–30 years. Instead, they put it in for a couple of days to a couple of years. What this means is that banks are lending money on real estate for 10–30 years based on their projected cost of funds today. To that end, lenders take a big risk by lending long term on a short-term supply of capital and thereby have to charge higher interest rates for fixed-rate loans. That way, they build in protection for themselves. In the 1970s, the banks learned this lesson the hard way. This is why the adjustable-rate mortgage was invented. Today, with adjustable-rate mortgages as part of the mix, banks win, as do borrowers.

The interest rate of the modern adjustable loan is based on an index plus a margin. It's actually pretty simple. An index is a source from which interest rates are determined. It generally is either treasury bills or treasury bond rates or the cost of money in local federal districts. The most common indexes are

- **COFI:** COFI stands for the Cost of Fund Index. This is the average cost of deposits and borrowing for a savings institution in a given Federal Home Loan Bank District. For example, the 11th District Cost of Funds Index is comprised of California, Arizona, and Nevada.
- **CMT:** CMT is the Constant Maturity Treasury Index. This is the weekly average yield on United States treasury securities adjusted to a constant maturity of one year. For larger fixed-rate apartment and commercial loans, which may have a maturity date of 7 or 10 years, the index used would be based on 7-and-10-year treasury securities.
- **LIBOR:** LIBOR stands for the London Inter-Bank Offered Rate. This is the average of lending rates from a number of major banks based in London, England.
- **CD:** The index based on certificates of deposit (CDs) is a weekly average of the secondary market interest rate on certificates of deposit with a 6-month maturity date.

Now that you are up to speed on the index, here is what a margin is: A margin is a pad that gets added to the index to make up the total interest rate. It's there to cover the lender's overhead, cost, and profit. It can and will vary depending on market conditions and competition.

You can calculate the interest rate on your ARM loan using the following formula:

$$\text{Current rate of index} + \text{Margin of loan} = \text{Interest rate}$$

As an example, if the index is 4.92 and the margin is 2.25, the interest rate on your ARM would be 7.17 percent, as follows:

$$4.92\% \text{ (Rate)} + 2.25\% \text{ (Margin)} = 7.17\% \text{ interest rate}$$

There are basically two types of adjustable-rate mortgages. There are "no-neg" adjustable loans. No-neg loans are ones that do not allow for any negative amortization. There are also "neg-am" adjustable loans, which are loans that do allow for negative amortization. Negative amortization refers to the possibility of your loan balance increasing, rather than decreasing with some of your payments.

Here's a simple illustration to help explain this concept: Let's say the agreed upon minimum monthly payment on your ARM for a given year is \$850, but it would take \$900 a month to pay off the loan in 30 years based upon the current interest rate. If that was the case, the difference of \$50 a month will be added to your loan balance. That's negative amortization.

In actuality, however, negative amortization is not nearly as bad as it sounds. In fact, the neg-am ARM is the loan that many seasoned investors prefer. The benefits for the investor are twofold: First, by allowing the investor to make just a minimum payment each month of interest only, the neg-am ARM allows the investor to maintain a healthy working cash flow on his properties. Second, by keeping more money in his pocket, a smart investor can buy much more building than he normally could have. In the end, this is the loan that helps more investors reach their goals in real estate on time, or sooner.



Moneysaver

Because they have the least risk for the lender, adjustable loans are probably the most common loans today, especially for smaller investment properties. This allows banks to offer them at the most favorable terms to the borrower.

Nonetheless, there are additional pros and cons to both types of adjustable-rate mortgages. The facts are laid out in detail in the following sections, so you can decide for yourself.

The “no-neg” ARM

As mentioned, the “no-neg” is an adjustable loan with terms that do not allow for any potential negative amortization. In guaranteeing that there will be no negative amortization, the lender builds in protection for potential market interest rate increases. For example, the loan may provide for two interest adjustments each year, one every six months, with a maximum increase or decrease in the interest rate of 1 percent each six-month period and a corresponding increase or decrease adjustment in the payment. For this maximum increase or decrease, the bank will absorb any costs above the 2 percent (1 percent every 6 months) increase per year.

To illustrate, let’s look at the potential increase on a \$190,000 loan at 7 percent interest with a 30-year payment schedule. We’ll assume the interest rates increased 1 percent each adjustment period. The change will look like this:

Interest Increase	Monthly Payment	Amount Going to Interest	Amount Going To Principal
1st 6 Months	\$1,264.07	\$1,108.33	\$155.74
2nd 6 Months 1%	\$1,394.15	\$1,266.67	\$127.48
3rd 6 Months 1%	\$1,528.78	\$1,425.00	\$103.78

The difference between the initial monthly payment of \$1,264.07 and the jump in a year and a half to \$1,528.78 per month is \$264.71. As you can imagine, \$264.71 is a pretty large monthly increase to swallow. At first glance, the best solution might be to offset this increase by simply raising rents.

If you remember, the rents on the Richmond Street example totaled \$2,200 per month. If we wanted to preserve the same cash flow we had when we began it would take the following increase in rent every six months:

Second 6-month adjustment

Second payment	\$1,394.15	
First payment	-\$1,264.07	
<hr/>		
Increase	\$130.08	
Increase	\$130.08	= 5.9%
<hr/>		
Rent	\$2,200	

Third 6-month adjustment

Third payment	\$1,528.78	
First payment	-\$1,394.15	
<hr/>		
Increase	\$134.63	
Increase	\$134.63	= 5.8%
<hr/>		
Rent	\$2,330.08	

The net result is that you'd have to raise your rents almost 12 percent if you wanted to maintain the cash flow you started with (5.9% + 5.8% = 11.7%). Even in a good economy, this may be more than most tenants would tolerate.

You are left with two choices here: Take the no-neg adjustable loan, and as time goes on accept a lower cash flow, or begin to think outside the box and consider a second option—the neg-am adjustable loan.

The “neg-am” ARM

The “neg-am” ARM differs in that the limit is put on how much the required cash payment can increase rather than how much the interest can increase. To protect the cash flow for the borrower/investor, lenders have built in payment caps to neg-am loans, usually set at a maximum of 7.5 percent increase per year. Using our example loan, this means the required loan payment could only go up \$94.81 ($\$1,264.07 \times .075 = \94.81) the first year, no matter what happened to the actual interest rate.

To compensate the lenders for the lower required minimum payment, the interest rate may be allowed to adjust every month according to the index to which it is tied. These adjustments usually will start six months after the loan begins. Given these parameters, the payment schedule on the example looks like this:

Interest Increase	Monthly Payment	Amount Going to Interest	Amount Going to Principal
1st 6 months	\$1,264.07	\$1,108.33	\$155.74
2nd 6 months 1%	\$1,264.07	\$1,266.67	-\$2.60
3rd 6 months 1%	\$1,358.88	\$1,425.00	-\$66.12

With the neg-am adjustable loan, there would only be one change in the payment in the 18 months of our example. We showed the interest increasing in the second and third periods, however, so it affected the principal reduction part of the loan payment. Because the principal due was not paid (that is, it actually was negative), the loan amount increased by the amount of the unpaid balance during these periods.

Now let's see how the payment increase compares to the existing rental income. If we want to preserve the cash flow for our building on Richmond Street, we'll need the following increase:

Second payment	\$1,358.88	
First payment	-\$1,264.07	
Increase	\$94.81	
Increase	\$94.81	= 4.3%
Rental income	\$2,200.00	

A 4.3 percent increase amounts to only \$23.65 per month on a unit that rents for \$550 per month. Now, compare that to the 12 percent increase you would have had to offset with a no-neg ARM. As you can see, the big advantage of the neg-am loan is that the low payment increase enables you to offset it with an affordable rent increase that maintains the cash flow you desire. If everything goes as planned and the cash flow isn't needed, you can always add more money to your payment each month so that no negative amortization takes place.

Because you have multiple payment options with each mortgage payment, many lenders refer to the neg-am adjustable loan as the flexible-payment-plan loan. The idea is as follows: If your building is running well, you can pay the interest due plus the principal due and not go negative at all. If, on the other hand, cash flow is necessary because, say, a water heater went out at your building, you can pay a minimum payment of interest only and keep more cash in your pocket to pay for your expenses. The choice is yours, as the lender allows you to change your mind with every payment.



Moneysaver

Keep in mind that the portion of your payment that goes to reducing the principal is taxable because it came from tenant income. Therefore, there isn't any real advantage in taking the money out of your bank where it is earning interest and paying down your loan. The cash in the bank is your security. If you keep it in the bank, you can pay the loan down anytime.



Bright Idea

Feel free to mention other loan quotes to lenders. The best approach often is a straightforward statement: “You know, Mel at Excalibur Mortgage offered me the same loan for 1/2 point less. Can you beat that?”

Finally, many people bemoan that neg-am adjustable loans create the possibility that the loan balance can increase rather than decrease. Sadly, many borrowers/investors dismiss adjustable-rate loans outright without ever being truly financially literate on the subject.

In reality, fear of negative amortization is a psychological problem and not a practical one. Why is it that we can finance a brand-new car, knowing full well that the loan will be larger than the car’s value the moment we drive it off the lot? And everyone knows that the computer systems we buy today will be behind the times in less than six months, but we continue to buy new computer systems all the time. In truth, we buy new cars and computers because they enhance the quality of our lives. Using adjustable-rate mortgages to purchase the real estate that will improve our lives should be no different.

Most importantly, keep in mind that lending is just a tool to help you reach your dreams. If you can use an ARM to grow your nest egg, go ahead and do it. If, however, you find that it is not in your best interest, find a fixed-rate loan, pay all cash, or invest in the stock market. The choice is yours.

Shopping lenders

Regardless of the type of conventional loan you choose, it’s important that you shop around for the best possible rate and terms. As you can see, many variables will affect your costs. Use the following uniform checklist to compare programs effectively:

- Interest rate
- Fixed or adjustable
- Loan-to-value ratio



Watch Out!

It is not just the interest rate you should take into account when shopping for a loan but a combination of all factors on your checklist and how they impact your long-term investment goals.

- Debt coverage percentage
- Points
- Appraisal fee
- Environmental review fee
- Margin
- Index
- Interest rate cap
- Payment cap
- Required impounds
- Prepayment penalty
- Yield maintenance
- Assumability
- Recourse or nonrecourse
- Processing, review, and closing time
- Good-faith deposit
- Other fees

Assumable loans

Assumable loans are loans that are already in place and can be taken over by the person purchasing the property. That is, the buyer can “assume” the existing loan rather than finding new financing and paying all the fees to obtain it. There usually are some small fees charged for assuming a loan, but they can be significantly lower than what it would cost to get a new loan from scratch. Your real estate agent should know whether the properties you are considering have assumable loans.

One advantage of taking over an older, assumable loan is that it often will have better terms than a similar new loan would have today. The major difference usually is in the margin. Remember that the margin is the profit that the bank adds on to the index to get the total interest rate on the loan.

When a loan has been in place for 10 to 15 years, it starts paying off principal at a faster rate. This means that principal, rather than interest, is now a larger percentage of each monthly payment. Because more principal is being paid to the loan, assumable loans allow for a faster buildup of equity. For this reason, many investors getting ready for retirement look for properties with loans like this that they can assume. The idea is that they won't have to add much additional principal to each payment to get these seasoned loans to pay off at about the same time as they retire.

Know that when you assume a loan, you still have to qualify just as the original borrower did. There are some loans, however, especially older FHA loans, that allow you to take the loan over and just start making payments. This is sometimes called taking the loan "subject to." Taking a loan subject to leaves the original borrower on the hook in case you default. They may be hard to find, but are like jewels in the dust when you do.

Private-party financing

The last source of financing is through private parties. These loans often are made by the sellers themselves, and they have several advantages over conventional loans. The first advantage is that you can save a lot of money in lending fees if you borrow privately. This is because most of the costs associated with conventional financing don't apply to private loans. This is a great help when assembling the initial cash required to close a deal.

Good rates

Many times, private loans have interest rates that are lower than the conventional market. If you look at the loan on 333 Richmond Street, which is \$190,000, and assume you can save a

mere 1 percent on the interest rate through private financing, it adds up to \$1,900 per year. The following chart should be an eye-opener, as it demonstrates how a \$1,900 per-year savings adds up over the span of 30 years:

Year	Savings
1	\$1,900
5	\$9,500
10	\$19,000
30	\$57,000

Low down

The down payment on most transactions is determined by the requirements of the institution making the loan. In the case of private financing, down payments are entirely negotiable. In many instances, sellers who are willing to carry a private-party loan don't want any money for a down payment at all. This is because they are not looking to get cash out of a sale. Instead, they want the monthly income from carrying the paper because any cash they receive is just a tax problem for them. In fact, you will find that many sellers only want enough cash down to pay closing costs.

Terms

In the grand scheme of owning a property, the terms of your financing can be far more important than the price you pay for a building. If you and the seller can agree, anything goes. Not only do many sellers carry the financing at lower interest rates,



Bright Idea

If money is tight, ask your real estate agent if he would be willing to take his commission in monthly payments. If so, you might be able to close private-party loans with only as much cash as it takes to pay title and escrow fees.

they also can make the payment plans fit your needs. The golden rule says, “He who has the gold, makes the rules.” In private-party lending, this couldn’t be truer.

It isn’t unusual for some sellers to carry financing long term with interest-only payments. This way, they are not using up any of the principal balance of the loan. Remember that any principal the seller receives is taxable as a capital gain. Many times, sellers who truly understand real estate investing would rather loan the money to you and receive interest-only payments than pay Uncle Sam capital gains tax.

In reality, a seller can make your loan payment any amount he wants. We (the authors) have seen many transactions over the years in which the payment schedules were actually lower than interest-only to accommodate the particular needs of a transaction. In most cases, this is because the seller has not kept the rents up with the market but wants a price calculated on rents closer to what they should be. The seller can carry the loan at a graduated payment schedule to give the buyer time to raise the rents.

Due dates

Another major component to consider in a private-party loan is the due date. This also is up for full negotiation. The parties involved can agree for the due date to be in 1 year, 5 years, or 30 years, just like any conventional loan. In addition, it’s not unusual for private loans to have partial payoffs at set times. These partial payoffs often coincide with the cash needs of the seller. The seller might have loans he needs to pay off in the future or some special need such as providing a college education for a grandchild. In the case of these partial payoffs, many sellers will allow you to get the funds by refinancing the

“When my agent talked the seller into carrying a straight note for me, it made the difference in being able to buy the property I wanted with a payment I could afford.”

—Michael B., investor

property and putting their loan in the second position. If you plan well enough ahead, these payoff obligations should be easy to meet.

Straight notes

You might find that some sellers don't need any cash flow at all and are willing to carry a straight note (or notes) with deferred interest. A straight note is a note that has one payment, which is due at the end of the loan. In the period between the start of the note and the due date, the interest accrues and is due at the same time as the principal. Other sellers might only want part of the interest and will allow the unpaid interest to accrue and be paid when the loan is paid off.

All-inclusive loans

An all-inclusive loan is one in which the loan the seller is carrying includes the seller's equity and any other loans the seller had previously put on the property. Sometimes seller-financed loans take this form because the terms of the existing financing don't allow the loan to be transferred, or—in many cases—because of tax reasons associated with the seller's capital gain position.

We'll discuss the problem of mortgage over basis in Chapter 10, "Planning for the Tax Man," but in short, it's a problem created by taking part of your profit out through refinancing. A taxable event occurs when the seller is relieved of the responsibility for the debt. Rather than allowing you to assume a loan that has a mortgage over basis problem, the seller can carry an all-inclusive loan.

Let's assume the \$190,000 loan on the Richmond Street example was actually an all-inclusive loan. This might be the actual structure:

Sellers equity	\$90,000
First loan	+\$100,000
<hr/>	
All-inclusive loan	\$190,000

In this case, you make a payment to the seller according to your agreed upon contract, the seller makes the payment on the existing first loan, and he keeps the difference. In this scenario, the seller has not been relieved of his responsibility for the repayment of the \$100,000 loan, so in many cases, this will not trigger the taxes due.

Land sales contracts

Another type of private lending is the land sale contract, or the contract for deed. In this case, buyers enter into a contract with a seller to purchase a property, but the buyer doesn't acquire the title until sometime in the future. These deals often are structured this way because the underlying financing is favorable to the buyer.

Land sales contracts and contracts for deed are structured in much the same way that cars are financed. That is, the bank keeps the title to the car even though you are the registered owner. When you eventually pay the car off, the bank gives you the legal title. The same premise holds true here.

Buyers need to be careful here. Many loans have acceleration clauses that make the entire loan due and payable if there is a title transfer. Lenders can't accelerate a loan, however, unless they know about the change. Because the title isn't actually transferred, many times, no one is the wiser. Nonetheless, agreeing to these kinds of terms might be a risk, so make sure you do your homework and be careful.



Watch Out!

When you are using creative financing such as a land sales contract, you always should consult a real estate attorney. That way you can go into a deal with complete peace of mind.



Watch Out!

Some people with money to loan advertise in the newspaper. You've seen the ads, "Money to loan!" You should use extreme caution here. Have your lawyer read the fine print carefully so that you are both well aware of what you are agreeing to.

Hard money loans

One final source for private financing is known as the hard money loan. This is when third parties make loans on real estate as if they were a conventional lender. Most of these loans are made to borrowers, or on properties, that can't get financing in the conventional arena for one reason or another. It might be due to the buyer's poor credit, or it might be that the property is in disrepair, and the buyer is making the purchase as a rehab project. Whatever the reason, know that hard money loans are available for those deals that cannot get financed conventionally.

Be aware that this route will be more expensive than the conventional lending market when it comes to up-front fees and interest rates. These higher costs shouldn't prevent you from investing, though. Rather, it should just keep you on your toes when it comes to keeping your other expenses at a minimum. You see, financing is just a means to an end. If the hard money market is where you need to go to get money to invest so that you can create a fruitful future for yourself and your family, then by all means, go there.

If you do some looking around, you sometimes can find family or friends who would be willing to make you a loan on real estate. In fact, making a real estate loan to you could create a great win-win situation for both parties. For instance, if your friend is currently getting 5 or 6 percent interest in a savings account, you could offer her 10 or 11 percent to loan the money to you instead. In this scenario, everyone walks away happy; you get the money you need, and your friend gets an investment that pays a much higher rate than she can get anywhere else.

And most important

Remember that financing is just a tool used to acquire the property that best fits your investment-plan goals. Don't get caught up in the emotion of the points or the margin being too high and then miss out on an opportunity to acquire a property that is perfect for your plan. Likewise, by carefully investigating the underlying financing of all properties under consideration, you might find one with exceptional assumable financing that makes it a better investment than another property with a lower price.

Just the facts

- The federal government has a number of programs that allow you to get into an investment and a home with a minimal down payment.
- Residential loans for one to four units come in all shapes and sizes.
- Qualifying for a loan on one to four units from a conventional lender rests primarily on your personal credit worthiness.
- A lender's primary concern when lending on five units or more is how the property performs as a business.
- If you choose an adjustable loan, the best way to maintain a steady cash flow is with the neg-am ARM.
- The beauty behind private-party financing is that it allows buyers and sellers to negotiate all the terms of the deal.

PART III

Mastering the Market

GET THE SCOOP ON...

The global economy and how it impacts real estate ■ Regional trends that affect value ■ How to find your target market ■ Methods of gathering value appreciation data

Real Estate, the Economy, and Your Target Market

By the time you finish this guide, you hopefully will have all the tools at your disposal to make an educated decision about what, where, when, why, and how to buy real estate. Ultimately, you will choose from a limited number of available buildings in a specific target market. Before you do that, however, it is important for you to understand how those few properties fit into the global market of which we are all a part.

In an effort to accomplish this goal, we need to have a quick lesson in basic economics, specifically how the economy affects real estate. By understanding some basic economic principles and how they can affect you, you can either take action and profit from market swings or, if bad times are ahead, be able to take preventative action and ward them off. From there, we'll talk about economic trends closer to home. This is because regional trends directly affect the market in the area in which you are trying

to make a profit. Finally, we'll conclude by teaching you a methodology that you can use to become an expert in your own target market.

The big picture

Most investment strategies are based on a study of past and present trends and benefits. The idea is to examine what has happened in the past to gauge what might happen in the future. In economics class, we learned about business cycles and the fact that real estate is a cyclical industry. That is, it responds to the overall cycles of our economy. When the economy is moving, so is real estate. When things slow down, real estate does, too. Even in a struggling economy, however, the clever individual can make a profit. This is because our product is a basic necessity of life; everyone needs a place to live.

A closer look at the economy as a whole will show you the dominating influence of real estate. It's easy to see how the buying, selling, and renting of property has a general impact on the

“A cellular phone company was looking for locations for cell sites. I gave them the use of my roof, and they've decided to supplement my income for the next 30 years.”

—Jay T., commercial property owner

economy, but this impact goes much further. Take the savings and loan industry, for instance. This industry is built around lending money to finance every aspect of real estate including its purchase and remodeling. Think of the revenue generated from all the goods and services that go into

keeping all this real estate functional and looking good. Finally, consider all the money spent on property insurance and construction. As you add up all these dollars, the figure becomes staggering.

Real estate is such a powerful storehouse of economic wealth that we literally have built our local city governments

around its value. For starters, real estate is the tax basis for most local governments. The money generated provides funding for fire and police protection, education, health and social services, and most of the other services cities provide. This value enables cities to raise the capital they need to function. In fact, some of the greatest advances in local communities come when civic leaders take over a blighted area through the condemnation process or a redevelopment district. They then can use municipal bonds and various incentives to turn these blighted areas into the crowning jewels of the community.

To make a long story short, real estate is probably the largest single segment of wealth in our nation. It has been estimated that two-thirds of the wealth of our country is composed of land, what's under that land, or what's built on top of that land. We even see the airspace above the land in some highly developed areas being sold as a separate commodity. It is this wealth that attracts investors to real estate.

Regional economic trends

To understand real estate as a vehicle to making a profit, you need to remember that the profit is made when we as consumers get together and utilize that product. Therefore, real estate functions more as a consumer product than as the capital asset it really is. It is a storehouse for wealth on our balance sheet, but we make the maximum profit by recognizing the consumer's needs and desires for it.

Take an apartment in Bakersfield, California, for example. There, a one-bedroom unit might rent for \$300 per month. The same size unit in Malibu, California, could rent for \$1,900 per month. How can this be if the units are exactly alike? The answer is simple enough—because one location is more desirable than the other. In fact, the value is really set by the people who buy or rent the property. The more they want a scarce product, the higher the price will usually go. It's really like an auction when it comes right down to it. As you know, the real

value is in the land. If consumers don't want to be there, however, land can be virtually worthless.

The market for real estate is the process in which we as consumers get together to buy, sell, and rent property. It is this market functioning within the economy in general that establishes value and trends. The following list covers some of the major factors that can impact values:

- The supply and value of money
- Occupancy levels (supply and demand)
- Rental rates and controls
- Employment levels
- Population growth and family formations
- Building activity
- Perceptions of the future
- Government regulations

Let's examine these factors one at a time.

The supply and value of money

We buy real estate for one of two reasons. The first reason is to provide a roof over our heads or to house a business. The second reason is as an investment to make a profit. The supply and cost of money isn't as important in the first case because, when purchasing a home, your foremost concern becomes what kind of lifestyle it provides. Most people's attitude is as long as they can afford it, they will buy it. If it goes up in value, that's great, but their life won't depend on how their home appreciates. The same holds true for a business looking for a location.

As an investor, however, the supply and cost of money does matter. This is because trends in the money market can either make or break your investment. The variables to consider are

- The supply of money to finance investment property
- The cost of borrowing (rates and fees)

- The percentage that can be borrowed (leverage)
- The length of time that the money can be borrowed (term)

These factors will have the greatest impact on your ability to make a profit. This is because an active money market for financing real estate usually goes hand in hand with a market in which you can earn some healthy profits catering to the consumers' desire for that product.

Occupancy levels, rental rates, employment levels, and population growth

The next four areas—occupancy rates, rental rates, employment levels, and population growth—all work together to impact the profitability of most real estate investments. When you see these four indicators on the rise in your area, it is a signal that there will be some opportunities to profit from the increased demand.

Obviously, the best environment in which to invest is one with a steady increase in demand and a shrinking supply of land to satisfy that demand. Manhattan and Hong Kong are perfect examples; there, they demolish fairly new high-rise buildings to build even newer and higher buildings.

We can't all live in or afford to invest in these areas, but we can learn from their example. Growth in an area with a lot of undeveloped land will minimize the increase in value for the existing properties. This is because, as the population increases, developers will build new buildings on the available raw land to satisfy the increased demand. These properties will be brand new and will have the latest styles and amenities. Human nature being what it is, this attracts the buyers who have the money.



Bright Idea

You can track most of these statistics through your local chamber of commerce or the business development department of your city.

These people usually are new residents brought into the market by new jobs.

We are talking about real growth brought on by new jobs that require an increase in population to fill the positions. In areas where unemployment is higher than the national average, jobs can be created that will have little or no impact on real estate values or rental rates. In these areas, real estate can increase in value, but this usually just reflects the impact of inflation rather than true growth.

Building activity

When there is an increase in building activity, it should have a direct impact on the value of existing properties. The amount of the increase usually depends on the amount of vacant land available. In areas with plenty of land available, builders usually can supply the demand for housing easily.

In areas that are more fully developed, however, it becomes tougher to satisfy the demand for new housing. Old homes need to be demolished to build new ones. Therefore, there is some upward movement in the price of the existing product. This is the cost-push increase, and it is similar to the increase from inflation. The biggest increases come from demand pulling the prices up. The consumers bid up the price because they want the product and supply is limited. This is the same thing that drives up prices at auctions for paintings and other commodities in limited supply.

The one instance in which this growth can be impacted in a negative sense even in a growth environment is when some kind of price control is put into effect. This usually is in the form of rent control. Make no bones about it; rent control can have a disastrous effect on your ability to generate a profit or to sell a property. In truth, it takes a very sophisticated investor to be able to generate a profit in areas with rent control. We're not saying avoid investing in such areas all together. Rather, just make sure you do your homework beforehand so that you know what you will be up against.



Watch Out!

Beware of investing in areas that are governed by rent control. Unless there is some allowance for rental increases when existing tenants move out, these areas prove to be hard ones in which to turn a profit.

Perception of the future

Another factor that can influence value is the perception that people have about the future. This involves emotions and gut feelings based on what has happened in the past. Perceptions are not always accurate, but they usually get lots of play in the press. Once the media gets an idea in its head and begins to publicize it, people tend to fall right in line and agree.

Understanding that popular opinion is not always accurate can be very profitable for smart investors. It's one thing to make a good buy when the economy isn't doing well. It's even better to make that same buy when the economy is improving but when sellers have yet to figure that out. The important thing to understand is that you must not be swayed by public opinion. Look for the facts and then make your decisions accordingly; you can wave to the masses in your rearview mirror.

Government regulations

It's important to be aware of the fact that the regulations local and state governments place on property can have an effect on property value. Fortunately, most of the changes are for the good in the long run. As you explore purchasing your property, be sure to pay attention to any recent or planned changes that may affect your property or the area close by.

Down-zoning is an example of what many cities do to hold down growth in the community. A piece of property that might have been zoned for 8 units 10 or 20 years ago might only be approved for 3 or 4 units today. If you bought your property to build on and this happened, you may suffer a loss for awhile. But, for most income property investors, this won't affect your

property's value. Down-zoning encourages the construction of larger units with more amenities, which usually sell at a higher price. In actuality, this pulls values up and the land values just increase that much more.

A growth moratorium is the ultimate form of down-zoning. A government will enact a law that halts residential development. The need for this law is based on overcrowding of schools or a lack of resources, such as water or sewage treatment capabilities, because of too many new people in a community. The government halts development until it can study how to efficiently deal with the population influx. This creates a constraint on the supply of properties and should accelerate price appreciation. Redevelopment usually brings many changes to zoning and usage of property. Over time it can make huge changes in values, but since it requires so much government involvement, the impact on value can take a long time. Be careful if you are in a redevelopment area that isn't completely settled. The uncertainty may scare away future buyers of your property and might make it tougher to get any loans you may need.

It's important to note that laws and rules effecting how property is built are constantly being changed. Many newer properties become "legal non-conforming" just a few years after they are completed. This is because building codes change at such a rapid rate. If that's the case, just think of how many codes that 50-year-old building you are thinking about buying violates. Don't worry. In the vast majority of cases you don't have to concern yourself with these non-conforming issues. Code changes are rarely retroactive, and those that are usually cover critical health and safety related issues. A good example would be the retroactive requirement to have working smoke alarms in all rental units.

Your target market

Regardless of the size of your community, it probably will have some definite neighborhood divisions. As is true in most places, there will be upscale sections, working class sections, and sections

that are on “the other side of the tracks.” You will need to look at all these areas before you make a final decision about which one offers the best opportunities to make a profit. As you zero in on this section choice, the following checklist will give you some factors to consider:

- Neighborhoods growing or declining
- Criminal activity and trends
- Current supply and demand for housing
- Adverse infrastructure changes
- Positive infrastructure changes
- Economic deterioration of the commercial districts
- Changes in local ordinances that affect real estate

Let’s now touch on each of these factors one at a time.

Analyzing the neighborhood

A class in economic geography would show that an evolution takes place in all cities. We learn how they are founded, how cities expand over the years, how they deteriorate, and then how they’re rebuilt through the redevelopment process. Even stagnant communities seem to go through these phases, although they might be harder to detect because the changes lack the momentum of the demand push from new residents. As an investor, what you want to do is make sure you are on the correct side of the growth curve.

“I found out a lot about the various neighborhoods I was interested in by just talking to the property owners as I surveyed rental rates.”

—Marianne C., investor

Criminal activity and trends

Local crime statistics can be a good indicator of what is happening in neighborhoods. Many communities publish crime statistics, and gathering this kind of historical data can be really

helpful. Your goal would be to see if you can spot trends rather than to find out about the specific kinds of crimes. Obviously, you will shy away from areas that have severe drug or gang-related problems.

Supply and demand for housing

Local neighborhoods all have their own mix of residential and commercial real estate. There also will be a certain percentage of owner-occupied properties as well as rental properties. Analyzing how much there is of each will dictate what kind of opportunities you will find to profit as an investor. Later in this chapter, we will discuss the actual statistics that help determine which areas offer the best opportunity for you to make money.

Adverse infrastructure changes

The city itself might have a negative impact on some neighborhoods with changes in ordinances or adverse infrastructure changes. We've all heard the story about the small motel that went out of business because the highway was moved. This is the kind of change we're talking about. A trip to city hall will let you know what kind of major capital expenditures are in the works. The most common city projects with adverse effects seem to involve work on streets and highways.

Positive infrastructure changes

You should also be on the lookout for positive infrastructure changes. For example, a new zoo, a federal building, or some other major attraction could improve the neighborhood because of new jobs or other commercial activity that follows. In Denver, for instance, the building of Coors Field in the middle of an empty, drug-ridden war zone resulted in a positive explosion of commercial and residential redevelopment.

Economic deterioration of commercial districts

Most communities have several levels of commercial districts. We'll call them the "A," "B," "C," and "T" districts.

- **The “A” district:** This is the new district with the mall or the freestanding mega-retailers.
- **The “B” district:** This is the area that used to be the “A” area but couldn’t keep up because it lacked the space to handle the larger shops.
- **The “C” district:** These areas serve as neighborhood business strips. They have the “mom and pop” shops and all the other smaller offices and retailers. You will see accountants, beauty shops, doctor and dental offices, and all the service businesses such as tune-up centers, tire stores, fast-food restaurants, and computer stores. These kinds of small operations thrive on serving the local community.
- **The “T” district:** “T” districts are commercial or small industrial areas that have deteriorated and are now in transition. Usually they are the old downtown commercial or manufacturing areas and can be easily spotted because they often have many “For Rent” and “Vacancy” signs around. These areas have deteriorated because the economic growth has moved to the suburbs. The transition and rejuvenation happens as developers and young professionals rediscover them. Old office buildings are turned into retail with offices and residences above, and old warehouses become live/work lofts.

Savvy investors can find opportunities in these areas by following the trends where other investors and developers are buying and fixing up formerly deteriorating properties. Many investors see huge potential gains in these transition areas. It’s important to understand that these



Watch Out!

Be careful when you see “C” districts deteriorating. This usually is a good sign that the residents who have money to spend are going elsewhere. In addition, it’s often the first step before they relocate their residence.

changes can take many years even if the city's powers that be are talking about the changes happening soon. If these kinds of sweeping changes happen to get started just as the economy slows, it can take many years for any significant impact on value to actually occur.

Changes in local ordinances that affect real estate

Most cities have master plans for how they see the city developing. Many times, these master plans can include sweeping changes to certain areas to accomplish the projected needs of the community as a whole. That new "A" business district no doubt was in the planning stages for many years. These kinds of changes can offer an opportunity to make a profit if you learn about them early on.

Learning about city planning in advance also can save you from making costly mistakes. An apartment building on the edge of a redevelopment area, for example, might suffer through years of waiting for the boarded-up buildings and vacant lots to be replaced by the proposed new shopping mall. This is especially true where public funds are involved. Announced projects are often delayed for years. In Brooklyn, a major development project was announced around the rebuilding of a train station. Ten years have passed and private investors have since opened a mall and new housing has been built, but the promised train station remains a weed-strewn empty lot. The result is that private investors have not been able to realize the profits they had hoped for.



Watch Out!

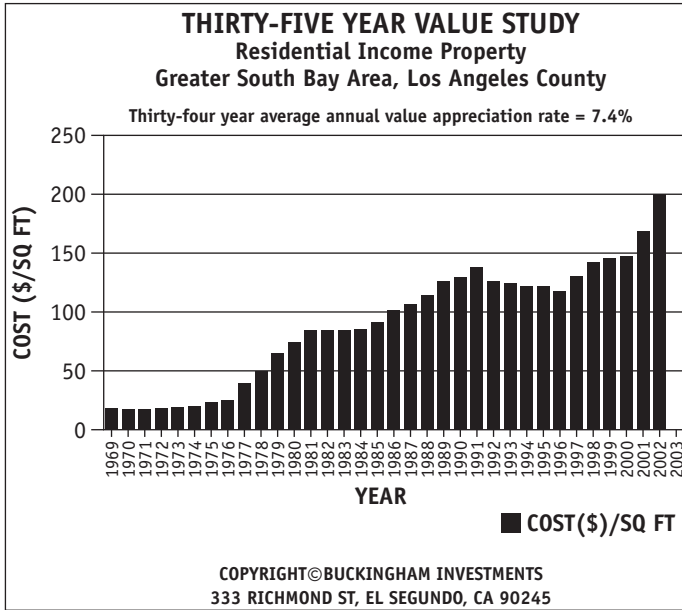
A trip to city hall and the planning department can give you an update as to what kinds of changes are in the works for your city. But be wary. Projects are often announced, commenced, then stalled indefinitely or even abandoned. Public projects are notorious for delays; private ones may go bankrupt.

Researching local markets

In addition to economic cycles and local trends and changes, it's important to look at historic appreciation in specific areas to help determine your best target market. As noted earlier, real estate is a cyclical commodity. It responds to the ups and downs in the global economy and to things that affect the local economy. There is no guarantee that history will repeat itself, but knowledge of how your local area has responded in the past is a more reliable forecasting tool than pure guesswork. Without something to base future projection on, it's tough to make a long-term plan of where you are going with your investments.

Take a look at the chart on the accompanying page. It shows value appreciation as seen in the greater South Bay area of Los Angeles covering the last 30 plus years. Notice that value is expressed as a price per square foot of living area. We showed the price-per-square-foot chart because the trend in price from this information enables us to calculate the yearly increase in value over the entire period. Note the 7.4 percent average appreciation rate shown at the top of the chart. This is the interest rate used in the compound interest formula (i) to estimate your rate of return over an extended period of time. (See the section on "Determining your general plan" in Chapter 9, "Building an Investment Plan.")

As you can see, the increase in value was not constant over the last 30 plus years. Looking at the chart, if you had done your projecting based on the data from just 1977–1981, you would have gotten pretty excited about investing because the market kept getting better and better. If you only had data for 1991–1996, you might have decided never to invest at all because we were in a downswing. As you can see, the market has started moving upward again. The lesson is to make sure you get plenty of years of data because that is the only way to determine a true appreciation rate for any given area.



You might find that it can be pretty difficult to gather this type of information, especially if you're looking for income-producing property alone, rather than at single-family homes. If you are fortunate enough to find an expert agent who specializes in income property in your area, he might have saved the kind of data you need. If not, you will need to do some research on your own to get some sense of the trend in property values. This is vital in projecting the long-term growth of your investments. The following list covers the data you should look for:



Bright Idea

Recruit a local librarian to help you research values in your area. Most libraries have great databases, and the librarians probably would be happy to help.

■ **Price per square foot:**

$$\frac{\text{Sale price of the property}}{\text{Square feet of living space}} = \$/\text{sq. ft.}$$

■ **Gross rent multiplier:**

$$\frac{\text{Sale price of the property}}{\text{Gross income of the property}} = \text{G.R.M.}$$

■ **Price per unit:**

$$\frac{\text{Sale price of the property}}{\text{Number of units in the building}} = \$/\text{unit}$$

■ **Rental rate:**

$$\frac{\text{Total rent per month}}{\text{Square feet of living space}} = \text{Rent}/\text{sq. ft.}$$

In the event that you are not able to find data for income property sales, you can use sales information for single-family homes to give you some indication of the trends. Many realty offices save sales data to assist in estimating the sales prices for listings and sales they make. If not, it's time to do some detective work. The information is out there; you just have to find it. The following are three good sources that can help you find this information:

1. Tax assessor's records
2. Appraisal services and title companies
3. Newspaper ads

Let's see how these sources can be used to help us gather the information needed.



Bright Idea

As the use of the Internet increases, more sources are available to track comparable sales (as well as any other data you may require). If you're computer savvy, go online and give it a try.

Tax assessor's records

Your local assessor's office should have records of the property values for many years in the past. The problem with the assessor's data is that the assessed valuation does not always reflect the actual fair market value of the property in the area. Some of these valuations are so old, or are based on original valuations done sometimes 50 or more years ago, that they occupy the realm of fantasy. The truth is that it is impossible for these departments to appraise all properties every year, so the valuations are based on current data combined with any historical data they might already have.

When using the tax assessor's records, it's important to choose a section of property that hasn't changed much for many years. A large tract of homes, for example, would be a good place to start. Then you need to check valuation changes in that area back as many years as you want your study to cover. Once you do this, it should show you a trend in the valuation of property in that area.

Appraisal services and title companies

Most appraisal services and title companies keep large databases for comparable sales of property. By contacting their customer service departments, you might be able to find one that would let you look through files of buildings that have changed hands. Some companies, however, use outside services to gather this kind of information. If they do, ask them who they use and then contact the service yourself. It might cost you something, but in



Bright Idea

If you are struggling to get someone to help you, contact a title representative that works at one of the local title companies. Tell her that if she helps you gather the data you need now, you'll give her your title business on the building you buy when it comes time for you to make a purchase. For a commissioned employee like a title representative, the idea of having a deal in the bank would probably be pretty attractive.



Bright Idea

It isn't necessary to look at every paper for every month of the year. Ask your agent which months of the year seem to be the most active in your area. This usually is just after school is out because most people don't like to move their kids in the middle of the year.

the long run, having this understanding about the history of value for your target area will be well worth a small expense.

Newspaper ads

A third method of acquiring appreciation data requires spending some time in the archives of your local newspaper or library. As with the research at the assessor's office, you will want to pick a section of your community that hasn't had much physical change for the time period you are researching. The best choice would be a housing tract in which the houses are advertised using the name of the tract. As an example, in Hawthorne, California, the most popular housing tract in the city is called Holly Glen. In Holly Glen, there are only a couple of floor plans in the entire tract, and they each have 3 bedrooms and 1½ bathrooms.

When you find the ideal tract of homes, it's time to gather and crunch some numbers. Look at the "For Sale" ads in the Saturday and Sunday papers as far back as the year the tract was built. You should be able to get enough sales prices to get a good feeling about the average price in the tract. Because you know the average number of square feet in the homes in this tract, it will be easy to get the average price per square foot for that year. When your research is complete, you will have enough data to do an estimate of the appreciation rate.

We'll assume you have reviewed past newspaper ads and have identified a tract of homes as previously discussed. The following shows how you could lay out your chart.

Year	Price	Change in Dollars	Percentage Change	Average Change
1993	\$89,500			
1994	\$93,500	\$4,000	4.4%	4.40%
1995	\$98,500	\$5,000	5.3%	4.85%
1996	\$97,500	-\$1,000	-1.0%	2.90%
1997	\$95,000	-\$2,500	-2.5%	1.55%
1998	\$95,000	0	0	1.24%
1999	\$97,500	\$2,500	2.6%	1.46%
2000	\$101,500	\$4,000	4.1%	1.84%
2001	\$106,500	\$5,000	5.0%	2.24%
2002	\$113,000	\$6,500	6.1%	2.67%
2003	\$119,950	\$6,950	6.2%	3.02%

The percentage change can be calculated by dividing the change in dollars by the price the year before. For example, the dollar increase from 1993 to 1994 was \$4,000. The percentage change is $\$4,000 \div \$89,500 = 4.4$ percent.

The average change is calculated by dividing the percentage changes by the number of years of changes. For example, the average change from 1993 to 1995 is 4.4 percent + 5.3 percent + 2 = 4.85 percent. We divide by two because we have owned the property for only two full years, 1993 and 1994. The percentage change shown on the line for 1995 is the value at the start of the year.

While you are researching the house ads in the paper, make sure you also look for ads for small units. You may find some useful information about old rental rates and even unit prices for prior years. Your study might just show the impact on houses, but our experience has shown that most properties in a given economic area appreciate at about the same rate.



Bright Idea

Most new calculators and computers have programs that can do linear regression analysis. If you can learn to use those programs, you will be able to chart appreciation rates quickly and easily.

The “comfort zone”

At a minimum, you now have a reasonable idea of what is happening in your area. It's time to start narrowing down the geographic area and deciding on one or two areas in which you'd feel comfortable investing. Establishing this zone where you feel comfortable will be a combination of the economic cycles of the communities and your personal feelings about the areas.

The best way to pick areas is by doing a comparison of the financial returns of all the areas in which you could buy. Pick a property size, let's say a 4-unit, and find one for sale in each of the areas in which you could invest. Next, calculate the return on investment for each property. Use the same down payment and loan terms so that you get an apples-to-apples comparison.

Invariably, you will be drawn to some areas emotionally but won't be able to afford them. Other areas will have an exceptional return, but you wouldn't feel comfortable in them. In the end, you should find several areas that could work for you, and we'll call these your comfort zones. As you learn about financial planning in Chapter 9, you will use this comfort zone information and the other statistical facts you've accumulated to complete your investment plan.

Just the facts

- A clever investor always can make a profit because housing is a basic necessity of life.
- Understanding the economic principles of supply and demand will help you succeed as a real estate investor.

- Be wary of letting public opinion influence your investment choices.
- To make long-term projections for your investments, you need to chart value appreciation in your target market.
- Finding your comfort zone is the first step in long-term real estate planning.

GET THE SCOOP ON...

- Raw land and why it's a risky investment ■ The truth about condos and single-family homes ■
- The golden opportunities of small apartment buildings ■ The allure of larger rental properties ■
- How to make money by owning and renting out commercial space

Subdividing Your Options

Much of this guide is built around our sample four-unit apartment building. This allows us to demonstrate many of the concepts of real estate investing with an easy-to-understand example. There is more to this game, however, than just four-unit buildings. There's land for development, smaller and larger apartment buildings, condominiums, single-family homes, commercial strip malls, and industrial properties to name just a few.

Yet, many investors develop tunnel vision when they begin making money in real estate. If someone is doing well investing in small apartment buildings, the odds are good that they won't even consider buying homes or commercial centers. Maybe an owner of an office building hasn't had a vacancy in five years. Why should he sink his money into commercial strip malls when he's doing great as it is? The reason is that there are opportunities to make lots of

money investing in all kinds of property. To illustrate our point, in this chapter we'll give you a guided tour of the entire market so you can choose the venue that will produce the best return. Let's begin with the foundation of all real estate, land itself.

Land ho!

When you own real estate, it's important to recognize that it's the dirt that holds the real key to the ultimate value of your property. A beautiful house on the beach that goes up in value every year isn't appreciating because the 2×4 s that went into building it are worth more annually. It's appreciating because the demand for the location is increasing—the demand for the land. You will learn that the secret to making money on a land investment is being able to recognize an increase in demand and then being able to capitalize on your insight.

Here, we'll focus on three different types of land investments. The classic purchase is raw land that sits in the path of progress. The other two involve buying land in areas that already are developed. Once you know the principles behind these three, you will gain a basic understanding of the opportunities and pitfalls that exist in this market.

Raw land

When thinking about investing money into raw land, you need to consider a number of variables. First off, know that raw land is a capital-intensive investment. What's worse, besides starting with a big bank roll, you will have to be willing to wait a good long time before you see any financial return. Unfortunately, these facts are just the nature of the beast.



Bright Idea

The county planning office is a good place to start when considering a raw land investment. Ask them to help you plot out the business, industrial, and residential growth of the community over the past 30 years. Your map of the past should give you insight into plans for the future.

Many smart investors try to get ahead of the game by researching growth trends in certain areas and then rolling the dice and hoping their predictions come true. Sometimes they pan out; sometimes they don't. Here's a real-life example:

In California, the communities surrounding the Los Angeles airport had become so crowded that there was talk of building a new airport 100 miles away in the city of Palmdale. The thought was that this would take the pressure off the Los Angeles basin and would provide millions of affordable acres for new jobs and new homes. In the movie *Field of Dreams* it was said, "If you build it, they will come." In *Field of Dreams* it worked. Kevin Costner had a vision to build a baseball diamond in a cornfield. He built it, and the people came. In Palmdale, however, they never built it, but the investors came anyway. Many sunk their savings into raw land thinking they were going to get rich, but the project fizzled. Will Palmdale ever be the thriving center envisioned? Probably, but not in the lifetime of those who had the dream.

As you can see, investing in raw land is an inherently risky proposition. This is because a land investment

- Often has enormous up-front costs including the cost of the land, sewers, utilities, roads, plans, permits, engineering, and so on
- Is extremely difficult to get financed
- Pays you no income at the beginning
- Might be highly taxed
- Usually is very slow to rise in value
- Might come with legal barriers to hurdle
- Is highly speculative
- Is subject to the whims of local politicians

This isn't to say, however, that you can't make money here, because you can. If you are in an area of rapid growth, have the money to risk, and see raw land as a potential winner, you should

- Do an in-depth analysis of growth trends, the speed of growth, and the direction of growth
- Determine which uses grow fastest in your area: commercial, residential, or industrial properties
- Attend planning meetings
- Obtain utility expansion plans
- Review historic examples of similar growth

Once this analysis is completed, you should have a pretty strong idea about whether raw land is an area of real estate where you want to sink your money.

In-fill opportunities

An "in-fill" project is another type of land investment. It involves buying a vacant lot surrounded by existing buildings of one type or another. The idea is to buy the lot, build something useful on it, and then sell it off for a profit. Compared to a raw land investment, these projects have considerably less risk for the investor because these opportunities are found in areas that already are developed.

In many cases, an owner has held a vacant lot next to his home or business for as long as he can remember. His original idea was to keep it just in case he needed it in order to expand. Now he is getting ready to retire and he realizes that he really doesn't need the property at all and, therefore, he decides to sell. This is where you come in.

Remember that, when buying this kind of lot, you need to do the same kind of research you would do if you were buying raw land. Check with the city and utility companies to see what can be built on the site. It would be disastrous to buy a lot with the intent and resources to build a small apartment building only to find out it is zoned for a parking lot only.

One important issue that comes up when doing an in-fill deal is determining whether there are any pollutants in the soil. As the developer of vacant land, this concern is now your problem. Think back to all the old gas stations and “mom-and-pop” manufacturing sites that may have closed near your property’s location. If one of those types of businesses was located on your lot, and if it left any pollutants behind, which is very common, you are the one who is legally required to clean it up. Most cities require developers to do extensive environmental testing. These tests always are expensive, and if any problems are found, the cost of removal can be staggering.

As real estate investors ourselves, we developed many apartment and commercial projects in the late 1980s. One time, while doing the foundation excavation for an apartment building, we found concrete and asphalt mixed in with the soil that filled the rear of the lot. The city could care less that the problem wasn’t toxic. They still forced us to excavate the entire rear portion of the lot, remove the concrete and asphalt, and then recompact the soil. This was because the dirt wasn’t natural. Instead, it was fill-dirt and was not compacted properly. The concern was that it would cause settling problems after the foundation was built. Because the integrity of the entire structure rests on the foundation, the process had to be observed and regulated by an expensive licensed soils engineer. This unexpected problem cost us all the money we had in reserve and then some.

Redevelopment opportunities

The last type of land investment we’ll touch on is called a redevelopment opportunity. This is when a piece of property is worth more for the value of the land itself than for the value of the land plus the existing structure that sits on it. In this situation, you are not looking for vacant land to build on as you did with the in-fill project. Instead, you are looking for a bargain property that should (and will) be torn down eventually. Like an



Moneysaver

Find an architect who is willing work for a percentage of the profit when your project is completed. He'll get paid on the back end, and you will save cash on the front end.

in-fill, however, once you have an empty dirt lot, the goal is to build something useful on it and then sell it off for a profit.

When doing a project like this, the rewards for the developer can be hefty. As an example, let's say you found an older two-bedroom house on a 50×150 R-3 (multi-unit) lot. The house can be had for \$60,000, and after checking, you determine that R-3 land in that area is going for \$10 per square foot. Here is how a redevelopment deal could yield a profit even before you build on it:

Value of land ($50 \times 150 \times \$10$ per sq. ft.)	\$75,000
Cost of the house	-\$60,000
<hr/>	
Potential profit before building	\$15,000

One great thing about redevelopment deals is that the structure sitting on the lot might already be producing income when you purchase it. This is especially helpful if the market for land isn't too strong when you initially find the property. You still can take advantage of the opportunity by buying the lot and then renting out the structure until the market improves. This way, you avoid the high cost of holding undeveloped land while you wait for the appreciation. In addition, you could begin the development process with the city and be able to have a turn-key project to do on your own or to sell to a builder when the time is right.

Condominiums

For many people, condos provide a pretty nice home. They're affordable, often have great floor plans, and include amenities like pools, gyms, and saunas that are just too expensive to obtain in a single-family home. But, truth be told, as far as a real

estate investment goes, you can do better putting your money in other places.

Here's why: The trouble with condos is that you are handcuffed by the condo association in terms of what can be done to the property to increase its value. As a real estate investor, you must always ask yourself, "How can I add value to any property I purchase to make it worth more when I sell?" The idea is to buy a property for X, find ways to add value to it, and then eventually sell it for Y. With condominium ownership, however, most associations will not allow you to make any improvements at all to the outside of your unit. They want your unit to look like your neighbor's unit, which looks like his neighbor's unit, and so on. For that reason, any profit to be made buying condos is limited to

- Finding a bargain in the market (pre foreclosure, foreclosure, desperate seller)
- Appreciation in value over time
- Adding value by doing interior upgrades only

Most people don't buy condominiums to make a profit; they do it to buy their first home. This is pretty smart because, as you can see, there is very little profit to be made here, beyond value appreciation, especially when held up against other real estate opportunities.

On the other hand, if you're looking for a home plus an investment and can afford it, a single-family residence or a small set of units may be a better way to go.

Single-family homes

Most of us with real estate on our minds long to be the king of our own castles. That is, we want to be homeowners. Thankfully, purchasing single-family homes offers a great opportunity to get your feet wet investing in real estate and a chance to create some extra profit as well, provided you're willing to put a little added effort into the mix. Additions to consider in order to add value to your investment might include outdoor shutters,

upgraded landscaping, outdoor lighting, new paint, attractive fencing, interior upgrades, and so on.

All of these kinds of additions are possible with single-family homes because there's a great diversity in the properties that the typical single-family home area offers. Unlike condo tracts, there's hardly ever (except in planned communities) a requirement for a single-family home to look just like the neighbor's. With the shackles off, the opportunity to add value to your investment only stops with your imagination.

Knowledge is power

When deciding whether to buy single-family homes as an investment, begin, as always, by researching your local market. Start by identifying areas that have some diversity in the homes and that sell well. Look at potential purchases with an eye toward what could be done to add value to the home. A good rule of thumb is that the more conforming the area, the fewer opportunities to find a bargain. The typical conforming area is a housing tract that has hundreds of homes in it but only three or four different floor plans. You can make money here, but because there is so little variation, it limits the possibilities.

If you are looking to add some value to increase your profit, you should take a trip to city hall. You need to determine how difficult the permit requirements are. Obtaining permits can be easy and inexpensive or costly and time-consuming. Answers to these questions will tell you if buying single-family homes in this area would be worth pursuing or not.



Bright Idea

Check with the local buildings department to see whether there are any restrictions to improving your property due to zoning regulations. Wealthier communities often impose severe zoning restrictions. Historic districts undoubtedly will have restrictions as well.

When searching for a bargain in the single-family residence market, knowing the following information will help you spot homes that are underpriced:

- The seller's motivation for selling
- The amount of time on the market
- The price per square foot
- The price per bedroom
- The value of extra bathrooms
- The value of a family room or den
- The value of amenities (pool, deck, garage, hot tub)
- The premium for condition

You can find even more profit by using other facts from your research. In the following scenario, let's say you've found an older two-bedroom house that has about 1,300 square feet. Your research shows that most of the three-bedroom houses also are about 1,300 square feet, and they sell for about \$125 per square foot (1,300 square feet \times \$125 per square foot = a sales price of \$162,500). Here, the house you found could be bought for \$110,000 because it only has two bedrooms, it's older, and it needs carpet, paint, and window coverings.

The plan would be to buy this house for \$110,000. Give the place a well-deserved face-lift and redesign the interior to turn it into a desirable three-bedroom house. Let's say you have determined that this can be done with a minimum of expensive



Watch Out!

Be aware that many of the homes or units that you are considering will have termites or termite damage. If either is found, it should be up to the seller to have treatments done and make the necessary repairs or to adjust the sales price accordingly.

structural work because you would only have to move some walls and build a new closet. The budget would look like this:

Construction of bedroom	\$15,000
Floor covering	\$1,300
Interior paint	\$750
Window coverings	\$500
Exterior paint	\$2,000
Landscaping	\$750
<hr/>	
Total cost to improve	\$20,300

Now you would have a sharp, three-bedroom home that should sell for \$125 per square foot just like the other three-bedroom houses in the neighborhood. Your gross profit would look like this:

Value added price	\$162,500
Less original cost	-\$110,000
Less cost to improve	-\$20,300
<hr/>	
Gross profit	\$32,200

One of the extra bonuses of this type of investment is that you combine this purchase for profit with your desire to live in and own your own home. Many investors have started out exactly this way. They pick a house for the investment and profit value and also live in it as their personal residence during the interim. The main goal isn't the personal desires you might have for a home but the profit you can generate by purchasing a particular piece of property. The property just happens to also provide a temporary place for you to live.



Moneysaver

Before buying a house with the idea of rearranging the interior, have a licensed contractor make sure he can do the work without any major structural alterations.

Living in this kind of investment provides several advantages:

- You gain an investment and a residence in one shot.
- You become your own boss.
- When you sell it, the profit might become tax free if you meet certain criteria.

The first two advantages are obvious, but the last is a new twist because of current tax laws in effect. As of 1999, you can exclude the entire gain on the sale of your main residence under the following conditions:

1. Up to \$250,000, or
2. Up to \$500,000 if all of the following are true:
 - a. You are married and file a joint return for the year.
 - b. Either you or your spouse meets the ownership test.
 - c. Both you and your spouse meet the use test.
 - d. Neither you nor your spouse excluded gain from the sale of another home after May 6, 1997.

The IRS says you can claim the exclusion if

1. During the five-year period ending on the date of the sale, you have owned the home for at least two years (ownership test).
2. Have lived there as your main residence for at least two years (use test).

This is probably the greatest method of delivering tax-free wealth that the government has ever enacted. Think about it. This isn't a way of deferring your taxes; instead, you have absolutely no tax due whatsoever. What's more, Uncle Sam says that you can take advantage of this technique every two years. This can work for both beginning and experienced investors.

For people just starting out, the message is: When you buy a home, don't buy with the idea that you are going to live there forever. Instead, buy a property that will generate the greatest profit within the two years following your purchase. You might

want to consider a house in an up-and-coming location, a place with an extra lot that you can sell off separately, or even a classic fixer-upper—anything that will help create some sweat equity.

After you've lived there for two years, the idea is to sell it, take all that free profit, and start over again. This time, however, you might have made enough money from the sale to buy both a home and a piece of income property. Now think about your portfolio. It would include two great pieces of real estate—a home and, say, a small apartment building. If you're game, you could even do it again in two years.

The plan will work just as easily for people who already have substantial equity in their current residence. It can be particularly helpful to people nearing retirement. A person can make money using the same methods previously mentioned, but a significant portion of the capital gain could be put into cash reserves for his latter years.

A final word on this benefit: Our government uses these kinds of tax benefits to stimulate the economy. Other methods are used to slow the economy. Conventional wisdom says that, because this benefit is so huge, it probably won't be around very long. If you wait, you might be left mumbling, "If only I had . . ."

Single-family homes as rental properties

Single-family homes also can be purchased as rentals and, as such, can generate the same returns previously discussed in this book. There are pros and cons to owning single-family homes solely as rental investments. The primary advantage is that the management and expenses of renting a house should be minimal. Management will be easy because you only have one primary tenant to be concerned with. As for expenses, you should make the tenant be responsible for all of his own utilities and general maintenance. Of course, you have to pay for major items such as new roofs, property taxes, and broken water heaters, but the tenant should basically live in the house as though he owned it.

There also are some disadvantages to buying and then renting single-family homes. The biggest disadvantage is that the financial return on single-family residences in a given area is usually far less than the return on an apartment investment. Go back to our discussion earlier in this chapter about the value of the dirt under any property. Because the land holds a great percentage of the value of any property, the rent you earn is being paid not only for the structure but also for the land. This is the only reason why there's a difference in rental rates for homes in differing economic areas in the same city. People don't pay more for the house; they pay more for the location, which is the land. Location, location, location!

Let's say you have a four-unit building on a 7,500 square foot lot. You have four tenants paying rent on that lot. If you had one house on that same size lot, you would only be getting income from one person. It is true that one house will always rent for more than one apartment a quarter of its size, but it is doubtful that it would rent for more than four apartments put together. In our experience, it is a rare case that the premium for a single-family residence will give you the same return as an investment in apartments in the same area costing the same amount.

The second disadvantage is that, when you have a vacancy in a single-family home, your vacancy rate is 100 percent. In times of vacancy, that could be quite a big load to carry. However, if you own a positive cash flow four-unit apartment building, the cash flow from the other three units might be enough to still make the mortgage payment and pay for your other expenses.

“I own several single-family homes as rentals. On two different occasions, I had tenants skip out on the rent and leave me to pay my entire mortgage without any income coming in from the properties at all.”

—Jillian L., property owner

Vacation homes

A vacation property can provide an interesting mix of benefits. The primary advantage of buying a vacation home is to have a place to go with family and friends—a home away from home where you can relax and enjoy the surroundings.

Because these properties are purchased primarily for personal use, we hesitate to classify them as truly investment property. But, they do take on the characteristics of investment property for two reasons. First, many owners do rent their vacation homes out, and this can produce income. Second, if these properties are purchased with the intent to sell some day at a profit, they qualify for the benefits of a 1031 exchange.

Many owners offset the cost of ownership by renting out their vacation homes when they can't use them themselves. The tax laws say that if personal use of the property exceeds the greater of 14 days or 10 percent of the total days rented, you cannot take depreciation to help shelter any income earned. This means that this income is taxable just like any other portfolio income we may have. The good news is that the expenses, interest, and taxes may be written off subject to the first and second home limitations.

As far as a 1031 tax-deferred exchange goes, a vacation home qualifies for an exchange even if it isn't rented and is only used for personal enjoyment. The key factor is that it was purchased with the intent of selling some day for a profit when the family no longer wants to use it. The good news is that this means you can trade for another vacation home or any other property that qualifies as investment property, like an apartment building.

It's important to note that all the rules of doing an IRS 1031 exchange must be followed. We will be reviewing these rules in detail in Chapter 10, "Planning for the Tax Man," but for now remember to always have your particular situation reviewed by your CPA before you make any moves.

Two-to-four-unit properties

One step up from buying a condo or a house is purchasing a small apartment building. We will define small as a duplex, triplex, or fourplex. As you may have guessed, we favor residential apartment rentals as investments and believe that they represent the safest form of real estate investing. One reason is because, as you learned in Chapter 5, “Borrowing Big Bucks,” these properties fall into the residential loan category. For that reason, they’re easy to finance with low down-payment options, which make them affordable for most of us.

Secondly, and maybe more importantly, apartment investing is a winner because you are investing in one of the three basic commodities of life—shelter. Thankfully for all real estate investors, every human being on earth needs a place to call home. This is true whether the times are good or bad. A business, on the other hand, which may operate out of a strip mall, can always close up shop and function out of the owner’s garage if times get tough. The people who worked there will be out of a job, but those same people will still need a place to sleep at the end of the day.

The premise is this: By providing shelter, we, as real estate investors, should always be able to stay in business.

The privacy factor

As a property owner, your tenants should feel a sense of privacy when living in their units. If given a choice, most people would opt to live in a single-family house. Because houses rent at a



Bright Idea!

Regardless of what we believe is the best real estate to buy, you can’t make any profit unless you do buy some property. In fact, “buying some” is the number-one secret to making a profit in real estate. If you can’t buy a four-unit apartment building, buy a duplex. If you can’t get a duplex, buy a house or condo. But above all, buy some and get started!

premium, however, most renters can't afford them. The next best thing for them is to pay a premium for a nice apartment that has the feeling of a single-family home. The best way to create that single-family feel is to find properties that have separate units on the lot. Even if fences do not separate the units, these kinds of apartments give the tenants more privacy than, say, three or four units that share common walls between them. As a general rule, the more private you can make the rentals, the less the tenants will call and ask for you to provide extra upgrades to their units. This is because privacy makes the tenants look at the unit as their home as opposed to a temporary residence. In addition, if you can add fences to separate the units, you can save on gardening costs as you make each tenant responsible for his own yard. You will see both of these benefits on the bottom line because your overall expenses will be kept at a minimum.

One lone building

The next best thing to completely separate units is to buy a building that sits on just one level. These properties don't have the inherent noise problems that come with tenants living over one another. Many of these situations offer the opportunity to fence off a private area for each tenant behind or in front of each unit. Again, this gives some private open space, and it should save on gardening costs.

Two + two

If you're not able to find these single-family-style properties, you will have to look for standard apartment-style buildings. Basic apartment buildings are usually two stories with a couple of units downstairs and a couple more upstairs. A parking area usually is either attached or separated, depending on the size of the lot. Although these buildings often do not have the same appeal of the other style properties, don't worry. There will always be a tenant available for a nice unit.

In many older urban areas you have two-family (“Philadelphia” style) houses and three-deckers. You also often find formerly single-family residences split into two to four units. The feel of these residences is somewhere between a single-family house and an apartment building. With growing gentrification, as in New York or Boston, some older neighborhoods with this type of housing could be a wise investment

Finding properties

One of the keys to finding the right two-to-four-unit property is to survey the market and get a feeling for the kind of style and amenities that seem to command the highest rent per square foot. Your goal then will be to acquire that type of property or one that can be converted at a minimum cost.

In finding the right property, it’s important to pay particular attention to your potential expenses. If possible, look for units that have all the utilities metered separately. This way, the tenants will pay the utility bills instead of you. Also look for units that have individual laundry hookups versus common laundry rooms. Again, this means that they pay for their gas and electricity, not you. Tenants also should supply their own appliances. Not having to purchase and maintain refrigerators and stoves will save you a lot of money over the years. From a practical standpoint, the bigger the items your tenant has to move in, the less likely he is to move out.

You will be restricted based on what tenants in the area expect when they rent. If you find that you will have to provide most of the appliances to keep up with the competition, make

“I bought a four-unit row house in Boston in the ‘80s, converted it to condos and sold them for triple my investment (purchase plus improvements). Twelve years later, the units were selling for 100 percent more than I sold them for.”

—Matthew K., investor.

sure you become an expert on the secondhand market and local repair services. This will help you keep costs under control.

Five units and up

When you graduate to the five-unit and larger category, you have moved into the arena of commercial loans and the economy of scale that comes from more units per square foot. The first time you start looking at these properties, this discount usually becomes quite apparent. Again, this is primarily because there is a limited availability of financing for these size properties versus single-family residences and two-to-four-unit buildings.

With five-unit buildings, specifically, there is a good method of creating some added value. Surprisingly enough, it is not by adding bedrooms like we did with the single-family example earlier. Instead, you can add value by turning a five-unit building into a four-unit building. In doing so, you turn a property that required a commercial loan into one that only requires a buyer to obtain a residential loan.

Let's say you find a five-unit building in the same neighborhood as our four-unit example. The four-unit is worth \$220,000, and we can buy this five-unit for \$175,000. (This kind of discount for bigger, harder-to-finance buildings is not uncommon. Once you start to research the market, you will see it to be true.) The four-unit is made up of all two-bedroom units. The five-unit has three two-bedroom units and two one-bedroom units. If the layout of the one-bedroom units is such that they are located right next to each other, you probably can take out a couple of walls and combine them into one really nice two-or-three-bedroom unit. All of a sudden, you have turned your hard-to-finance (and hard-to-sell) five-unit building into an easy-to-finance (and easy-to-sell) four-unit building.

Surprisingly, it's relatively easy to get a conversion like this through city bureaucracy because you are down-zoning the

property, which is a preferred situation to creating more units. You are decreasing the density and increasing the parking on your property, which most cities like.

Of course you will have to do diligent research before you attempt this kind of project. You need to know in advance specifically what kind of permits and costs will be involved. If you find that the city is going to require extensive drawings or engineering work before they issue permits, make sure your contractor and architect are in the loop. Their expert opinion will help you to determine whether the project will be worth the expense.

Big apartment buildings

When you become really successful at this game and begin to buy great big apartment buildings with multiple units, your decision-making becomes entirely dependent on the analysis of the financial operations of the property. The good news is that when you get into this range of properties there are usually plenty of loans available. Know, however, that when it comes to commercial loans like these, you are going to have to come up with a great deal of cash for a down payment. With these purchases, lenders usually require you to come up with upwards of 25–35 percent of the purchase price. Just to illustrate what you'll be up against, 25 percent on a \$2,000,000 piece of property comes to \$500,000 down.

Tenants who rent in larger properties tend to be looking for a different environment than tenants who like the privacy of



Moneysaver

When buying big apartment buildings, always be on the lookout for any available owner financing. If you can find some, it often can considerably increase your leverage and, thereby, your percentage return on your investment.

smaller two-to-four-unit properties. These tenants have similar thinking to people who want to buy and live in large condo developments. They want the luxury of pools, workout rooms, and clubhouses, but they can't afford or don't want the hassle of paying for or taking care of these amenities themselves. Items that attract tenants to larger apartment complexes include

- An attractive appearance from the street (curb appeal)
- Well-maintained common areas
- A security entrance system
- A secure parking area
- Recreational amenities (pools, jacuzzis, saunas, barbecues, tennis courts, a clubhouse, and so on)
- Laundry rooms
- Large square footage apartments
- Appliances
- Multiple bathrooms
- Walk-in closets
- A private balcony or patio area
- Air-conditioning
- Upscale amenities (wet bar, fireplace, and so on)
- Cable or satellite television services

Note that it is not unusual for tenants in larger properties to move a bit more frequently than those who rent in smaller properties. By maintaining a high degree of pride-of-ownership, you will make it harder for tenants to justify moving for purely emotional reasons.

As you move into progressively larger properties, you will be leaving the “mom-and-pop” phase of real estate investing and entering the “just business” phase. The properties produce good cash-on-cash income, but they need the kind of organized



Bright Idea

Unless you have the confidence and experience to manage a large apartment building yourself, you should hire a property management company before you buy. Make sure you take a company representative with you to look at each and every property you are considering. The representative will provide insight about things that you never even considered.

management that any larger business would need. The principles we will be discussing in Chapters 13–15 will be most applicable to these size properties.

Commercial and industrial properties

Commercial and industrial properties can be a great investment vehicle for you to consider. This is because, like residential tenants, businesses also need a roof over their heads and will pay good money for just the right place to hang their shingle. In fact, you should think of these properties as a “home for a business.”

Commercial and industrial properties fall into many categories including

- Freestanding stores
- Small strip malls
- Office buildings
- Mobile home parks
- Mixed-use commercial and residential
- Parking lots
- Garages
- Multistory office buildings
- Specialty commercial (restaurants, gas stations, and so on)
- Small factories
- Larger industrial buildings

Partner up

When you rent commercial or industrial space to a tenant, you really are becoming a partner in their business. If they do well in your location, the odds are good that they will continue to be a tenant and will continually be able to afford your rent.

The fact of the matter is, however, most new businesses fail in the first year or two of operation. If one of your long-term tenants fails, your real estate investment could be in serious trouble. For this reason, you should personally interview all the tenants in any commercial property you consider purchasing. You need to find out the following information:

- The length of time the owners have been in business
- The credit rating of the owners and the business
- Why they left their last location
- Why they chose this location
- The goals of their business
- The type and term of lease they desire

Be especially wary of a property in which most of the leases are coming up for renewal. Many clever sellers have unloaded a prize building with a great long-term tenant because they got wind that the tenant was going to be moving on. You don't want to get stuck owning a great strip mall without any tenants.

Types of leases

The foundation of most commercial properties is the lease as opposed to the month-to-month agreement used in residential property. Having long-term leases with successful tenants/businesses is one of the greatest advantages of owning a commercial property—provided your lease is structured properly. Therefore, it is imperative that you hire a real estate lawyer to help you handle these kinds of transactions.

Generally speaking, leases fall into two categories:

1. Gross leases
2. Triple net leases

The difference in the two depends on whether the property owner or the tenant is going to pay the bills. In a gross lease, the tenant pays the rent, and the property owner pays all the expenses of operation except the tenant's utilities. In a triple net lease, the tenant pays for everything including the rent, the taxes, the insurance, the utilities, and most of the maintenance of the property. In some retail leases, the tenant even pays a percentage of their sales as part of their rent.

Commercial and industrial properties have some distinct advantages and disadvantages when compared to residential purchases:

Advantages

- Long-term tenants
- Limited management
- Consistent return on investment
- Consistent value appreciation

Disadvantages

- Limited availability of tenants
- Limited availability of financing
- Significant holding costs between tenants

Niche markets

There are a couple of interesting trends in this type of real estate. The first is the niche market of providing small office and commercial space for new enterprises. One of the effects of the leaning of our new entrepreneurial economy in the late 1990s is the emergence of the displaced or energetic person who has an idea for how to make a better mousetrap. This started with more and more people working from home. When they outgrow their home office, these workers usually end up looking for a small space to rent where they can have a desk, a copy machine, and maybe a secretary instead of a house full of kids. What's more, young entrepreneurs are usually willing to pay a premium rent per square foot to house their new ventures.



Moneysaver

Many communities offer low-interest loans and redevelopment funds to help investors restore older historical properties.

The other phenomenon is the conversion of older commercial and industrial buildings into loft apartments or live/work spaces. This mirrors the trends in cities such as New York and San Francisco for a hip, open environment for young adults and trend-setting businesses. These older buildings sometimes can be purchased at a very low price per square foot. Then, with a minimum of improvements, they can be rented or sold at a fantastic profit. If the structures are of any historical significance, there are some very attractive tax benefits. In these cases as well as the other commercial/industrial properties, the secret to your success will be staying on top of the market so that you are not caught owning a white elephant.

Just the facts

- A real estate investment in raw land requires two things from you: money and patience.
- Adding value to a condo or a single-family home is the best way to get more out of that kind of investment.
- An investment in a single-family home will never bring you the same return as a unit investment on that same lot.
- Because of the great financing available, two- to four-unit buildings can be huge moneymakers.
- Big apartment buildings require huge down payments and intensive management.
- There are a lot of opportunities to make money by buying commercial and industrial properties.

GET THE SCOOP ON...

- Whether fixer-uppers are really for you ■
- Mismanaged properties and why they're an investor's dream ■
- The truth behind the foreclosure market ■
- Getting in on "short sales" ■
- Buying property with little or no money down

Tricks of the Trade

You've seen the ads on late-night TV—the “get rich quick” ads where the *nouveaux riches* testify to the glory of foreclosures, fixer-uppers, and no-money-down deals. Yep, those people sure look like they're living the high life. Perhaps they are, but probably because they made a bundle starring in infomercials rather than investing in real estate. The truth is there are several types of properties that present an opportunity to make an extra profit—that is, if you are an experienced investor with deep pockets. But, suggesting novice buyers go out and invest in these deals right out of the gate is like asking someone to jump off a high dive before they know how to swim. Nonetheless, people have made loads of money (and others have lost bundles) investing in these “sure things.” Here are the facts so that you can analyze those opportunities and make an educated decision.

The fixer-upper

The classic property that offers a chance for the investor to make an extra buck is the fixer-upper. A fixer-upper is a property that is in disrepair and needs money and TLC to bring it back to life. The idea, in theory, is to buy a fixer-upper, do any necessary repairs yourself, and then reap the rewards of an investment property purchased below market value. Countless books have been written about these types of investments, and countless people have invested in them only to discover that they are in over their head. To explain, let's look at a variation on our example property and see how fixer-uppers really pencil out.

The facts and the figures

We'll assume that 333 Richmond Street is an average fixer-upper. Here are some estimates for what the necessary repairs will cost:

Exterior

Exterior paint	\$2,500
Landscaping	\$500
Garage doors	\$800
Fence	\$750
Roof	\$3,000
<hr/>	
Total	\$7,550

Rehab Unit

Carpet	\$750
Interior paint	\$350
Misc.	\$75
Lost rent	\$550
<hr/>	
Total	\$1,725
<hr/>	
Grand total	\$9,275

If you recall, 333 Richmond Street was listed on the market for \$225,000, but we estimated the value to be \$222,500 using

the appraisal methods learned in Chapter 4, “Appraising Like an Appraiser.” In this instance, because the property needs some fixing up, we were able to negotiate a \$20,500 discount from the list price and bought it for \$205,000.

Let’s take a look at what this means in terms of our potential profit. The first logical assumption is that this fixer-upper will be worth the full \$222,500 as soon as we finish the work. Therefore, our estimated gross profit from the project will be

Finished value	\$222,500
Purchase price	-\$205,000
<hr/>	
Gross profit	\$17,500

In order to find the net profit, we deduct the cost of the necessary repairs from the estimated gross profit:

Gross profit	\$17,500
Less upgrade costs	-\$9,275
<hr/>	
Net profit	\$8,225

In order to determine the percentage return the first year, we then need to add the net profit to the estimated return for the first year of ownership, and then divide by our down payment and fix-up costs. To recap, remember that in the first year 333 Richmond Street had an estimated total return of \$13,419. We had \$1,080 from cash flow, \$300 in equity growth from loan reduction, \$11,000 in equity growth from appreciation, and \$1,039 in tax benefits (see Chapter 3, “Elements of Return”). After this bit of math, we can calculate our percentage return for the first year is as follows:

“I found a fixer-upper that sounded like a winner. The hitch was that the building was in truly terrible shape. After comparing the actual cost to the return, I saw that buying it and spending every dollar and weekend I had fixing it up wasn’t going to be worth my effort.”

—Valerie D., investor

$$\frac{\text{Returns } \$13,419 + \$8,225}{\text{Investment } \$30,000 + \$9,725} = 54.4\% \text{ return}$$

As you can see, a 54.4 percent return isn't half bad. But, remember, on the original nonfixer-upper example, as demonstrated in Chapter 3, we obtained a pretty good return the first year as well, of 44.7 percent. The question then becomes whether the higher return of 54.4 percent on the fixer-upper project was worth the extra time, extra money, and extra energy it took to achieve it? As your parents used to say, "We'll see." Let's keep analyzing:

When you look beyond the first year and examine the return in subsequent years of ownership, you will note that the percentage return on the investment begins to drop at a rapid clip. This is because the extra profit you gain in a fixer-upper is a one-shot increase in value that first year, which requires an additional cash investment over and above the original down payment. Keep in mind that in each subsequent year of ownership you will have to divide your annual returns by a much higher equity position. This will decrease your leverage, and thereby your return, significantly.

Let's illustrate: We'll make the assumption that the profit in the second year would be about the same as it was the first year. If so, look at what happens to our overall return because we now have the extra cash it took to fix up the building invested without any extra return the second year to offset it.

$$\frac{\text{Second year return } \$13,419}{\text{Investment } \$30,000 + \$9,275} = 34.2 \%$$

Yes, 34.2 percent in the second year is a sizeable decrease in percentage return from 54.4 percent the first year. Again, this is due to our increased equity position and no fix-up profit this year, which proportionately decreased our leverage.

Many other investors use a different strategy when investing in fixer-uppers. Mistakenly, they (like many before them) fail to



Bright Idea

Compile a notebook with the cost of basic property maintenance items as well as a list of work you have had done on your property. This will come in handy when a crisis arises and you need to know how much it will cost to fix it.

recognize that the real wealth from real estate investing comes from taking advantage all four elements of return over the long haul. Instead, to them, buying real estate is like buying raw materials to produce a product to resell. In real estate, however, this is usually a recipe for disaster. The trouble is that most people with this “flip-it-quick” mentality never do the kind of analysis you are learning here, and thereby never really see the percentage return they are making. If they did, they surely would see the error in their ways.

To illustrate, let’s look at the percentage return in this instance. This time, we will assume that you will hold the property for just one year like many investors do, and then sell. Of course, you will get the normal returns as well as the fixer-upper profit, but the rub is that we now have to add in the costs of selling. A good guesstimate of sales costs would be \$15,000. Our profit, therefore, now looks like this:

First year return	\$13,419
Plus fix-up profit	+\$7,725
Less sale costs	-\$15,000
Net profit	\$6,144

We then divide the net profit by our equity, as follows:

$$\frac{\text{Net profit } \$6,144}{\text{Investment } \$30,000 + \$9,275} = 15.6\%$$

As you can see, a 15.6 percent return isn’t a very impressive profit at all. Especially when you factor in the tremendous amounts of time, money, and effort required to fix up and then flip fixer-uppers.

Nine times out of ten, the only way to make financial sense out of a classic fixer-upper would be if

1. You were a skilled contractor and had the resources to drastically reduce the cost of the repairs and the time it takes to do them.
2. You were also a licensed real estate broker and could reduce the costs of selling.

Yes, we are being a little tongue-in-cheek here, but we're trying to prove a point. The truth is fixer-uppers tend to sour the average person on real estate investing long before he ever finds out that they aren't necessary in order to make an excellent return on investment (see the 44.7 percent return on the example property from Chapter 3, "Elements of Return").

Nevertheless, if your goal is to consider a fixer-upper and see an opportunity to make an extra profit, you must thoroughly evaluate whether it will be truly worth the extra risk and extra money. Remember, the added capital investment decreases your leverage. As you are learning, leverage is one of the most significant elements that drive the return on your invested capital. For that reason, the percentage return from any fixer-upper project needs to be pretty darn good to warrant the loss of leverage and increased risk.

From a practical standpoint, it may make better sense to take the extra capital it would take to repair the 333 Richmond Street fixer-upper and, instead, put it toward the down payment on a second building. Remember, if you go with a 3-percent-down FHA loan, the down payment on a \$200,000 building



Watch Out!

You are taking on an extra risk when you buy a property that needs work to bring it back to life. Many times, a job that looks like it will only take a month to complete and only cost a few dollars ends up taking six months and costing four times the original estimate.

would only be \$6,000. That's \$3,275 less than it cost to fix up the example property.

Management fixer-uppers

As you know by now, real estate, by nature, is not a get-rich-quick investment. You can't (and shouldn't) get in and out quickly like you can when buying and selling stocks or bonds. Unfortunately, many people jump into real estate not knowing this reality and get stuck owning property that they are unwilling to maintain and properly manage. For the knowledgeable real estate investor, however, finding "management fixer-uppers" such as these, is like striking oil deep in the desert.

Unlike standard fixer-uppers that offer very little profit compared to the money necessary to achieve it, management fixer-uppers offer a superb opportunity to add value to your bottom-line. Because they have been mismanaged for one reason or another, they often can be described as properties in which "the inmates are running the asylum." Rents usually are well below market, and they always arrive late or, sometimes, not at all. Often, mismanaged buildings cause their owners so much grief that they discount the selling price dramatically just to be rid of the headache. Thankfully, buildings like these are often priced well below market, but cost very little to turn around; a starkly different story than that of the standard fixer-upper.

For both part-time and out-of-state owners of small properties, mismanagement of their real estate is a common problem. It also is common with properties owned by partners or groups of investors. Owners of these buildings either get tired of owning property, get tired of the losses their properties produce, or both. The truth is, they have given up on real estate investing all together and are ready to do whatever it takes to get the property off their books.

When individual investors find themselves in this situation, it usually is because they have something more pressing than landlording to attend to in their lives. Many people find out



Moneysaver

Mismanaged buildings are a much wiser choice for the real estate investor than standard fixer-upper opportunities. They generally require less money and very little physical effort to straighten them out.

after the fact that they don't have the time, energy, money, or desire to make their buildings perform. For groups, the problems come from the fact that they usually lack a leader willing to do the job necessary to save the investment. That person would have to put in a larger amount of effort only to receive his proportionate share of the profit.

Your real estate agent will have to do much of the detective work to find a good mismanaged building for you to make a run at. This is because many of these opportunities are sometimes not even for sale on the open market. Instead, your agent will have to network with other agents who have contact with disillusioned property owners who might consider an offer. Other agents might not come right out and say, "Your client can steal this property," but they will give you and your agent hints along the way. Common clues that might lead you to a management fixer-upper opportunity are

- The rents are well under market.
- The partners are having problems.
- The seller can't handle the maintenance problems anymore.
- The partnership is breaking up.
- The owners moved out of state.
- The seller needs the money for (fill in the blank).
- The seller lost his job.
- This is the last property the seller is getting rid of.
- The sellers are separating or getting a divorce.
- There is high vacancy or credit losses.

- The building has a lot of deferred maintenance.
- The exterior looks shabby.
- Expenses are way too high.
- Nobody is watching the property.
- Theft is happening by the staff, tenants, or others.

When you find a property with a motivated seller and some management problems, it's time to sharpen your pencil and do your homework because this is where you can make some real money. The first thing to do is analyze the true value that might be there, provided the building could be turned around. As with the standard fixer-upper, you want to be sure there is adequate profit available for the risk you will take by buying someone else's problem.

Assume that because 333 Richmond Street has been mismanaged, we buy it for \$205,000—a bargain, considering we determined earlier that comparable, properly managed buildings in the same neighborhood are worth \$222,500.

In this scenario, not only did the listing agent indicate that the owners were anxious to sell, we noticed that they had lost interest altogether. Here is why:

1. **The exterior looks shabby.** Paint is peeling, and the landscaping is terribly overgrown.

2. **There has been a unit vacant for more than two months.**

There are two reasons for this: First, the unit isn't rent ready. It needs new blinds on the windows, the carpets need cleaning, and the kitchen and bathroom need painting. The second reason for the vacancy is probably due to the "For Rent" sign stuck in the window of the vacant unit. It can barely be seen from the street, it doesn't say anything specific about the building, and it only lists a phone number that is hard to make out. What's more, we discover that besides the sign, the owner didn't advertise the vacancy in any way.

3. The rents are all too low. The market rent for the neighborhood is \$550, but the current rents in the three occupied units are just \$475, \$490, and \$505. The reason it's under rented is that the sellers didn't want to rock the boat by raising them. In addition, because the sellers were reluctant to maintain the property, they didn't want to have to worry about cleaning units up if tenants decided to move out because of a rental increase (a common problem with uninterested owners).

Before we raise the rents on the existing units, we first decide to offer some upgrades to ease the pain of the increase. The budget for all of the repairs and upgrades is as follows:

Exterior

Exterior paint	\$500
Landscaping	\$250
<hr/>	
Total	\$750

Rehab vacant unit

Clean carpet	\$75
Paint	\$350
Misc.	\$100
Lost rent	\$250
<hr/>	
Total	\$775

Upgrade to other units

Unit #1: New garbage disposal	\$75
Unit #2: New blinds	\$125
Unit #4: New screens	\$110
<hr/>	
Total	\$310
<hr/>	
Total cost of upgrades	\$1,835



Bright Idea

Offer your tenants a referral fee if they recommend a new tenant for one of your vacancies. The whole idea of successful landlording is to keep your units full. A small cash outlay to achieve that result will always be well worth it.

Let's review the profit from the purchase and see how this compares on a percentage basis. The gross profit is

Finished value	\$222,500
Purchase price	-\$205,000
Gross profit	\$17,500

Now we deduct the estimated cost of the repairs from the estimated gross profit to find the net profit:

Gross profit	\$17,500
Upgrade costs	-\$1,835
Net profit	\$15,665

Now, in order to determine the overall percentage return on investment the first year, we need to add the first year's return to the \$15,665 profit, and then divide by the down payment and the \$1,835 it costs to do the fix up, as follows:

$$\frac{\text{Returns } \$13,419 + \$15,665}{\text{Investment } \$30,000 + \$1,835} = 91.3\% \text{ return}$$

A 91.3 percent return the first year is nothing to scoff at. As you can see, for financial reasons alone, the management fixer-upper is the investment of choice for many seasoned investors. The cost involved and the effort needed to fix the problems are minimal, yet the rewards, as demonstrated, are significant. Of course, your return will drop in subsequent years, as it will with any leveraged real estate investment, but an initial return of 91.3 percent the first year on our example property would be a great leg to start out on.



Watch Out!

One drawback to buying REOs is that you will not receive any type of disclosures regarding the condition of the property. Therefore, you bear all the risk of any hidden problems the property might have.

Bank-owned properties

Back in the 1990s there was a rash of bank-repossessed properties on the market. In the business, these are known as REOs, which stands for Real Estate Owned. Today, you can still find the occasional REO. These properties can offer the investor an opportunity to purchase real estate at a substantial discount, but as is true with most things in life, with a discounted REO, you often get what you pay for.

Consider how the bank came into possession of the REO. Someone bought the property with one of two ideas in mind: to get a nice home for himself or herself or to get a set of units that was hopefully going to make a decent profit. Along the way things started to go wrong. It might have had to do with the economy in general, a problem with the building itself, or perhaps some issues in the person's own personal life. Whatever the reason, the borrower stopped making her mortgage payments and the lender was forced to take the property back. The problem for the investor is that he will never know why things went sour. This is because, with a foreclosure property, the bank is not required to give any disclosures or warranties at all. In fact, with foreclosures, you will be going into the deal with your eyes wide shut.

The enticement of buying REOs for the layperson is that these buildings usually have a large discount in price compared to the average property listed on the open market. This discount, though, can give novice buyers a false sense of profitability. Remember, bankers are not interested in losing money. They are out to make a profit just like the rest of us. The truth is, when they set the price of their foreclosure properties, they do diligent market research just like any other seller would. In

fact, they have their own expert appraisers on staff who can give them an opinion of value based on market research, the property's current condition, and the cost of needed repairs. Although banks might leave a bit of extra profit on the table in order to move the property off their books, don't assume that every REO will make you a windfall profit.

The biggest trouble when trying to buy a bank-owned property is finding adequate financing. On rare occasions you can find a bank that is willing to finance their own foreclosures, but these are buildings that are usually still in good condition (which is harder to find). Additionally, any property that is still in decent condition will certainly be priced accordingly, which, when bargain hunting, defeats the purpose. Remember too, that if a conventional loan was to be had here, it would probably have to be for an owner/occupant only.

You could discover that if a property has a lot of deferred maintenance and has one or many vacancies, it might not be possible to get financing from a conventional source at all. At a minimum, you probably will have to put substantial cash down for a new loan. As an alternative you might have to go to a hard-money lender to get the money needed for the purchase. To add insult to injury, all your financing will usually need to be in place before you make an offer to buy. Just the opposite is true when it comes to financing conventional deals. For most real estate investors, this requirement is really putting the cart before the horse.

As you will come to appreciate, substantial fix-up costs, higher fees, higher interest rates, and—especially—higher down payments, can all make or break the profitability of an investment.



Moneysaver

When buying any REO property, it is advisable to have a thorough inspection done by a professional contractor or a licensed property inspector before you sign on the dotted line.

Nonetheless, the first thing to do when considering an REO is to do an accurate assessment of the current condition of the property and any management problems it might have. In most cases, you have to purchase the property “as is” and, as mentioned, will not get any reports, disclosures, or clearances from the lender whatsoever. Once you gather all your data, you then will do the same kind of diligent analysis we have been preaching for eight chapters now.

To illustrate, let’s revisit 333 Richmond Street. Here, we will attempt to paint a picture that is as close as possible to the typical REO situation you might find yourself in. To begin with we will assume the Richmond Street REO has severe repair and management problems, which is typical with most REOs. In this case, three of the four units are vacant and need a complete overhaul. The last unit has a tenant, but the tenant isn’t paying rent and will need to be evicted after you close. We will use the same market value of the finished building (\$222,500), but because it’s owned by the bank and has some serious problems, we can get it for \$170,000.

Some additional facts are as follows:

1. As with many REOs, the rent loss and eviction expense will be significant. One reason is because the clock isn’t able to start ticking on any necessary evictions until we actually take possession. In this instance, we will assume that it will cost \$300 in legal fees and will take one month to get the tenant out.
2. It will take one month to do the repair work on the units.
3. We will be able to rent one unit in July for an August 1st move in. We will rent two units in August for a September 1st move in. The last unit will be rented in September for an October 1st move in.

Here is a summary of what we’re getting into:

Exterior fix up

Exterior paint	\$2,500
Landscaping	\$500

Garage doors	\$800
Fence	\$750
Roof	\$3,000
Total	\$7,550

Interior fix up (four units)

Carpet at \$750 each	\$3,000
Paint at \$350 each	\$1,400
Misc. at \$100 each	\$400
Total	\$4,800

The timeline of the vacancies, assuming we close June 1st, looks like this:

	Close	End Month 1	End Month 2	End Month 3	End Month 4
Month	June	July	August	September	October
Vacancies	4	4	3	1	0

As you can see, we have lost a total of 12 months of rent (4 months in June, 4 in July, 3 in August, and 1 in September). We also have lost the cost of the eviction plus the cost of the repairs. With an assumed rent on the units of \$550 each, our total expenses due to lost rent and eviction costs are as follows:

Rental loss	\$6,600
Eviction expense	\$300
Total	\$6,900

We then need to add this \$6,900 to the fix-up costs in order to determine the total cost of the project:

Exterior fix up	\$7,550
Interior fix up	\$4,800
Rental loss and eviction cost	\$6,900
Total upgrade cost	\$19,250

Now we will review the profit and see how it compares on a percentage basis. The gross profit is

Finished value	\$222,500
Purchase price	-\$170,000
<hr/>	
Gross profit	\$52,500

In order to find the net profit, we then need to subtract all the estimated upgrade costs from the estimated gross profit:

Gross profit	\$52,500
Upgrade costs	-\$19,250
<hr/>	
Net profit	\$33,250

Finally, in order to determine our percentage return the first year, we now need to add this net profit to the first year's return, and then divide by the down payment and upgrade costs. We will assume that we were indeed able to obtain a loan with 20 percent down. Twenty percent of a \$170,000 purchase price is \$34,000; therefore, the return is

$$\frac{\text{First year return } \$13,419 + \$33,250}{\text{Investment } \$34,000 + \$19,250} = 87.6\% \text{ return}$$

As demonstrated by an 87.6 percent return the first year, there can be a lot of profit to be made with REOs. The problem

“It all looked good from the start, but completing the work took longer than projected. The negative cash flow because of the lost rents tapped me out and made me rethink this approach to investing.”

—Blake M., investor

is that in order to achieve those returns you must always sink a lot of extra cash into them. Cash that you could, in essence, throw at a second investment property. In this instance, it took an additional \$19,250, which was above and beyond the down payment of \$34,000,



Watch Out!

When banks are forced to take a property back in foreclosure, they usually do the least amount of work necessary to get the property off their books. As far as they are concerned, peeling paint, rotting stairways, and overgrown landscaping are all just fine.

to get the building running again. Unfortunately, the facts remain: Tons of extra money and hard work are the rules with REOs, not the exceptions.

Remember too, that your return will drop the second year, as it will with any leveraged investment. This is because, like the standard fixer-upper, the extra return is only a one-shot increase, but the extra \$19,250 it cost to fix up the building is now equity that you have invested that will decrease your leverage year after year.

Some deep-pocket investors who have cash to spare buy foreclosures with the flip-it-quick mentality. If so, let's demonstrate the kind of profit we would have made on this deal, provided we sold after the first year:

First year return	\$13,419
Plus fix-up profit	+\$32,750
Less sale costs	-\$15,000
<hr/> Net profit	<hr/> \$31,169

Once you know the net profit, you can determine the percentage profit as follows:

$$\frac{\text{Net profit } \$31,169}{\text{Investment } \$34,000 + \$19,250} = 58.5\% \text{ return}$$

A return of 58.5 percent on your invested capital is pretty decent. So much so, that the flip-it-quick and then do-it-again strategy is an excellent approach, that is, provided you have the management expertise and extra cash on hand to buy, fix up, and carry these properties until you can sell them again.

For most laypeople, however, the allure of buying repossessed properties is that they offer the illusion of a deep discount in price over fair market value. As you can see, though, this deep discount is usually always offset by the necessity of sinking in lots more money out of your pocket. In the end, most purchases of repossessed properties never end up being the gold mine that the average investor had bargained for.

But don't despair; there is another similar class of properties that can bring a smile to anyone's face—that is, the preforeclosure, or “short sale.”

Short sales

A short sale is one in which the property has yet to be formally foreclosed on, but the lenders have agreed to take less than is owed on the loans to get a payoff on the balance owed. At this stage, the owners have been doing the best they can to keep the building running. All the units are probably rented, but the owners are still drowning for one reason or another. In situations like this, lenders have found that they can minimize their loss on bad loans by getting the property sold before they have to go through the formal foreclosure process.

In these instances, you will be negotiating with the actual owner, subject to approval by the lender. Most owners in this situation aren't too concerned with what kind of price they accept since the bank is going to get it all anyway.

To get the best pricing, you need to present a well-organized story to the seller and the lender. Your offer should include

- A brief biography of you and your knowledge of real estate
- A complete financial package on you and two years of tax returns
- A prequalification letter from a reputable lender
- A copy of the purchase contract
- A good-faith deposit check



Moneysaver

Lenders who have said they would consider a short sale are already tipping their hand in admitting that they will take a lower amount than is owed on their loan.

A second section of your proposal should include a detailed discussion of the physical condition of the property. It should include the following:

- A professional property inspection report
- Photos of all items that need repair
- A termite report if necessary
- Disclosures on other systems as needed
- Bids to repair any deferred maintenance items

Next you need to give the seller and the lender your estimate of value, which will justify the price you offered. At this point, you could consider hiring a professional appraiser because he could present the valuation in a format to which the lender is accustomed. If this is not practical or cost effective, you can present the information yourself. Make sure you get your real estate agent's help to find the best comparable sales to justify your offer. Your opinion as to the value of the property should include

- Copies of comparable sales with pictures
- Details of how you determined your price via accepted appraisal techniques

You should end the proposal with a strong statement as to why the lender should accept your offer. The format of the following letter should give you an idea of what you might say.

September 27, 2003
Bodian Savings and Loan
410 Hauser Blvd.
Los Angeles, California 90036
Re: Short Sale Proposal Loan # 14283

Gentlemen,

Enclosed you will find my proposal to purchase the property secured by your loan number 14283. As you know, this loan is in default, and I am asking you to consider a short sale to avoid the long and costly process of doing a foreclosure.

I have included my financial information so you can verify that I have the background and capability of closing this transaction quickly if you grant your approval. I have chosen a lender to handle the financing and have included their letter to show their willingness to make the loan.

The price I am offering is based on careful consideration of current sales in the area and a detailed inspection of the property in its current condition. I felt it was important for you to have this information about the current condition because it does impact the value, based on a comparison with current sales. If you were forced to take this property to foreclosure, your expenses would increase significantly, and the condition of the property would no doubt worsen.

I am prepared to close the purchase within 45 days of opening escrow. I urge you to accept my proposal, which will allow you to get this nonproducing loan off your books.

Sincerely,



Spencer Strauss
333 Richmond Street #10
El Segundo, CA 90245

**Bright Idea**

Many lenders have lists of approved appraisers. You might be able to hire one from this list, which should help you sell your bid to that lender.

Will a strong proposal guarantee acceptance? Unfortunately, the answer is no. We admit that, after 30-plus years in real estate, we are still baffled by some of the decisions made by banks and savings and loans.

Although these properties offer an opportunity to get a great discount in price, that doesn't mean this is the right type of property for you. You will need to do the same analysis that was done for the previous examples to see if the overall returns are worth the extra effort and capital investment.

Low- or no-down deals

When it comes to alternative real estate deals like those mentioned in this chapter, know that it's not always an uphill battle. As you have learned, investing in leveraged real estate is the best way to make a great percentage return on your money. Well, how about being able to buy property with little or no down payment at all? Well, believe it or not, creating that kind of leverage can be achieved. It's done by finding buildings where the seller will carry some or all of a loan for you.

There are several common motivations of sellers in this situation. Some have purchased rental property and then realized that landlording just isn't the business for them. Many are moving out of the area or have had a career change that makes it difficult to continue running the property. Many are just retiring and want to quit being a landlord. No matter what the reason, what they want is someone to take the property off their hands and give them enough cash to pay selling expenses. Some of these owners might even be willing to take money out of their pockets to move the property.

In these situations, the seller's primary goal is to reap the rewards of an installment sale (as mentioned in Chapter 5, "Borrowing Big Bucks"). These sellers know that by carrying a big loan on the sale of their buildings they can still receive a great yield without the everyday hassles of being a landlord.

Properties in this category offer a willing buyer two distinct advantages:

1. Lower down payments
2. Seasoned financing

The first advantage is obvious. If you only need to put closing costs or less down, you are getting into a property with great leverage. This leverage will work to your benefit and will greatly increase the percentage return on your investment in the first few years of ownership.

Second, seasoned financing offers a distinct advantage to you as an investor. It is the nature of conventional financing that there will be very little payoff on a loan balance in the initial years of the life of a loan. In the middle years, this increases; in the final years, principal pays off quickly. What this means is that, if the loan you are taking over was written for 30 years and has 20 years or fewer to go until it is paid off, it is beginning to make some significant reductions in principle.



Bright Idea

It's not unusual to be able to pay a loan off in 10 years that actually had a 20-year payment schedule by just a small increase in the payment from the cash flow of the building. Collecting the cash flow from a property with no mortgage is a great position to be in during retirement.

A word of caution

The examples in this chapter have given only a broad overview of kinds of special-circumstance properties. Our goal was to expose you to the opportunities and how they give you the possibility to make some extra profit. The most important lesson is that you must look at these special properties closely to be sure the extra profit is worth the increased risk and the increased capital required. Make sure that you do a complete analysis of each special opportunity before you make a purchase.

Just the facts

- Fixer-uppers are better left for the later years of your investment career—after you've made some good money and have had considerably more hands-on experience.
- Management fixer-uppers are relatively cheap and easy to cure and are the vehicle of choice for the savvy investor.
- REOs usually require way too much money out-of-pocket to make them profitable—or feasible—for the average investor.
- A short sale gives the investor an opportunity to buy a troubled property from a lender at a considerable discount.

PART IV

Setting Your Investment Goals

GET THE SCOOP ON...

The key components in a profitable investment plan ■ Learning how to set attainable real estate goals ■ Projecting a future net worth for planning purposes ■ The compound interest formula and how it will help you grow your fortune ■ Creating a detailed year-by-year investment plan

Building an Investment Plan

When was the last time you heard someone say, “I’m happy just scraping by,” or “I don’t care if I get ahead in life”? Never, right? This is because that kind of thinking goes against human nature. Instead, as human beings we long to be successful. In fact, we’re obsessed with it. We dress for success, read about success, and—above all—we spend money (borrowed at 18 percent) as if each of us was the most successful person on earth. Truth be told, however, most of us aren’t any closer to our dreams than we were last year at this time. The question then becomes, how come?

Perhaps there is a piece of the puzzle missing? In Chapter 1, “Planting the Seed,” we talked philosophically about taking control of your own destiny. Unfortunately, if you take control but don’t have a clearly defined set of goals with a plan, you’ll probably spend most of your time simply spinning your wheels. For that reason, the purpose of this chapter

is to teach you how to turn your good intentions into achievable results through planning. The end result could be a great future you designed yourself.

Good intentions versus planning

Most people's lives are so complicated that they put things off until they absolutely have to do them. This is true whether it's something as simple as taking out the trash or something as vital as planning for retirement. We all might have the best of intentions, but in reality, no matter what the chore is, we put it off until we decide to get around to it.

We learned of a sales tool many years ago that might help you overcome this problem. Get a piece of card stock about three inches square and cut it into a circle. With a red marker, write the following words across the middle of your circle: "to it." After you've done that, put the card-stock circle in your pocket and keep it with you at all times. Problem solved. You no longer have the excuse of being able to wait until you get around to it because you now have one—a round "to it."

In all seriousness, having a plan with stated goals is one of the most important foundations of successful investing. Yet, even people who want to get ahead in life often fail to make a distinction between good intentions and planning. A good intention could be the desire to have the better things in life. For example, declaring that "I want to be worth a million dollars one day," would be a nice, good intention. The problem, however, is that declaring it doesn't bring you any closer to achieving it. This would be true even if you said you wanted to be worth a million dollars with *conviction*.

On the other hand, a person who plans expresses a specific goal or goals and a method on how to get there. A good example of well-thought-out planning would be, "I plan to have a net worth of \$500,000 within 10 years by purchasing small rental properties." As you can see, the plan is specific and lays out a methodology for achieving the desired result.

To that end, let's put all our good intentions aside, and learn how to write a winning investment plan for your budding real estate empire.

Writing a winning investment plan

Although a good investment plan doesn't need to start out in minute detail, it should be in writing from day one. Your plan gradually will grow in detail as you proceed through your investment career. To get things started, buy yourself a three-ring binder in which to put your plan. This way, you can change the contents easily as you make progress. Your planning binder should contain the following four sections:

1. **Goals:** Here you will lay out your long-term investment goals and the time frame you have scheduled for their achievement.
2. **General plan:** This spells out how you will achieve your goals over the time limits set forth in the plan.
3. **Detailed plan:** The detailed plan is similar to the "profit plan" of a business. It establishes the year-by-year goals of the plan. This is the measuring stick to determine how you are doing along the way.
4. **Follow-up and goal review:** Here you will enter predetermined dates to periodically monitor your progress. This is a perfect opportunity for equity and property budget reviews.

We'll spend the remainder of this chapter going over each of these sections one at a time.



Bright Idea

Give copies of your investment plan to people whose opinions and knowledge you respect. By knowing your intentions, your respected confidants will help keep you on track.

Section 1: Your long-term investment goals

The goals section of your investment plan should be divided into the following subsections:

- Cash flow requirements
- Net worth projections
- Tax shelter benefits required
- Cash withdrawal from plan
- Other goals

Cash flow requirements

Cash flow requirements refer to your cash flow projections during and after completion of the plan. The point at which you will begin to achieve a significant cash flow depends on two things:

1. The amount of cash you invest in the plan initially
2. How well you manage your plan

To that end, let's look at some ways of setting cash flow requirements for your investment plan with a few typical examples:

- **Case #1:** You are well employed, expect to remain so for the immediate future, and would like to retire in 10 years. You have available to you between \$30,000 and \$40,000 for investment purposes. Your current salary is \$40,000 per year, and you expect to be making about \$50,000 per year in 10 years. To supplement your company-sponsored and Social Security retirement income, you would like to have about \$20,000 per year of income from your real estate equities at retirement. Because you feel that you can support yourself and your family adequately until you retire, you will require no cash withdrawal from the plan; however, you would prefer no significant negative cash flows during the life of the plan.



Bright Idea

Make it a habit to read and reread your investment plan. When you look at your goals daily, you keep yourself tuned in to the future you want.

Your cash flow requirements from the plan would be
Cash flow of \$20,000 each year after the 10th year. No significant negative cash flow during the plan.

- **Case #2:** You are young, ambitious, and single. You have a good job that pays \$35,000 per year. You borrow \$10,000 from your parents and are willing to invest that money in real estate. Your plan is to parlay that nest egg into \$500,000 in real estate equities in 15 years.

Your cash flow requirements from the plan would be
Generate \$500,000 in net equities at the end of 15 years. Pay off the loan from your parents from cash flow over the first 5 years. The \$500,000 invested at the end of the plan at 10 percent in trust deeds should yield \$50,000 per year income.

- **Case #3:** You have been employed in the aerospace industry for 15 years, and your salary is \$40,000 per year. Over 50 percent of the employees in your department have been laid off recently due to budget reductions. You suspect that you, too, might someday lose your job, and your prospect for a new job in this field is slim. You have saved \$50,000, but you know that amount won't last long without other income to supplement it. With the right real estate purchase, you believe your net equity could grow to \$350,000 in 8 to 10 years. If you are laid off after that date, you could sell the property and carry the financing. At a 10 percent interest rate, you would have \$35,000 in interest per year. With your company retirement and this interest, you could live comfortably in case you couldn't find other work.

Your cash flow requirements from the plan would be

Invest \$50,000 into a four-unit building that will appreciate to yield \$350,000 in equity in 8 to 10 years. No cash flow is required during the plan. All cash flow proceeds are to be put back into the property to promote payoff of the financing.

Cash flow is generated from a property in two ways. The first way is from net income from the property after paying all the expenses and loans. This cash flow should increase yearly as you increase rents. By retirement, this cash flow can be significant, depending on the amount of financing you have left on the properties.

The second way to generate cash flow is from the sale of your building and carrying your equity as a note against the property. As a general rule, the cash flow at that time will be equal to the going rate of interest multiplied by the net equity of your property. The great thing about this is that you generally can get a larger percentage yield by carrying the financing than you could get in a typical savings account or certificate of deposit. Another advantage is that you postpone the capital gains taxes due when you carry the financing because the government considers this to be an installment sale.

Let's say you need \$20,000 per year cash flow to supplement your retirement income. It normally is safe to plan on a 9 percent interest yield. To find out how much net equity you would need at retirement, you would use the following formula:

$$\frac{\text{Cash flow required}}{\text{Interest yield}} = \text{Net equity needed}$$



Bright Idea

When it's time to sell, make sure to let your listing agent know that you are interested in carrying an installment note. This way, your agent will make sure to bring you buyers who desire this type of financing.

Or:

$$\frac{\$20,000}{.09} = \$222,200$$

What this tells you is that you will need at least \$222,200 in net equity in order to generate the cash flow you need. By figuring out this number for yourself, you will be able to create a target for your own investment plan.

Net worth projections

Your net worth projection will be your second subsection under the Goals category of your plan. Simply put, your net worth projection is the amount of money you want to be worth at the end of a given period of time. As we have previously shown, net worth and cash flow are related. In cases where your investment plan is set up as a retirement vehicle, your net worth projections probably will be about 10 to 12 times your net annual cash flow requirements. This assumes that, at the time of retirement, you will be able to locate savings investments that offer yields of 8 to 10 percent per annum. This is a very reasonable assumption based on the available returns for the last 10 to 20 years.

One of the advantages previously discussed is the installment method of selling property. By acting as a banker and carrying a note when you eventually sell or trade up, you usually can earn a higher interest rate than the market is offering. What's more, you can postpone the payment of your capital gains taxes and can even earn interest on the tax money you are keeping. This is a great advantage, and you need to remember to factor this possibility into your calculation when setting your net worth goals.

If you decide against carrying paper and instead decide to take the profit and run, you will need to make an estimate of the capital gains taxes due when you sell. This is because settling up with Uncle Sam will dilute the net amount you have to invest

when you retire. The calculation to determine your net equity for reinvestment looks like this:

Gross equity at sale
–Sale costs
–Capital gains taxes
<hr/>
Net equity for reinvestment

If you decide to use the installment method, you can eliminate the tax from the calculation. Capital gains tax rates have been known to change at the drop of a hat depending on who holds political office. You need to factor in a reasonable tax rate in the event you decide to sell at the end of the plan because it will have a significant impact on your net equity.

You might want to establish your net worth projections for reasons other than just cash flow requirements. For example, you might want to provide a college education for your children, purchase a business to run in your retirement, or you might just have the old American desire to be a millionaire. Regardless, if that is what you want, your net worth projection goal might look like this:

Attain a net worth of \$1,000,000 at the end of 15 years by investing in rental properties.

Tax shelter benefits

Your next subsection to your plan will be tax shelter benefits. Recognize that in real estate investments, tax shelter benefits are complicated and can vary widely. Therefore, we are going to devote the entire next chapter to this subject. For now, however, we will provide a few necessary guidelines and warnings for you to keep in mind. Here are some general tips:

- We do not recommend buying real estate for tax benefits only. The tax benefits have been diluted by the tax law changes in the late 1980s.
- It is important to consider the amount of depreciable improvements when making your final decision on a



Moneysaver

Tax-deferred exchanges are best made after you have had a few years of experience in real estate investing. Why? Because the experience with your own properties will improve your ability to judge potential winning trade opportunities.

purchase. All things being equal, the property with the highest improvement ratio will give you the best return because of the higher write-off.

- We recommend the use of the tax-deferred exchange and the installment sale.

A reasonable tax benefit goal would look like this:

Maximize tax benefits on purchases and use tax-deferred exchanges and installment sales when available.

Cash withdrawal from the plan

Cash withdrawal refers to any lump sum amounts of cash you take out of the plan. By penciling them in at the onset of your plan, you have the opportunity to make provisions for these expenditures long before you will ever have to dip into your pocket to pay for them. What's more, building in perks for you is a great way to stay connected to your plan's ultimate success. You could make provisions for your children's education, a trip to Europe, a new boat, or building a dream home on the lot you own—all of which should bring you a magnitude of pleasure.

Major cash withdrawals can occur either by selling or by refinancing. In some cases, money in your property accounts can adequately cover the withdrawals. Examples of these types of goals are

- *Withdraw \$2,500 in year 2 to go on a fly-fishing vacation with my poker buddies.*
- *Generate \$75,000 in year 5 to pay for an addition to the house.*
- *Withdraw \$15,000 in years 7–10 for Jillian's college fees.*

**Watch Out!**

Exercise considerable care and thought in setting your goals; they form the cornerstones of your investment plan.

Other goals

The last subsection is for any other goals you would like to accomplish with some of the earnings from your real estate investments. This section could involve helping family and friends through your investments or perhaps benefiting a charity in the future. Examples of these kinds of goals might be

- *Buy a four-unit apartment building that has a nice owner's unit for the folks to live in.*
- *Donate the expected second trust deed from the sale in the 5th year to the college scholarship fund.*
- *Buy new carpet for the pulpit at the synagogue.*

Section 2: Determining your general plan

As we already have seen, setting future net worth at a given interest rate also sets future cash flow. Therefore, we will concentrate most of our discussion of the general plan to achieving a given future net worth.

The first step in developing a general plan is knowing what you can logically expect to achieve. This depends on a few key criteria:

1. The capital you have available to invest
2. The length of time for which you will be invested
3. The amount of your own effort you can afford to contribute to the plan

In making these projections in real estate, we commonly use the compound interest algorithm. The mathematical formula for this is

$$FV = PV(1 + I)^N$$

Relax, it's really not so intimidating. Nevertheless, in language that the math-challenged student can understand, this translates as follows:

- FV = Future value of the investment
- PV = Present value of the money invested (down payment)
- I = Average interest rate you earned on your investment
- N = Number of years the money is invested

This formula states in simple language that, if you invest an initial amount of money (PV) at a compounding rate of return (I) for a given number of years (N), your total investment will have a future value (FV) at the end of the period. For example, if you invested \$50,000 (PV) for 10 years (N) at 30 percent (I) compounded interest, the value of your investment at the end of the period would be \$689,292 (FV). The equation would look like this:

$$FV = \$50,000(1 + .30)^{10}$$

The following is a table of various combinations of the compound interest formula. It will quickly give you an idea of the kind of future equities you might expect at various times with differing investment amounts. The compound interest percentage on the following page might seem high and unattainable to you, especially if you are used to the 4–6 percent interest you receive from your bank, but this is where real estate rises head and shoulders over any other investment vehicle. Study the chart, do the math, and see for yourself how the money adds up.

PRESENT VALUE/FUTURE VALUE TABLE					
PRESENT VALUE	YEARS	I = 10%	I = 20%	I = 30%	I = 40%
\$10,000.00	5	\$16,105.00	\$24,883.00	\$37,129.00	\$53,782.00
	10	\$25,937.00	\$61,917.00	\$137,858.00	\$289,255.00
	15	\$41,772.00	\$154,070.00	\$511,858.00	\$1,555,681.00
	20	\$67,275.00	\$383,376.00	\$1,900,494.00	\$8,366,822.00
\$20,000.00	5	\$32,210.00	\$49,766.00	\$74,259.00	\$107,565.00
	10	\$51,875.00	\$123,835.00	\$275,717.00	\$578,509.00
	15	\$83,545.00	\$308,140.00	\$1,023,717.00	\$3,111,361.00
	20	\$135,550.00	\$766,752.00	\$3,800,989.00	\$16,733,640.00
\$30,000.00	5	\$48,315.00	\$74,650.00	\$111,388.00	\$161,347.00
	10	\$77,812.00	\$185,752.00	\$413,575.00	\$867,764.00
	15	\$125,317.00	\$452,211.00	\$1,535,576.00	\$4,667,042.00
	20	\$201,825.00	\$1,150,128.00	\$5,701,483.00	\$25,100,476.00
\$40,000.00	5	\$64,420.00	\$99,533.00	\$148,517.00	\$215,130.00
	10	\$103,750.00	\$247,669.00	\$551,434.00	\$1,157,018.00
	15	\$167,090.00	\$616,281.00	\$2,047,434.00	\$6,222,722.00
	20	\$269,100.00	\$1,533,504.00	\$7,601,977.00	\$33,467,290.00
\$50,000.00	5	\$80,526.00	\$124,416.00	\$185,646.00	\$268,912.00
	10	\$129,687.00	\$309,587.00	<u>\$689,292.00</u>	\$1,446,273.00
	15	\$208,862.00	\$770,351.00	\$2,559,293.00	\$7,778,403.00
	20	\$336,375.00	\$1,916,880.00	\$9,502,471.00	

It's important to remember that this is the average expected return on your investment, combining all four components of return: cash flow, equity growth from loan reduction, equity growth from appreciation, and tax benefits.

The underlined portion of the chart is an example of how to use the chart to make a projection for yourself. Down the left column (PV), locate the amount of the original investment of \$50,000. Move over one column to the right to locate the number of years of the plan (N), which in this case is 10. The next columns are the future values (FV), based on the range of returns, and (I), located at the top of the chart. For our example, we are projecting an average return of 30 percent, so the final value is \$689,292. If you are starting with an amount that isn't on the chart, you can combine totals to estimate the return.

Now let's look at how we use the table to determine what financial goals you can logically expect to meet. Let's say you have \$30,000 to invest and require a net worth of \$1,500,000. Here, you will have two variables to work with in order to meet this goal:

1. The rate of return on the investment (I)
2. The number of years invested (N)

If you look at the chart, you will notice that you can meet this goal in 15 years at a 30 percent rate of return. These percentage returns might seem high. Surprisingly, however, due to the power of compound interest, they are not unrealistic. Remember, Albert Einstein called compound interest the most powerful force on Earth.

Let's refresh your memory of the return from the example property at 333 Richmond Street. The return components were

Cash flow	\$1,080
Equity growth (loan reduction)	\$300
Equity growth (appreciation)	\$11,000
Tax savings	\$1,039
<hr/>	
Total	\$13,419

Therefore, our percentage return the first year was

$$\frac{\$13,419}{\$30,000} = 44.7\% \text{ return}$$

Each year, your percentage rate of return will drop a bit from the previous year because your equity in the property will increase significantly faster than your total annual return. For this reason, you should use a percentage return of the compound interest



Bright Idea

Most business calculators have the compound interest algorithm, which you can use just in case you aren't carrying this book around with you for the rest of your life.

column that is lower than the initial return you expect so as to offset this decrease. This compound interest number should be the rate you can expect as an average over several years of ownership.

Now that you have a handle on how to use the compound interest chart, let's return to determining a general plan and setting your future net worth goals. Most of us start with the

“I've learned that when my rate of return drops below 25 percent, it's as if a red light goes off. It's then that I know it is time to refinance or trade out of that property.”

—Mareeva S., investor

primary constraint of a limited amount of capital to work with. Knowing the amount you plan to invest initially, we will combine the percentage return we can expect with the number of years we are going to invest to estimate our net worth. We are, of course, constrained by the maximum

rate of leveraged return (compound interest) we can achieve, but 20–30 percent should be a comfortable rate for the average investor.

Using the formula, let's review a couple of the cases we used earlier in this chapter when we were discussing setting goals.

- **Case #1:** You have \$30,000 to \$40,000 to invest and have the goal of having \$20,000 per year income in 10 years. This requires approximately \$200,000 in equity invested at a 10 percent interest rate. Because this is your first investment, it would be wise to only invest \$30,000 and keep the other \$10,000 for contingencies. You will see from the table that this goal requires a sustained rate of return of 20–25 percent, which is in our comfortable rate range.
- **Case #2:** You can borrow \$10,000 to invest and want to have a total equity of \$500,000 in 15 years. Again, using the table, we can see that this requires a rate of return of

30 percent for the 15 years. This is at the top of our range, so our young and ambitious investor will need to devote the energy and sacrifice to attain this goal.

Now we are ready to pull all this work together and set your general plan. There are three steps in this process:

1. **First determine how much cash you have available to invest comfortably.** Always keep some cash in reserve. You can always invest some of your reserves later as your experience and confidence increases.
2. **Next set the feasibility of your future net worth.** You can convert this to a cash flow at retirement by assuming it can be invested at an 8–10 percent interest rate return.
3. **Set the number of years you want for the overall plan.** Using the table, move down the column on the far left (PV) to the amount nearest your available capital. Move across this row until you come to a value at least as large as your future net worth goal. The rate at the top of this column is the rate you will have to maintain to meet your general plan goal. Remember, you can combine two lines and add the totals to get a combination that equals your capital investment if it isn't on the chart.

Your general plan should look something like this:

I am going to invest \$ _____ for ____ years in real estate investments at a sustained rate of return of ____ percent and be worth \$ _____ at the end of the plan term.



Bright Idea

If time is not a particularly important factor in your plan, you would be well advised to pick a conservative rate of return and extend the years of the plan accordingly.

Section 3: Establishing a detailed plan

In establishing a detailed investment plan, we will use the \$30,000 it took to buy 333 Richmond Street as our capital, and that property will be the beginning investment of the plan. In this instance, let's say we have decided that \$350,000 is the target we are shooting for. Therefore, we will have the following general investment plan:

We are going to invest \$30,000 for 10 years in real estate investments at a sustained rate of return of 30 percent and be worth \$350,000 at the end of the plan term.

It's now time to crunch the numbers and make our detailed plan. We (the authors) are fortunate to have a proprietary computerized system for building investment plans that makes this process much easier. For the benefit of those without access to a computerized system, we will demonstrate how to do this manually. It necessitates eliminating some of the fine-tuning a computer is capable of doing, but it will give an adequate plan to measure your progress against. We have included a copy of a computerized investment plan of the four-unit at 333 Richmond Street in Appendix D.

The next step in building your detailed plan is to establish the variables to be used in making the estimates for the future calculations of the plan. You will need the following:

- The appreciation rate
- Interest rates for first and second loans
- Loan-to-value ratios
- Income and expense increase rates
- Buy and sell costs
- Gross rent multipliers for various size properties

You will establish these variables after you have done your research and with the help of your investment real estate agent. Your agent's input will be helpful because the prior history of



Bright Idea

Consider seeking out an investment real estate agent who has access to a computerized planning system. With a simple click of the mouse, any variable in the equation can be changed to suit your needs.

the market helps establish the future trends, and this will help you set the rates for the future years of the plan. Using these variables, you will be estimating the financial performance of the properties that you will be acquiring in your detailed plan.

We will start the detailed plan with the specifics of 333 Richmond Street and then use our estimated rates for the preceding factors for the balance of the plan. The heart of the detailed plan is the accompanying projection worksheet on the next page. The horizontal lines are the year-by-year estimates of the performance of the property we acquire. The vertical columns are the financial parameters of the plan. The most important columns are the last two columns—the return on equity (ROE) and average return on equity (AVG ROE).

The return on equity is essentially the same concept as the return on investment. In the first year of ownership, the return on investment and the return on equity are the same because your equity is your investment. In the second and succeeding years, the equity is the initial investment plus the profit you made during the year. This is why we call your investment in subsequent years your “equity.” Recall that in our example, our return on investment for the first year is

Cash flow	\$1,080
Equity growth (loan reduction)	\$300
Equity growth (appreciation)	\$11,000
Tax benefits	\$1,039
<hr/>	<hr/>
Total	\$13,419

The percentage return on investment (ROI) is

$$\frac{\$13,419}{\$30,000} = 44.7\% \text{ return}$$

To make the estimates for the second year of the plan, we will assume there are no changes in the cash flow, loan reduction, and tax savings. The appreciation will be adjusted because the property appreciated \$11,000 during the first year of ownership, as we used an appreciation rate of 5 percent. Our investment, now called our “equity,” is

Original investment	\$30,000
First year profit	+ \$13,419
<hr/>	
Equity second year	\$43,419

This calculation is repeated in successive years to find the equity.

The appreciation for the second year is calculated as follows:

Starting value	\$220,000
Appreciation	+ \$11,000
<hr/>	
Value second year	\$231,000

Value second year	\$231,000
Multiplied by appreciation rate	× .05
<hr/>	
Second year appreciation	\$11,550

The profit the second year is now

Cash flow	\$1,080
Equity growth (loan reduction)	\$300
Equity growth (appreciation)	\$11,550
Tax benefits	\$1,039
<hr/>	
Total	\$13,969

The percentage return on equity the second year is

$$\frac{\$13,969}{\$43,419} = 32.1\%$$

The average return on equity (AVG ROE) is

$$44.7\% + 32.1\% \div 2 = 38.4\%$$

The following worksheet shows the calculations through the third year. You'll see that in the third year the average return on equity (AVG ROE) dropped from 38.4 percent to 34 percent. No need to panic. It just means it's getting time to do something to increase the average return. We have two options: We can either refinance or do a tax-deferred exchange. In this example, we'll do a tax-deferred exchange because it is the most common way for investors to reposition their equity.

Now is when the experience of your investment real estate agent will really help with your plan. This is because you will have to make an estimate of what property will sell for and how it will perform years into the future. If you are not fortunate enough to have an agent who tracks value appreciation trends, we suggest using "the world doesn't change that much" method of estimating probable future value.

Let's assume you can make almost the same purchase in the future as you can make today. We will eliminate the cash flow, equity growth from loan reduction, and tax benefits from our calculation as a way of evening up any errors and simplifying our estimate. In some locations, the cash flow and equity growth might be the most significant aspect of the return. In these areas, you will need to keep these elements of return as part of the planning process.

The next step is to estimate the costs of the transaction (selling and then trading via a 1031 exchange) and then build the model of our new property for the plan. Here's how: At the start of year four, 333 Richmond Street is valued at \$254,600, and you have \$71,907 in equity. Remember that this assumes you have put aside all the cash flow and tax benefits from this investment.

The costs of doing this trade will be the sale expenses on the existing property and the purchase costs on the new building.

To simplify this step, we will assume the selling expenses of the existing property to be 5 percent of the sale price, and we will round this off at \$12,000 ($\$254,600 \times .05 = \$12,730$). In addition, we will assume that we get the seller of our new property to pay our purchase costs. This technique usually can be accomplished in the negotiation process by adding the costs to your final offer. The benefit to you is that you get to finance these expenses in the price you pay for the building. The equity left for reinvestment now is

Equity at start of fourth year	\$71,907
Costs of transaction	-\$12,000
Equity for reinvestment (rounded)	\$59,900

For the next step in our plan, we will invest these proceeds in one or two new properties using a 1031 tax-deferred exchange. To calculate the correct size of the next property that will fit in with our plan, we need to use the following formula:

$$\frac{\text{Equity to invest}}{\% \text{ of down payment}} = \% \text{ value of new property}$$

Using our available funds, the value of the next property can be calculated by plugging in these numbers:

$$\frac{\$59,900}{.10} = \$599,000$$



Bright Idea

When using a manual system for planning, don't hesitate to round off the numbers to make your calculating easier. This plan is just an estimate of where you are going, and the rounded-off dollars will not make a significant difference in the final numbers.

As you can see, we will need to trade into a building worth \$599,000 in order to keep our plan alive.

The chart on the following page has the values added for the trade in year four (the trade we just worked together) and the trade that was needed in year seven. The trade was needed in year seven because the average return on equity (AVG ROE) again fell into the low 30 percent range. Through trial and error, we determined that one more year of ownership would make the average less than the target 30 percent. Note that the further into the future your plan gets, the tougher it will become to estimate the smaller components of return. For that reason, when planning for future trades, you can eliminate any estimates for income, operating expenses, total interest, amortization, cash flow, and tax benefits.

Section 4: Follow-up and goal review

Just as important as preparing your investment plan is managing the plan to its successful completion. This involves, among other things, monitoring the progress of the plan to make sure you stay on plan at both the general and detailed levels.

The general review of your plan starts with your goals for your family and how they affect your investments. As things change in your personal life, you sometimes need to make alterations in your financial commitments. A job change might take away some of the time you had to dedicate to the properties. A bonus at work might now allow you to buy another property, which will get you to your goal sooner or will raise the amount of your final net worth. The market might change, which will affect what you buy or sell.

As for reviewing your detailed plan, this book started out by recommending that you gain knowledge about the market and property. The secret of a successful plan is to never stop that education process. Monitoring your plan at a detailed level requires that you stay in touch with the market. It is easy to get involved in the day-to-day operation of your property and forget to look at what is happening around you. In the review section of your planning binder, you should keep a blank copy of the projection worksheet previously shown in this chapter. At the end of each year, make it a point to meet with your investment real estate agent and do an estimate of value based on the current market conditions. Discuss how the market is doing and where it looks like it is going in the next 12 months. Use the new value and the actual performance figures from the year's operation of your property to complete the next line of your worksheet.

Now compare what really happened in that year with the plan you laid out 12 months earlier. How did you do? If there are any significant changes—good or bad—go back, revise your plan, and get ready for next year. This will force you to stay involved in reaching your final goals. There is no doubt that many changes will occur over the life of a 10–15 year plan. Some changes will be positive; some will be negative. The secret is to take full advantage of the positives and take the necessary steps to minimize the negatives. This requires staying informed by monitoring what is really happening.

Just the facts

- A written plan with stated goals is critical to successful investing.
- Installment sales are a great method to help you achieve a desired net worth.

- The compound interest formula demonstrates how your equity will rapidly multiply in real estate.
- Your detailed plan will give you a year-by-year projection of where you are headed.
- It's advisable to revise your plan as necessary along the way.

GET THE SCOOP ON...

The tax laws and how they affect you as an investor ■ The two types of expenses and the tax deductions you can take on them ■ How the depreciation allowance works ■ Capital gains tax and how to calculate it accurately ■ The three types of IRS 1031 tax-deferred exchanges ■ Installment sales and refinancing options

Planning for the Tax Man

As the cost of government increases, the burden of individual taxation increases proportionately. Built into the framework of federal, state, and local tax laws, however, are certain techniques whereby investors can legally defer their taxes due for an indefinite period of time. To take advantage of these techniques, you need to have an understanding of certain taxation rules.

There is no beating around the bush; these rules can be complicated. To that end, we suggest you seek the advice of your accountant, tax attorney, or other tax expert from the outset. You do need to have a basic understanding yourself, however, because it is not practical to have professionals review every transaction under consideration.

There are two broad areas in which knowledge of taxation is important. The first is during the ownership and management of the property. The second is upon the sale of the property. In this chapter we will

examine both of these areas in great detail, making them easy to understand and almost enjoyable.

Deductions, deductions, and more deductions

As a real estate investor, a number of tax benefits are now yours for the asking. They are

1. The deductibility of your purchase costs
2. The deductibility of your operating expenses
3. The corresponding annual depreciation allowance that Uncle Sam provides

Purchase costs

As a general rule, most of the costs incurred at the time of your purchase are tax deductible in the year of the purchase. The following list covers some of the most common:

- Prepaid interest on the loan
- Fire and liability insurance
- Property tax proration
- Escrow fees
- Title insurance costs
- Miscellaneous fees from the lender and escrow company

You'll notice that loan fees and points are not in the preceding list. The rule is that any money paid to secure a new loan for income property must be written off over the period of the loan. If the loan for our example property at 333 Richmond Street required a loan fee of 1.5 percent and the loan was a 30-year loan, the yearly deduction would be calculated as follows:

Loan amount	\$190,000
Loan fee rate	× .015
<hr/>	
Fee (points)	\$2,850

**Watch Out!**

Be sure to check with your tax expert each year to see if there have been any changes in the tax laws. It would be a shame to miss out on opportunities for write-offs because you were uninformed.

To calculate how much of a deduction you could take, you then would divide the loan fee by the term:

$$\frac{\text{Loan fee } \$2,850}{30\text{-year term}} = \$95 \text{ per year}$$

In the past, points could be written off in the year of purchase, but after years of abuse, this loophole was closed.

Operating expenses

In addition to the purchase costs, all the expenses you incur in the operation of the property also are deductible. The biggest problem in determining deductibility is distinguishing between expense items and capital items. As a general rule, if you incurred the expense by fixing a problem in your building or merely by maintaining the value of the property, it should be considered an expense item. These normal operating expenses are deductible in the year you spend the money. Examples of these include

- Utilities
- Interest on loans
- Insurance
- Taxes
- Gardening and cleaning expenses
- License and city fees
- Roofing, plumbing, electrical, and miscellaneous repairs
- Management fees
- Advertising and rental commissions

- Mileage, postage, and phone expenses associated with the operation of the property
- Any other noncapital expenses

On the other hand, if the improvement increases the value or completely replaces a component of the property, it should be considered a capital expenditure. With capital expenses, the cost needs to be depreciated rather than expensed in the year the money is spent. The tax code says that capital items must be written off over the period of time they contribute to the usefulness of the property. Capital expenses include

- Carpeting
- Drapes or window coverings
- New roof, plumbing, or electrical systems
- Building additions
- Major appliances or furnishings
- Major repairs—a new driveway, replacing stucco or siding, replacing landscaping, and so on

It's important to note that the principal paid each month on your loan payment is not a deductible expense. It actually is one of those returns on your investment that you must pay tax on, but you never see the money because you have to give it to the bank to pay down your loan. If you have a positive-cash-flow property, you are paying off your loan with the income you are receiving from the tenants. The rule says that you cannot deduct the portion of your payment that goes toward paying off the loan. Note: You don't need to worry about calculating the principal. Your lender will send you a statement at the end of each year showing you how much of your payments went toward principal and how much went toward interest.

The depreciation allowance

As the owner of your own real estate business, you now are able to deduct a certain amount of expenses for the loss of value on



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Keep detailed records of each expense related to your property. This way, you will be able to take advantage of every single deduction to which you are legally entitled. We would rather see you keep your money than give it to Uncle Sam.

the improvements (improvements = the structures on the land) of your property—things such as wear and tear from aging. Remember that, because the dirt does not depreciate, this depreciation expense is only for the physical structure of the building and other improvements, not the land.

The most important point to remember is that the depreciation schedule you originally calculate will be with you as long as you own that property. If you sell the property and pay your taxes, you can start fresh with the next property. If you trade via a 1031 exchange, however, that basis and its schedule stays with you.

As you learned in Chapter 3, “Elements of Return,” the most important component of the depreciation schedule is the land-to-improvement ratio. (See the section, “Inflationary appreciation,” also in Chapter 3.) For any improved property, part of the value is for the land and part is for the improvements. Because you can’t depreciate the land, a property that has a high ratio of improvements has a high depreciation deduction. To set your ratio, you must make sure to use an accepted method. If you don’t, the IRS might disallow your schedule, force you to set a new one, and probably end up sending you a bill for additional taxes and penalties.

Limitations on deductions

To calculate the tax benefits from a property, you need to understand the rule changes adopted from the Tax Reform Act of 1986 (TRA ’86). These new rules affected the amount of depreciation that property owners can take per year, and they also defined investors into different classes depending on the

amount of their involvement in their properties. The new tax code recognizes two classes of investors: passive investors and active investors.

Passive investors

Generally, you are a passive investor if you buy property as a limited partner or with a group of more than 10 partners. As a passive investor, you can use the depreciation deduction to shelter any profit from the property. It's like having a savings account of tax benefits that can be drawn upon to cover future profits.

Active investors

You probably are an active investor if you purchased your property alone or with a couple of partners and are active in the management of the building. The IRS calls this “materially participating” in the management. This means that you have a say in how it runs, how the bills are paid, and how much you are charging for rent. You might not actually run the property if you have hired a company to do this, but the key is that you have the ultimate responsibility for it. There are two classes of active investors:

1. Those who consider real estate investing and management as their primary career
2. Those who invest in real estate as a secondary career

Rules for active and passive investors

If you are “in the business” of real estate and it is your primary career, you have no restrictions whatsoever on the dollar amount of losses you can claim against earnings.



Bright Idea

If your spouse doesn't work outside the home, he or she can help you qualify for unlimited deductions by obtaining a real estate license and handling the management of your properties. This may qualify your spouse as a full-time property investor.

Most people, however, fall into the category in which real estate is a secondary career. If this describes you, your real estate losses are limited to \$25,000. If your adjusted gross income before real estate deductions is \$50,000, for example, and your losses from property are \$30,000, you can only deduct \$25,000 of the \$30,000. You don't lose the remaining \$5,000. Instead, it goes into that tax shelter bank account previously mentioned. What this deduction means is that, instead of paying tax on \$50,000 of income, you only pay tax on \$25,000. The tax you save is profit and therefore is included in the overall return from your investment.

The earnings limitation

A second code change from the Tax Reform Act of 1986 limits your ability to use the losses from your real estate against the earnings from your regular career. This limit occurs when your earnings exceed \$100,000. For every \$2 you earn over \$100,000, you lose \$1 of deduction. This means that, at \$150,000, you have no deduction against your income. Remember that these are not lost; they're just saved up for future use.

Calculating capital gain

Capital gains taxes are taxes on the profits you make when you sell your property. To understand capital gains and how to calculate them, you first need to be familiar with some new terms:

- **Sale price:** The price for which you sell the property
- **Adjusted sale price:** The net price after deducting sale costs
- **Cost basis:** The original purchase price plus capital expenses
- **Adjusted cost basis:** The cost base minus depreciation

To estimate your capital gain, you would complete the following calculation:

Sale price
– Sale costs
Adjusted sale price

Cost base
+ Capital expenses
– Depreciation
Adjusted cost base

Adjusted sale price
– Adjusted cost base
Capital gain

To illustrate this formula, let's use the Richmond Street property that we bought for \$220,000. We've depreciated the property for five years at \$5,090 per year for a total depreciation of \$25,450 ($\$5,090 \times 5 = \$25,450$). We also just put on a new roof for \$5,000 (a capital expense). We can sell it for \$320,000, and our total expense to sell will be \$20,000.

Knowing this information, we can calculate the capital gain as follows:

Sale price	\$320,000
Sale costs	– \$20,000
Adjusted sale price	\$300,000



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Before you decide to use one of the tax-deferral methods, you first should determine your capital gain and what the tax implications are. You might actually be better off in the long run if you pay your tax now and start fresh with a new property.

Cost base	\$220,000
Plus capital expenses	+\$5,000
Less depreciation	– \$25,450
Adjusted cost base	\$199,550

Adjusted sale price	\$300,000
Adjusted cost base	–\$199,550
Capital gain	\$100,450

As you can see, the capital gain of \$100,450 is a sizable chunk of money to have to pay tax on. Instead of giving it to Uncle Sam, let's learn about some methods of deferring or reducing these taxes.

The 1031 exchange

As far as saving on taxes is concerned, the IRS 1031 tax-deferred exchange is probably the single most important technique available to the real estate investor. An exchange enables you to pyramid your equity while deferring the payment of taxes. In effect, Uncle Sam becomes your partner by letting you use the taxes you owe on your capital gains as a down payment on the buildings you trade into. When you trade into larger properties, the government figures that, in turn, you will make more profit. By making more profit, you eventually will owe more tax. It's a win-win situation.

You must be aware of the three rules to qualify for a tax-deferred exchange:

1. You need to trade for like-kind property. Like-kind property in this instance would be a property you are purchasing for investment purposes. You can't trade a duplex you've been renting out for a new dream house. This is because the duplex is income-producing property and the dream house would be a primary residence. You can, however, trade the duplex for an office building or a

strip mall. The idea is to trade income-producing property for other income-producing property.

2. The property should be of equal or greater value than the existing property, hence the phrase “trading up.”
3. You should not receive cash, mortgage relief, or “boot” of any kind in the transaction.

Note: In an exchange, “boot” is the term used to describe something of value given in addition to the like-kind property, as in “this acre and cash to boot.”

Three categories of exchanges

Most 1031 tax-deferred exchanges fall into one of three categories:

1. The straight exchange
2. The three-party exchange
3. The delayed exchange

The straight exchange

The straight exchange occurs when two parties get together and simply trade properties. At the end of the transaction, each party goes his separate way. This scenario doesn't happen very often because most investment property owners either trade up or just get out altogether. By trading straight across the board, one party probably ends up with a lesser property, which fails to meet the requirement of trading into a property of equal or greater value.

The three-party exchange

The most common type of tax-deferred exchange is the three-party exchange. As its name suggests, three different parties are involved in the process. One of the key elements of doing a tax-deferred exchange is that the party trading up never receives

the equity in the property being traded. For that reason, the party cannot just sell the property, collect the proceeds, and go out and buy a larger property. Because most people with bigger properties don't want to trade into anything smaller, these three-party exchanges have evolved so that each party can get what it wants and stay within the framework of the law. Here's an example of how one might work:

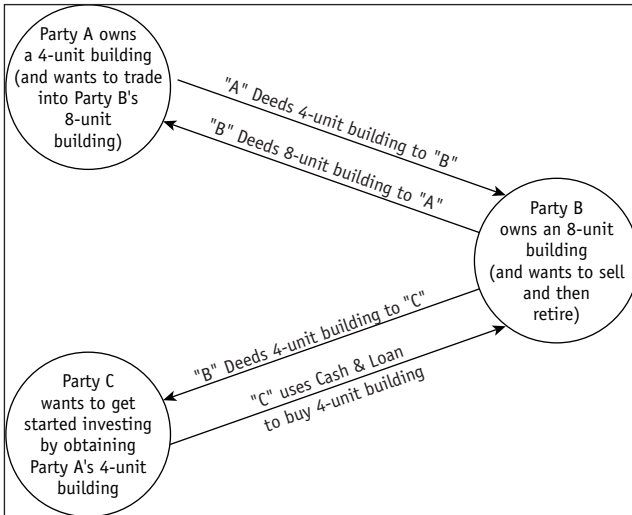
Facts:

- Party A owns a four-unit building and wants to trade into an eight-unit building.
- Party B owns an eight-unit building and wants to sell, pay the taxes due, and retire to Florida.
- Party C is just getting started investing and wants to buy the four-unit building of Party A.

Solution: Parties A and B enter into an exchange escrow in which Party A gets the eight unit and Party B gets title to the four unit. In a separate escrow, Party B agrees to accommodate the exchange and deed the four-unit building to Party C immediately after he acquires title from Party A. Both of these escrows contain contingencies stating that they must close concurrently. This means that if Party C can't buy the four unit for some reason, Party B will not have to take Party A's four unit in trade for his eight unit.

Result: At the close, Party C owns the four unit he wanted, Party A owns the eight unit he wanted, and Party B is sipping margaritas at his beach house in Florida.

Recap: In case you're wondering, Party B doesn't pay any tax by taking the title to the four unit because it is sold for the same price at which it was taken in trade. This is what is called a non-taxable event.



The delayed exchange

The final category of exchange is the delayed or Starker exchange. Starker refers to one of the principles in *T. J. Starker v. U.S.*, a case in the Ninth Circuit Court of Appeals. In this case, Starker exchanged some timber acreage for 11 different parcels of property owned by Crown Zellerbach. As was agreed between the parties, Starker selected the properties and they were transferred to him by way of the exchange. This was called a delayed exchange because the transfer spanned more than two years.

Because of the two-year delay, the IRS questioned whether this was an exchange at all and took Starker to court. Fortunately, for all investors, the Ninth Circuit Court approved of the process, and this has since been codified nationally for use by all U.S. investors. The Starker court held that

1. A simultaneous transfer of title was not required.
2. IRS Section 1031 should be broadly interpreted and applied. Treasury regulations under IRC 1001 to the contrary were deemed invalid.

In an effort to update the rules concerning exchanges in light of the new rulings, a number of additional changes were made to IRC 1031. These changes included

1. Partnership interests are no longer of “like kind” for exchange purposes.
2. To identify the potential replacement properties, the taxpayer must complete a written 1031 Property Identification Statement by midnight on the 45th day after escrow closes. More than one property may be identified with the following restrictions:
 - Three or less properties without limit on their value or on the percentage of the identified properties, which must actually be acquired
 - Four or more properties provided the combined fair market value of all the properties does not exceed 200 percent of the price of the property sold
 - The purchase of 95 percent of the total value of all replacement properties identified should the total values of four or more properties exceed the 200 percent limitation
3. The taxpayer must receive the identified property within the earlier of 180 days after the date he transfers his property in the exchange or the due date of his tax return for the year of the exchange including extensions.

To accomplish a delayed exchange, an accommodator is used. An accommodator is an unrelated party (or entity) that holds the exchange proceeds. These proceeds are called “exchange valuation credits,” or “EVCs.” The EVCs are contract rights allowing the investor to use the net proceeds being held by the 1031 accommodator to purchase a replacement property. The investor will find the replacement property, and the accommodator will fund the purchase with the money that the EVCs represent. The accommodator can even take the title to the property that the investor trades into in order to complete the exchange.

**Watch Out!**

Before you do a 1031 delayed exchange, you should be very sure of your next purchase. If you miss the 45-day or 180-day deadlines imposed by the IRS, you will have to pay the capital gains tax on the sale.

In choosing an accommodator, make sure you check their credentials, business history, and insurance coverage. Remember that the accommodator will be getting all your funds from the sale of your property. He or she holds it for you until it's time to purchase the replacement property. Be sure to choose your accommodator wisely. Over the years, some unscrupulous ones have been known to close up shop, pack their bags, and get the heck out of Dodge—taking the trust funds with them.

Since the first edition of this book was published in 1999, we have seen a surge in property values. This surge has created a renewed interest in buying property, and—conversely—a marked decrease in the inventory of properties to purchase in most areas. This increase in prices has produced more capital gain, which most property owners would like to shelter by using the benefits of the 1031 exchange.

As you can well imagine, more profit and less property, combined with a 45-day window in which to identify potential up-legs have created some tense moments for investors who have closed escrow without properties to trade into. It's important to note that these delayed exchanges offer many advantages over the straight or three-party exchanges, but there are also additional risks involved. If you close your delayed-exchange escrow 181 days after your down-leg property closed, you will owe the capital gains tax due and will probably not have the cash to pay for it.

There are some additional complicated rules associated with completing a successful delayed exchange. To that end, make it a point to consult with your tax advisor before making any

decisions in this regard. The net result of an ill-informed decision could be costly.

Exchanging versus paying your taxes and buying another

An additional problem created when you do a tax-deferred exchange is that you limit the depreciation deduction on your new property. Part of the exchange process is that you carry forward your profit and your basis from the traded property. Whatever the depreciation schedule was on the old property now becomes the schedule for that part of the new property.

We'll illustrate this using our example property. Assume that 333 Richmond Street can be sold for an adjusted sale price of \$300,000. We will net \$80,000 from our sale, and we'll use that \$80,000 as a 15-percent down payment (with a seller carrying another 10 percent) on a new property worth \$550,000. This new property has a land-to-improvement ratio of 80 percent. The depreciation deduction we will be carrying forward is \$5,090 per year. This means that, if we started fresh, the depreciation deduction on the new property would be

Price of the property	\$550,000
Percentage of improvements	× .80
<hr/>	
Depreciable improvements	\$440,000

In order to find the depreciation deduction, you do the following calculation:

$$\frac{\text{Depreciable improvements } \$440,000}{\text{Useful life } 27.5 \text{ years}} = \$16,000 \text{ depreciation deduction}$$



Watch Out!

None of these tax-deferral methods get you out of paying your taxes. Instead, these techniques simply help you put the taxes off until sometime in the future.

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